Economy
Bitter fruits of fiscal disorder

Petrochemical Industry
Petrochemical partners at odds

Interview
Cledorvino Belini
President of Fiat Chrysler Automobiles for Latin America



THE BRAZILIAN ECONOMY

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New China, old challenges

Change in the growth pattern of the world's second largest economy has exposed structural problems in Brazil that will have to be addressed if the country is to gain lost traction in the Chinese market.

FGV IBRE

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IN THIS ISSUE

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News Briefs

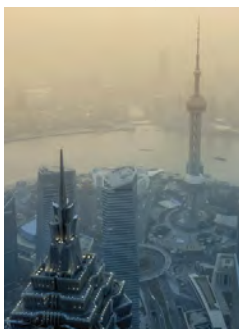


Photo: Antonio Cruz/Agência Brasil

5 Retail sales, industrial production tumble … 12-month inflation hit 9.49% … Senate approves tax increase for banks … Supreme Court bans corporate political donations … administration injunction request denied … new taxes, spending cuts coming, if Congress okays … BNDES lending cut drastically … Rousseff eliminates 8 ministries, battles to suppress Congressional spending

Cover Stories

8 New China, old challenges



Changes in the growth pattern of the world's second largest economy have exposed structural problems in Brazil that will have to be addressed if the country is to gain lost traction in the Chinese market. China's economic turmoil is exacerbating the risks of economies like Brazil that are dependent on China. The Chinese transition, with likely periods of instability, will require that Brazil address the structural problems that limit exports of new products to boost trade with China. Solange Monteiro reports on the sectors that could benefit.

18 The Silk Road: Everything old is new again

The Chinese government is working to revive the ancient Silk Road, which will expand China's trade potential in areas that contain 4.0–4.4 billion people and nearly a third of the world's wealth. It will also give China access to the natural resources abundant in some countries through which the road will pass, in exchange for Chinese investments in infrastructure there. Claudio Conceição analyzes what Silk Road success could mean for Brazil.

Petrochemicals

22 Petrochemical partners at odds



U.S. shale gas sales and the fall in international oil prices have brought the Brazilian petrochemical industry to its knees. The interests of Petrobras and Odebrecht, the two partners in Braskem, the sole Brazilian raw petrochemical provider, are on a collision course, and the domestic petrochemical market is shrinking. Chico Santos looks at what companies are doing to counteract the negative trends.

The Economy

28 Bitter fruits of fiscal disorder

Fiscal and political tensions are eroding any expectations that the economy will recover any time soon. The problems are not new; what is needed is new political will to find solutions. And as developed economies continue to show signs of improvement, although that will increase demand for Brazil's exports, it will draw off external financing. Brazil will have to adapt to the new conditions. Solange Monteiro reports.

Interview

34 "The country needs major reforms"



Cledorvino Belini, president of Fiat Chrysler Automobiles for Latin America, talks to Solange Monteiro, about how the automotive industry is adjusting to lower sales, the problems undermining Brazil's competitiveness, the pace of efforts to control inflation, the high cost of capital in Brazil, his concerns about the volatility of the exchange rate, and the shortage of political will to make the changes that must be made.

Editors' Note

IN 35 YEARS, CHINA HAS CHANGED dramatically and the transformation continues. More than 50% of Chinese now live in urban areas, compared to 20% in the 1980s. The service sector has become dominant, accounting for 48.2% of GDP in 2014, with manufacturing down to 42.6%. China's development has been accompanied by a significant increase in income, stimulating new consumption patterns.

As China, its main trading partner, is being transformed, Brazil's challenges multiply. It needs to coordinate trade policies to position itself as a supplier of primary products with higher added-value, move more actively to open up protected sectors in China, and address structural problems so it can tailor its exports to changes in Chinese consumption habits, which have opened up opportunities for, e.g., Brazilian medical supplies, cellulose, and meat, as well as the traditional soybeans and iron ore.

The discovery of large reserves of shale gas in the U.S., now being sold much more cheaply than the naphtha that is the principal input of Brazil's petrochemical industry, has frozen sector investments in Brazil and toppled such grandiose projects as the Petrochemical Complex of Rio de Janeiro (Comperj)—today simply a traditional oil refinery. The dramatic fall in international gas prices has not only exposed the vulnerability of the Brazilian petrochemical industry, dependent as it is on one input, it has set at odds the interests of the two partners in what is now almost the sole Brazilian petrochemical producer, Braskem—the private Odebrecht Group and the state oil company Petrobras. The conflict between Braskem and Petrobras over the pricing of naphtha has sent the petrochemical industry scrambling for investments abroad and looking for alternative products.

When this year began, few analysts could have foreseen the current dire prospects for political consensus about the necessary fiscal adjustments or the continuing deterioration of public finances, which in recent months have pushed the economy into a faster downward trajectory. IBRE economists estimate that GDP will contract by 3% in 2015 and another 2.1% in 2016. Yet even though recession is deepening, inflation is still high: IBRE is forecasting inflation of about 10% in 2015. In the IBRE Seminar on the Brazilian Economic Outlook in early September, economists inventoried the problems that are depressing any expectations of Brazilian growth this year.



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ECONOMIC POLICY

New taxes, spending cuts coming

The government responded to Standard & Poor's rating Brazil's debt as junk by announcing spending cuts and tax increases adding up to R$65 billion (US$16.9 billion) as it races to close a budget deficit that led to the downgrade. The biggest item was revival of the unpopular tax on financial transactions, which if approved by Congress would raise R$32 billion in 2016. The speaker of the House says approval is unlikely. The spending cuts hit health and low-income housing programs, infrastructure investments, agricultural subsidies, and government salaries and bonuses. The government also reduced tax subsidies for the chemical industry, cut refunds to exporters of manufactured goods, and raised the capital gains tax to a maximum of 30%. The measures are meant to bridge a shortfall of R$30 billion in the 2016 budget to reach a budget surplus of 0.7% of GDP before interest payments. The latest round of spending cuts sought by Finance Minister Joaquim Levy includes elimination of 10 federal ministries in Brasilia, a symbolic measure that will save just R$200 million. The reduction in spending on public health and housing was a difficult decision for the president, whose Workers' Party has resisted cuts to Brazil's social programs. However, the party's flagship conditional cash-transfer program, the Family Grant, was not touched. (September 14)

BNDES disbursements plunge

Total loan disbursements by Brazil's National Development Bank, BNDES, will fall dramatically in 2015, the bank's head, Luciano Coutinho, said early in September. Disbursements reached R$190 billion (US$49 billion) in 2014, but at R$69 billion were 18% lower in the first half of 2015 than in the first half of 2014. "We are going to see a significant reduction this year. I don't know if it will come in the 20% or so we saw in the first half, but it will reflect the rising uncertainties in Brazil," Coutinho told reporters. (September 15)

Photo: Valter Campanato/Agencia Brasil.



Finance Minister Joaquim Levy and Planing Minister Nelson Barbosa announce spending cuts and tax increases.

Petrobras raises fuel prices

As of September 30 Brazil's state-run oil company Petrobras has raised the price of gasoline by 6% and diesel by 4% at refineries in Brazil. (September 29)

Rousseff eliminates 8 ministries

President Dilma Rousseff eliminated 8 ministries and cut her and ministers' salaries by 10% to reduce government spending; she also reshuffled her cabinet to bolster coalition allies support for fiscal austerity measures and avert a threat of impeachment. Rousseff made no changes to her economic team of Finance Minister Joaquim Levy, Planning Minister Nelson Barbosa, and Central Bank Governor Alexandre Tombini. (October 2)

Rousseff battles to suppress spending

For the third time Brazil's Congress postponed voting on whether to overrule President Rousseff's vetoes of two spending bills. For lack of a quorum, Congress put off considering the vetoes, which are crucial to Rousseff's effort to balance Brazil's overdrawn fiscal accounts. The bills she vetoed would raise public spending by US$16.4 billion over the next four years, pay judiciary employees 78% more in salaries, and raise payments to retirees.

Rousseff's government has projected a 2016 primary budget deficit of R$35.5 billion and is scrambling to plug that gap to avoid another debt downgrade after Standard & Poor's dropped Brazil's rating to junk.

Upholding the vetoes is the first test of Rousseff's attempt to secure support among her unreliable coalition allies to back her austerity policies and block opposition efforts to impeach her. On Friday she reshuffled her cabinet to give more positions to the center-right PMDB party. (October 6)

Photo: Antonio Cruz/Agencia Brasil



President Rousseff announces cabinet reshuffle.

ECONOMY

Retail sales, industrial production tumble

According to government statistics agency IBGE, retail sales fell in July for the sixth straight month, down 1% month-on-month, as rising unemployment and record-low consumer confidence threatened to deepen the country's worst recession in 25 years. (September 16)

In August Brazilian industrial output declined for the third straight month on weak demand for capital goods, falling 1.2% month-on-month—9% year-on-year. This was the 18th consecutive month of decline. Capital goods production plunged 7.6% month-on-month as businesses put off investments and durable consumer goods production fell by 4%. (October 2)

Month-on-month, in September automobile production fell 19.5% and sales dropped 3.5%, the national automakers' association Anfavea said. Year-on-year auto output plunged 42.1% and sales by 32.5%. (October 6)

12-month inflation hits 9.49%

Though consumer-price inflation slowed in the 12-month period ended in September, it is still far above the government's 6.5% inflation ceiling target. The official IPCA price index rose 0.54% in September after an August rise of 0.22%, IBGE said. (October 7)

POLITICS

Senate approves tax increase for banks

Brazil's Senate has approved a presidential decree raising the income tax on banks and other financial institutions from 15% to 20% by 2019. The tax is one of several President Rousseff has proposed to help plug the budget deficit; it had already passed the lower house. Brazilian presidents can issue legislation as a temporary decree but both houses of Congress must act to make it permanent. (September 15)

Ban on corporate political donations

The Supreme Federal Court has ruled 8–3 to forbid corporate donations to political parties and candidates. In the 2014 elections, more than 70% of campaign funding came from companies. The decision will first apply to the 2016 municipal elections. It should allow President Rousseff to overturn a law approved by Congress early in September that permits corporate donations of up to US$5.13 million. The Supreme Court also decided that individuals can still donate up to 10% of their income to parties and candidates. (September 17)

Federal Audit Court rules against Rousseff administration

After the Supreme Court rejected an injunction the Rousseff administration had sought to delay an audit court ruling on its 2014 accounts, the Federal Audit Court ruled unanimously that President Rousseff had manipulated the budget to cover a widening fiscal deficit and urged Congress to reject last year's government accounts. It is the first time in nearly 80 years that the court rejected the accounts of a head of state.

Although the ruling is not binding on the administration, the opposition could use it to build a case for Rousseff's impeachment; Congress has the final word on administration accounts. Rousseff's administration has acknowledged a delay in payments because of lack of cash but denies any irregularities. The government has begun to repay its arrears and has issued a decree forbidding future delays. (October 7)

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New China, old challenges

Change in the growth pattern of the world's second largest economy has exposed structural problems in Brazil that will have to be addressed if the country is to gain lost traction in the Chinese market.



Solange Monteiro

IN RECENT MONTHS, CHINA has attracted global attention because of the volatility of its stock market and the devaluation of the renminbi. Analysts have observed that heavy-handed government intervention was a blow for China's status as a market economy, making it harder to transform its currency into an international means of exchange. If the path to a market economy is not as clear as previously thought, China's economic turmoil is enough to exacerbate the risk of economies like Brazil that are dependent on China.

IBRE researcher Lia Valls has noted that although all its exports account for only 10% of GDP and its exports to China

only 1.7%, Brazil's dependence on Chinese demand for primary goods has been rising over the years, surpassing demand from Peru and Colombia. Without the high commodity prices caused by Chinese demand, Brazil's structural problems have been unmasked.

Now, says Livio Ribeiro, also an IBRE researcher, "Despite the importance of Chinese demand for commodities, Brazil needs to rethink its strategic targeting of China on its way to 'new normal' growth." He points out that in China the population living in urban areas exceeds 50%, compared to 20% in the 1980s; and its service sector already dominates the economy, accounting for 48.2% of GDP in 2014 compared to 42.6% for primary industry. China's development has been accompanied by a significant increase in income, heralding new consumption patterns. "Last year, household consumption was already showing signs of recovery—unlike investment," he says.

In this new setting, Brazil's challenges multiply. "The new China is less dependent on production and export of traditional industrial products and geared to more elaborated products, which require equally sophisticated services. China is developing segments with higher value-added and will be seeking partners that point in the same direction," says Jorge Arbache, professor of economics at the Federal University of Brasilia (UNB).

The Chinese economy will not be totally transformed, however. Shortages of water and arable land will keep the country dependent on food imports. The U.S. Department of Agriculture

The Chinese transition, with likely periods of instability, will require that Brazil address the structural problems that limit exports of new products to boost trade with China.

Although in traded values, cellulose brought in only a tenth of the revenues from the top two exports to China, iron ore and soybeans, the recent impetus to the sector has fueled the plans of large producers to expand and attracted new producers like Eldorado Brazil.

estimates that imports of soybeans to China will grow 40.8% by 2024. In contrast, banks estimate that the country's imports of iron ore will go up only 1.2% annually between 2015 and 2019. "Prices are not as high as in the past, the demand will not grow as much, but new opportunities will appear," says Roberto Castello Branco, researcher at FGV Growth and Development. But the Chinese transition, with likely periods of instability, will require that Brazil address the structural problems that limit exports of new products to boost trade with China.

Export opportunities

One sector that has benefited from the changes in China is cellulose, thanks to China's burgeoning demand for personal hygiene products. The Brazil-China Business Council points out that between 2008 and 2012, China's demand for pulp imports grew 75%. The Brazilian Lumber Industry found that, from January through August 2015, Brazilian pulp exports to China grew 9.6% compared to the same period in 2014. A National Confederation of Industries survey found that real revenues for cellulose rose 7.7% in January-August, even as manufacturing revenues declined by 6.6%.

Although in traded values, cellulose brought in only a tenth of the revenues from the top two exports to China, iron ore and soybeans, the recent impetus to the sector has fueled the plans of large producers to expand and attracted new producers like Eldorado Brazil. Founded in 2012 in Mato Grosso do Sul, that company has focused on exports, which represent 90% of its sales, of which 39% to Asia, especially China. Luis Felli, director of commercial operations for Eldorado Brasil Celulose S.A., says, "We think opportunities will continue to grow as China's urbanization has increased demand for both tissue products — toilet paper, disposable towels, napkins— and packaging." In 2018 Eldorado will bring on line another 2 million metric tons of production a year, compared to the current 1.7 million. "We expect to export to China between 40% and 50% of additional production," Felli notes. The total investment is R$8 billion, financed with equity and credit lines from equipment suppliers and the National Development Bank (BNDES). He points out

Photo: Eldorado Brasil.



Brazilian pulp exports to China grew **9.6%** from January through August 2015,compared to the same period in 2014.This expansion in demand has fueled the plans of large producers to expand and attracted new producers like Eldorado Brazil.

that among other favorable factors, Brazil has "the shortest production cycle of eucalyptus trees in the world, six to seven years." But once again, the great challenge in trying to compete is outside the plant. Felli says, "With our production concentrated in the Brazilian savanna, we are far away from the consumer market. We need better transport to ports."

Another promising segment already reaping the fruits of China's transformation is the meat industry. In April this year, a new agreement ended the Chinese embargo on Brazilian beef that began in late 2012 because of an outbreak of mad cow disease. By mid-June eight slaughterhouses were again exporting to China. "Since then, we have exported about 15,000 metric tons per month, which is the average we expect until the end of the year," says Fernando Sampaio, director of the Brazilian Association of Meat Exporters.

Another nine slaughterhouses await authorization to sell there, once their plants are certified as complying with Chinese requirements, and more are applying. Official figures put China beef imports at just over 300,000 tons a year but market estimates are that volumes are three times higher. Sampaio emphasizes that China is a market for all cuts and brands—meats used to prepare ready-to-eat dishes, everyday meats sold in supermarkets, and gourmet cuts offered in restaurants and steak houses. It is also possible to achieve higher profit margins in products like muscle beef; as Sampaio explains: "Although these are among the cheapest cuts, Chinese use them often mixed with rice or pasta. It has a huge market in China, where a ton of muscle beef costs US$1,000 more than in Hong Kong." The challenge now is to build partnerships with Chinese distributors, retailers, and processors.

The Chinese market opened to poultry in 2009 after six years of negotiations. Francisco Turra, president of the Brazilian Animal Protein Association, said, "We sold 18,000 metric tons the first year and 120,000 the second; this

While in sectors like electronics there are already strong Asian regional supply chains, agribusiness supply chains are still primitive.

year we expect to sell 360,000 to 400,000." He explains that the Chinese are accustomed to consuming chicken wings and claws, adding, "We are looking into how we can provide value-added products for these preferences." he says. Brazil's BRF SA, one of the world's biggest chicken exporters, looks to expand further into Asia. Marcos Jank, Vice President of Corporate Affairs and Development of BRF SA, points out that the major challenge in Asia is market access: "In China, the barriers to access are the factory approval process, from phytosanitary agreements to surveillance missions that can take years to complete. In India, the barriers are import tariffs of 30 to 100%. And Indonesia literally prohibits poultry entry. It is very difficult to move to higher value-added food products." He notes that moving from soybean to meat increases the value of exports by four to ten times. Recently, BRF SA bought a share in Singapore Food Industries, a subsidiary of the largest provider of airport catering services in Asia, which gives the company access to processing facilities, distribution center, and trademark licenses. "With this partnership, we will process Brazilian meat to meet the demand of local markets in addition to airlines," Jank says.

Photo: Eldorado Brasil.



Higher Chinese incomes have expanded the regional air transportation market in China for companies like Embraer, which has produced planes in China since 2002.

For Brazilian meat processors, one major factor that affects their business in China is the lack of a policy to speed up the negotiation process. "A few years ago the Chinese said they needed the chicken production of over 40 plants. We managed to get 5 plants approved, but in fact we could have offered 50," says Turra. Everyone recognizes, however, that Minister of Agriculture Katia Abreu has been working on this. "I followed a recent

mission of the minister to Japan where she highlighted the need to add value in agribusiness," says Jank. "She plans to go to Southeast Asia by the end of the year, with the message of integrating [agribusiness] supply chains." Jank points out that, while in sectors like electronics there are already strong Asian regional supply chains, agribusiness supply chains are still primitive: "Intra-regional trade in Asia accounts for 60% of total trade because supply chains are integrated. … Addressing these barriers to trade is as important as investment in infrastructure and logistics to promote Brazil's exports."

The lack of trade agreements with China is another hurdle, according to Sampaio: "Australia, our strong competitor, signed a trade agreement with China and therefore has export quotas and preferential import tariffs, [but] the Mercosur has proved ineffective in concluding any agreement…. If we add this disadvantage to logistical problems, bureaucracy, taxes, we see that there is still much to be done to improve the competitiveness of Brazilian products."

"Australia, our strongest competitor, signed a trade agreement with China and therefore has export quotas and preferential import tariffs, [but] Mercosur has proved ineffective in concluding any agreement."

Fernando Sampaio

Doing business in China

Higher Chinese incomes have expanded the regional air transportation market in China for companies like Embraer, which has produced planes in China since 2002 through a joint venture with state-owned China Aviation Industry Corp. II (AVIC II) and

Photo: Fanem.



Even exporting hospital products to **118** countries, the Brazilian company Fanem has not yet gone to China because of non-trade barriers such as expensive export licensing.

Photo: Marcopolo.



The Chinese factory of Brazilian company Marcopolo produces luxury buses only for export. Marcopolo does not produce for China's market because regulations require too high a minimum investment of **€220** million.

Harbin Embraer. In mid-September during the aviation industry exhibition in Beijing, the company released a market overview projecting that in the next 20 years China will need 1,020 commercial jets in the 70–130-seat segment—about 16% of global demand. Currently, Brazil holds an 80% share of the Chinese market for this size aircraft. Embraer plans to be even more active in China because it believes that in the short term it will be the main world aviation market. In the past three years, China accounted for on average about 8% of Embraer's annual revenues, which in 2014 were US$6.29 billion.

"Today the government is cash-strapped, but if BNDES continues financing capital goods Brazil may export its way out of the crisis."

Ruben Bisi

Sergio Lazzarini, professor at the Institute of Education and Research, points out that Embraer managed to sell airplanes in China only after it associated with a local company to produce there. Before that, the Embraer sales office, set up in 2000, had contracted five sales and obtain 30 firm orders but did not realize any of them because after the Chinese government raised tariffs on imports of small jets from 7.1% to 22.9%, the Chinese buyers cancelled the orders. This incident convinced Embraer to joint venture with AVIC II.

Something similar happened with Brazilian company Fanem, which produces hospital products, such as incubators, that it exports to 118 countries. With relaxation of the one-child-per-family law and the prospect of expansion of health services, Fanem applied for an exporter license for China. In late 2013, it began to register its equipment, but "As we entered the final certification phase, … we learned from our representative that registration fees had been quadrupled, which

suspended the process," said José Flosi, Fanem general manager of exports.

With the depreciation of the renminbi, which raised the cost of imported raw materials, and rising wages, the competitiveness of Chinese products has been reduced, making room for foreign competition. According to Brazil's Marcopolo S.A., which manufactures bus chassis, from January to August this year Chinese salaries went up on average by 10%, says Ruben Bisi, Marcopolo international operations director. Although higher salaries make the company's operations in its Changzhou factory more expensive, it improves Marcopolo's competitiveness in relation to Chinese products in the world market. Bisi says that for many years China would sell products similar to Marcopolo's at prices 30% lower in South America and 35% lower in the Middle East. Now,

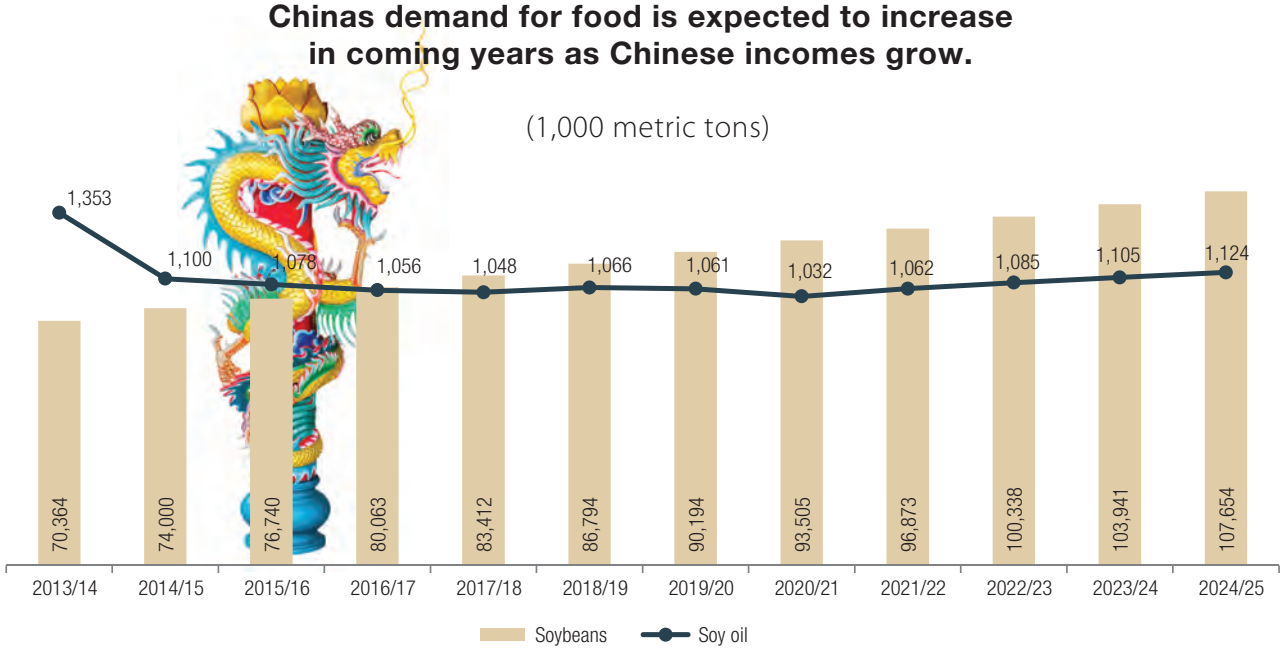
"We stumble in the absence of a long-term vision and strategy for Brazil's inclusion in the world economy."

Jorge Arbache

Marcopolo is becoming more competitive in these markets, exporting products directly from Brazil. "From January to August this year, China sold 7,000 buses in South America [excluding Brazil] compared to 22,000 in the same period last year," he notes.

Marcopolo has factories in eight countries. In general, the company exports chassis in PKD (partial knock-down) format to be assembled close to the destination. However, the Chinese factory, which produces about 300 luxury

Chinas demand for food is expected to increase in coming years as Chinese incomes grow.

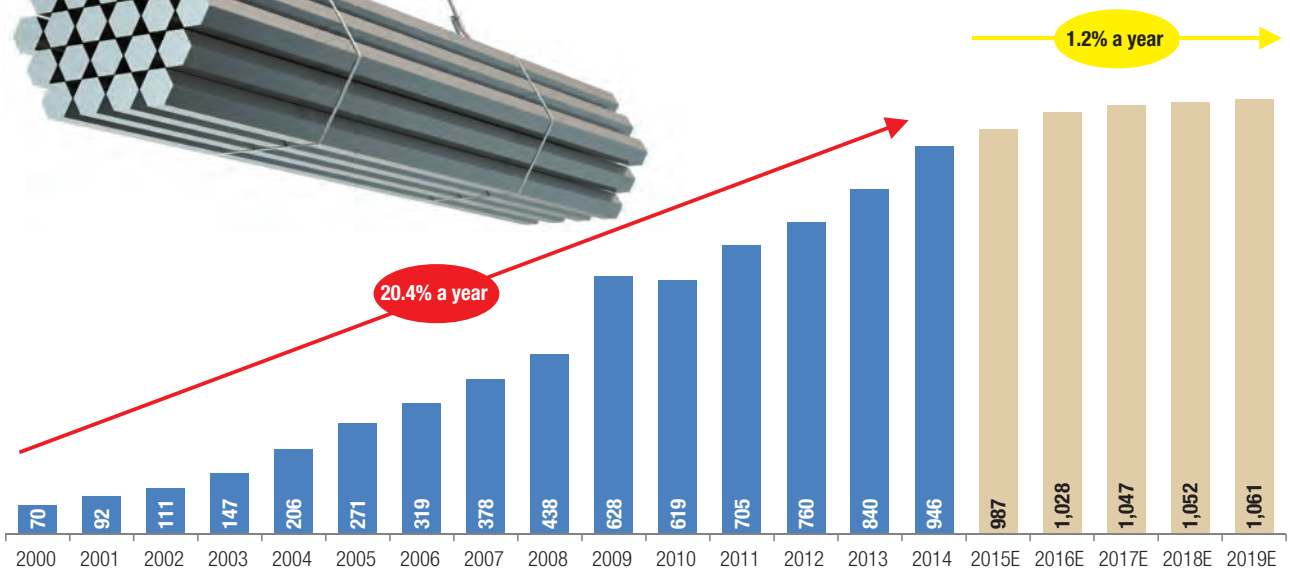


Source: USDA.



China's iron ore imports are expected to growth moderately in coming years as the share of primary industry in GDP is reduced.

(Millions of metric tons)



Projections are the average of banks (Macquarie, Citi, BTGPactual, UBS, Morgan Stanley, Clarkson) and CRU. Source: China Customs.

buses a year, is dedicated to export—the local market is still closed to Marcopolo. "We do not want to partner with local companies because companies that have partnered there have had problems with management and sharing technology" Bisi says. "But the biggest obstacle to setting up operations in China is the minimum investment required by law of about €220 million. That makes no sense if I can set up a factory with €40 million," he says. Chinese authorities are saying that the law should change, as the Chinese automotive industry develops its technology, enters world markets, and does not need protection from foreign competition.

Bisi pointed out that to have access to markets a company needs credit lines: "We need the National Development Bank [BNDES] to continue to support exporters. Today the government is cash-strapped, but if BNDES continues financing capital goods Brazil may export its way out of the crisis ." He points out that Scandinavian competitors such as Volvo and Scania are ahead because they can get financing at lower cost.

Improving competitiveness

Companies that have tested the Chinese market confirm that Brazil will have to address old problems if its companies are to compete successfully. "We stumble in the absence of a long-term vision and strategy for Brazil's inclusion in the world economy," says UNB's Arbache.

To improve competitiveness, Brazilian companies should invest in adding value to

their products, starting with commodities—something that had a low priority when prices were high. Former Minister of Agriculture Roberto Rodrigues, coordinator of the FGV Agribusiness Center, suggests, for example, negotiating export contracts that gradually raise the proportion of processed soybean meal and reduce that of soybean grain.

Roberto Castello Branco, former director of mining company Vale and now a researcher at FGV Growth and Development, argues that Brazil needs to negotiate better trade advantages: "It's a long-standing habit of our diplomats to not focus on commercial factors. We must change this." When in 2006, China threatened to cap the prices that steelmakers would pay for imported iron ore, defending freedom of trade was Australia, the second largest iron ore exporter. Brazil did nothing.

Castello Branco also argues that long-standing structural factors that affect the competitiveness of Brazilian exports need to be addressed. In addition to a clear export strategy, Brazil also needs a competitive exchange rate and policies to reduce the Brazil costs. Even so, Arbache believes Brazil will have great difficulty in adding more value to its exports to China: "We have built up a production system that to make money did not depend on innovation, better worker skills, sophistication, … and interaction with world markets; meanwhile, the Chinese adopted insightful policies to attract foreign capital, and learned from American, Japanese and European companies, until they became independent," he says.

"It's a long-standing habit of our diplomats to not focus on commercial factors. We must change this."

Roberto Castello Branco

Arbache thinks that Brazil has a useful opportunity to take advantage of the new wave of Chinese foreign investment, noting that since the first wave, focused on commodities, and the second, on consumer goods, China is now aggressively investing abroad to diversify use of its international reserves, which are heavily in U.S. government bonds. However, Castello Branco points out that to take advantage of China's investment appetite, conditions in Brazil have to be attractive. He notes that the US$53 billion in cooperation agreements announced during the visit of Chinese Prime Minister Li Keqiang to Brazil last May will require more than good intentions to materialize. Brazil has serious deficiencies in infrastructure, and Chinese contractors have significant experience in executing hydroelectric projects, roads, railways, and ports. Their experience could help make Brazilian exports more competitive.

The Silk Road: Everything old is new again



Claudio Conceição, Beijing

"We have an important role to play before the world. Cultural differences between countries should be understood and respected. The greater integration of China in the world involves building a new trade and knowledge road." With these words, Yang Zhenwu, president of the *People's Daily* newspaper, the official publication of the Chinese Communist Party, informed an audience of 172 journalists from 60 countries of the Chinese government's intent to revive the ancient Silk Road, the largest commercial network of the ancient world.

The *People's Daily* hosted the 2015 Media Cooperation Forum September 21–22 in Beijing to encourage deeper international understanding of and cooperation with the "One Belt, One Road" initiative. Chinese President Xi Jinping in October 2013 had announced the country's intent to reactivate the Silk Road as vital for sustainable expansion of the economies of China and other countries. A maritime route is also part of the initiative. In Sri Lanka, which has joined the project, the Chinese are already building a port in Colombo as one of the maritime bases.



If the Silk Road project indeed becomes reality by 2025, China will expand its trade potential in areas that contain 4.0–4.4 billion people and nearly a third of the world's wealth. The project is already well underway. The investments planned total some US$40 billion, in addition to about US$54 billion in loans to be granted for construction of logistics centers in Central Asia and beyond.

One large logistics center is already rising in Kazakhstan, where President Jinping first announced the Silk Road project. In several Chinese provinces, among them Gansu, Shaanxi, Henan, Jiangsu, and Shandong roads, railways airports, and storage areas are also being constructed.



Dauren Diyarov, director general of Kazakhstan's Kazinform Agency, reported that his country has signed more than 250 agreements with China and 48 projects have already been launched, with US$70 million invested.

In addition to significantly expanding the universe of potential consumers of Chinese products, another Silk Road goal is to access the natural resources abundant in some countries through which the road will pass, in exchange for investments in infrastructure as such investments in China itself wind down.

In the Province of Henan, which ranks 5th in its contributions to Chinese GDP, investment of US$100 million in a major logistics center with water, air, and land connections has begun. Guo Gengmao, secretary of the Chinese Communist Party Central Committee in Henan, says that distribution routes are planned to link China to European countries by rail, which would make "Henan the main logistics center for the new Silk Road."

There is not yet much detailed information about the Silk Road. What is known is that the road will cut across China from east to west. The gateway to Central Asia and Europe would be in the Xinjiang region. Goods would mainly be transported via highways and railroads; for instance, part of the project is a Madrid-Yiwu rail link that will be the longest in the world.





Chinese effort
Chinese officials and journalists of 60 countries discuss in Beijing the importance of the revival of the Silk Road.

The maritime route—90% of China's trade is by sea—will start in the east, cross the Strait of Malacca, touch on Bangladesh, Sri Lanka, and Pakistan, and move through the Red Sea to reach Athens, Greece. From there, it will connect with such countries as Italy, Egypt, Portugal, and even Sweden.

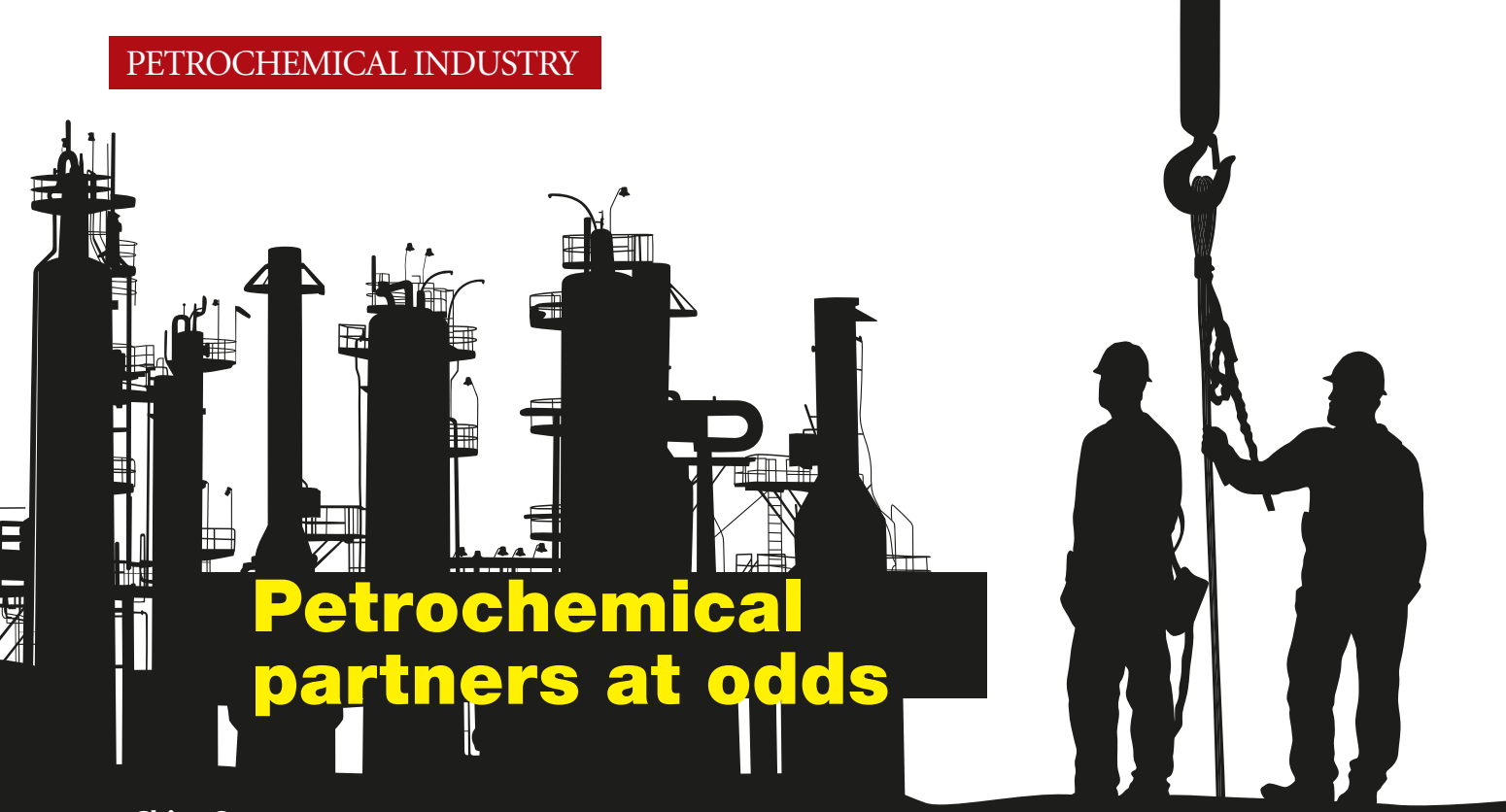
Although some countries oppose the project, the Chinese claim that 50 others have already shown interest in participating. But the obstacles are many. The new route will cross countries that are roiled by wars and fierce fights for power. In the poor countries it traverses, especially on highways security against terrorist and smuggler attacks is a huge challenge.

Although the two countries are jointly building a huge gas pipeline to link them, Russia is not supporting the Silk Road initiative, which would give China immense economic and political influence.

The U. S. is expected to use its own economic and political weight to discourage other countries from participating. After eight years of negotiations, in October 12 countries approved the largest free trade agreement in the world, the Trans-Pacific Partnership (TPP); the countries signing account for 40% of world GDP. China is not one of them, though it has close trade ties with many TPP members. However, it now has serious competition, led by the United States, in these markets.

"When more than 95% of our potential customers live outside our borders, we cannot let countries like China write the rules of the global economy," said U.S. President Barack Obama, after the TPP agreement was approved. The agreement, a victory for President Obama, seeks to strengthen ties with countries in Asia where the U. S. and China compete for greater political and economic influence. Partners to the agreement, which must still pass through the U.S. Congress, are Japan, Chile, Canada, Vietnam, Malaysia, Singapore, Brunei, Australia, New Zealand, Peru, Mexico, and the U. S.


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Petrochemical partners at odds

Chico Santos

TOGETHER THE EXPLOITATION of large shale gas reserves in the United States, and the fall in international oil prices have brought the Brazilian petrochemical industry to its knees. In the late 1990s when the sector was successfully privatized, this would have seemed improbable.

Abundant U.S. gas, sold at much lower prices than the naphtha that feeds the main petrochemical complexes in Brazil, has frozen investments here and toppled grandiose projects like the Petrochemical Complex of Rio de Janeiro (Comperj), which today is just a traditional oil refinery. As a result, the interests of the private Odebrecht Group and the state-oil company Petrobras, the leading supplier of raw materials (naphtha and natural gas), have diverged, and the two partners in Braskem company are now in conflict. Since Braskem purchased Quattor in January 2010, creating a petrochemical company that could compete globally, Braskem has become almost the sole Brazilian producer of raw petrochemicals. According to the 2014 Braskem annual report, Odebrecht has 50.11% of the voting capital, Petrobras has 47.03%, and other private shareholders have 2.86%.

Today Braskem and Petrobras are arguing about the long-term price of naphtha, which is used in three of the four Braskem ethylene plants. Ethylene is the basis for such thermoplastic resins as polyethylene and polypropylene. Currently, Petrobras sells naphtha to Braskem based on a formula that is in turn based on prices in the European market, which is usually more expensive.

Braskem wants a more flexible pricing formula that takes into account other markets, such as the U.S., to float the naphtha price in a wider range than it contracted with Petrobras

for in 2009, which is 92.5% to 105% of the ARA (Amsterdam-Rotterdam-Antwerp) price. In February 2014, realizing that it would be more profitable to use its naphtha to produce its own gasoline, Petrobras applied an exit clause in the contract and has since supplied naphtha based on addendums to the original contract without a long-term solution. The current addendum was just signed on October 31st.

Without a long-term formula for pricing naphtha, investments in the sector are highly unlikely. Armando Guedes Coelho, former Petrobras CEO and now president of the Business Council of Energy of the Federation of Industries of Rio de Janeiro State (Firjan), thinks one solution could be vertical integration of the petrochemical industry as is occurring in the fertilizer sector, with Petrobras building plants to manufacture nitrogen from raw materials it produces itself.

If that should happen, either Braskem would have to become a producer of oil and naphtha —which would be hugely expensive and take considerable time—or Petrobras would take control of Braskem—which Coelho also realizes is implausible for strategic and political reasons.

For nearly two years various parties have been seeking an economic and political arrangement to ensure the supply of naphtha to the petrochemical market. The current working group—which has representatives from Braskem, Petrobras, the ministries of Mines and Energy, Finance, and Development, other federal agencies, and the state governments involved, especially Bahia and Rio Grande do Sul—has been looking for a solution that satisfies Petrobras but does not risk disrupting petrochemical projects.

Abundant U.S. gas, sold at much lower prices than the naphtha that feeds the main petrochemical complexes in Brazil, has frozen investments here.

Possible alternatives?

Since the 1970s naphtha-petrochemical plants have made sense for Brazil; at that time, Europe and Japan, among others, depended on imported oil and produced no natural gas. Moreover, naphtha is richer than gas, so it can be used to make more petrochemicals, such as ethylene, propylene, benzene, toluene, and xylenes; gas basically produces only ethylene. Coelho says, however, that cracking of petroleum in refineries could produce plenty of benzene, toluene, and xylene, which would justify future investments in gas-petrochemical plants.

The only Brazilian gas-petrochemical plant is Rio Polymers (Riopol), originally a joint venture of Petrobras and the National Development Bank (BNDES) but now part of Braskem. It took nearly two decades to build the Riopol plant, which started operations in 2005. Coelho says that it is more competitive than other naphtha-based plants in Bahia,

The interests of the private Odebrecht Group and the state-oil company Petrobras, the leading supplier of raw materials (naphtha and natural gas), have diverged, and the two partners in Braskem are now in conflict.

São Paulo, and Rio Grande do Sul, because the Riopol gas price is referenced at Mont Belvieu, Texas—the pricing point for North American LNG [liquid natural gas] markets. As a result, Braskem is considering expanding the Riopol plant.

Another Petrobras initiative, Comperj (the Petrochemical Complex of Rio de Janeiro), has not been as successful as Riopol. According to Coelho, Comperj had its origin late in the 1980s in research by Petrobras and partners Ultra group and the Dutch Akzo Nobel in the Carioca Factory of Catalysts (FCC) on producing catalysts for cracking hydrocarbon molecules to produce such refined oil products as gasoline. FCC research suggested that it could be highly advantageous to produce petrochemicals by directly cracking heavy oil from the Campos Basin, Rio de Janeiro without having first to produce naphtha. Petrobras embraced the idea and, although Ultra withdrew, decided to start with an estimated investment of US$8.4 billion, the largest the company had ever made in a single project. The technology was absolutely new, Coelho said; the expectation was that if the project was successful the technology could be later sold to naphtha-dependent European petrochemical plants. However, when the Comperj project was still on the drawing

Braskem's production of petrochemicals fell by 8.5% in 2014.

(metric tons)

Products	2012	2013	2014
Ethylene	3,329,758	3,372,825	3,237,886
Propylene	1,472,488	1,505,595	1,306,636
Butadieno	355,703	389,854	374,827
BTX*	1,246,517	1,217,831	1,013,837
Total	6,404,466	6,486,105	5,933,222

Source: Braskem.
*** Benzene, toluene, para-xylene and ortho-xylene.**

board, light oil of high quality (the lighter the oil, the more associated gas) was discovered along the Brazilian coast. The priority then became to industrialize deep sea oil and gas, changing the purpose of the Comperj project.

Another blow to Comperj was the U.S. launch of large-scale shale-gas production. This caused the Henry Hub natural gas spot price, main reference for U.S. gas prices, to plunge from US$12.69 per million BTUs (units of thermal energy) in June 2008 to US$2.77 in August 2015. With American gas so cheap, Braskem began to press Petrobras to define the benchmark price for deep-sea gas to be supplied to Comperj. Getting no response, Braskem abandoned the Comperj project and Petrobras decided to turn it into a conventional oil refinery. The petrochemical project was put on hold indefinitely. Meanwhile, Comperj construction costs exploded to US$13 billion. To minimize the losses Petrobras is now struggling to get the refinery operating as fast as possible.

New U.S. projects

Meanwhile, in the U.S. the petrochemical industry is expanding rapidly. According to the MaxiQuim consultancy, by 2018 eight more petrochemical plants will be operating, with annual capacity of 9.03 million metric tons of ethylene production —well over twice Brazil's current capacity of 3.95 million tons. However, the steep drop in oil prices since last year is already causing several projects to be reassessed, according to Solange Stumpf, MaxiQuim director.

By 2018 eight more petrochemical plants will be operating in the U.S., with annual capacity of 9.03 million metric tons of ethylene production—well over twice Brazil's current capacity of 3.95 million tons.

Nevertheless, Braskem continues to expand its activities in the U.S. Braskem confirmed that the ethylene plant with an annual capacity of 1 million tons a year that it is operating in partnership with Mexico's Idesa in the Mexican state of Veracruz will start producing in 2016—at which time Braskem's U.S. production will shoot up to over 10 million tons a year within three years. To remain competitive in the international market, since 2010 Braskem has acquired two U.S. polypropylene plants from Sunoco Chemicals and five other polypropylene plants from Dow, three in the U.S. and two in Germany.

As the domestic resin market in Brazil shrank 15% in the first quarter to 1.2 million tons of polyethylene, polypropylene, and PVC, of which Braskem sold 792,000 tons, the company has compensated by increasing its exports by 53%, to a total of 373,000 tons.

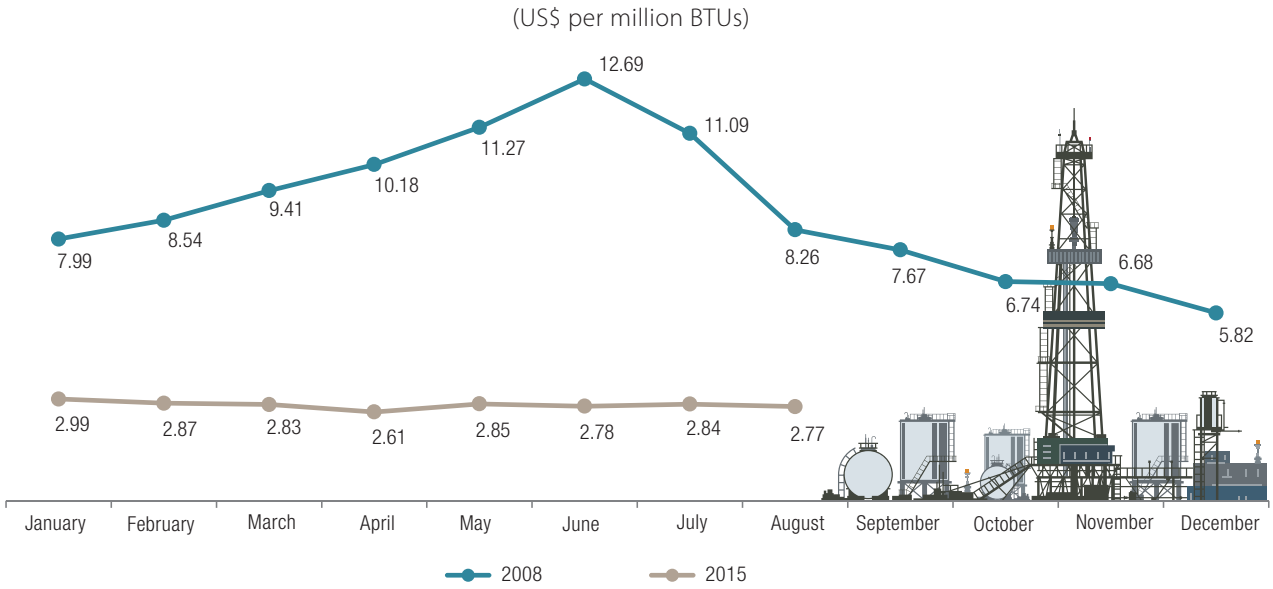
"The petrochemical industry depends on two factors: internationally competitive raw materials and energy. Without both, investment [in Brazil] does not grow."

Fernando Figueiredo

At home, Braskem has a new joint project in Camaçari with multinationals Styrolution and Ineono to build an ABS plant (this is a high-strength plastic used in vehicles and home appliances), an investment of US$250 million. ABS plastic is not currently produced in Brazil. However—coming full circle—continuing the project depends on Braskem finding a solution to the standoff with Petrobras about the price of naphtha.

"The petrochemical industry depends on two factors: internationally competitive raw materials and energy. Without both, investment [in Brazil] will never grow," said Fernando Figueiredo, chief executive of the Brazilian Chemical Industry Association. According to Figueiredo, in the last 20 years domestic demand for petrochemicals grew by an average of 25% above gross domestic product (GDP) and, with little domestic production, in the last 10 years imports went up from 10% of domestic consumption to 35%. "Our companies have made the right decision to grow overseas," he said. With ample oil and gas reserves, Figueiredo believes the Brazilian petrochemical industry has "a bright future" once its current problems are resolved—and if

Gas prices in the U.S. market fell significantly between 2008 and 2015 because of the abundant supply of shale gas.



Source: Henry Hub Gas Spot Price.

the companies also do their part by increasing investment in research and development (R & D), which today is just 0.7% of GDP. The international average is 1.5%.

Solange Stumpf believes that not only must the industry deal with the problems that affect all Brazilian industry, such as high taxes, poor logistics, and the high cost of electricity, "the petrochemical industry has its own specific problems. The most critical is its high dependence on a single raw material, naphtha …, which makes the petrochemical industry more vulnerable and therefore unattractive for investment." She adds that Brazil has "a robust domestic market [for petrochemicals] and great growth potential in the long term," and finds it unfortunate that there is no industrial policy to encourage better conditions to make the industry more competitive. Stumpf says that the government needs a strategy to encourage the sector to add value to the new supply of oil from deep-sea oil. She also said that "the relationship of naphtha with other oil products, especially gasoline, affects both the supply and price of naphtha," and that "the absence of a long-term public policy makes the petrochemical sector extremely vulnerable to political influences, since Petrobras controls the supply of oil products."

BNDES petrochemical support program

Recognizing virtual stagnation in the petrochemical industry, the BNDES "has changed focus to support production of chemicals of higher added value that do not depend so much on raw material," said Gabriel Gomes, head of the BNDES chemical industry department.

"[The BNDES] has changed focus to support production of chemicals of higher added value that do not depend so much on raw material."

Gabriel Gomes

The change of direction is the result of a "Study of Potential Diversification of the Brazilian Chemical Industry" commissioned by BNDES and conducted by consultants Bain Company and GasEnergy. Based on the findings, the BNDES, in partnership with the Financing Agency for Studies and Projects (FINEP) drafted a stimulus policy that is scheduled to go into operation this October that is directed to six products: additives to animal feed, silicon derivatives, carbon fibers and composite products for oil exploration and production, personal hygiene products, perfumery and cosmetics, and chemicals from renewable raw materials.

The study looked at 60 sectors and identified 20 as having the most potential. Among them are many related to petrochemicals that may be the object of future BNDES stimulus policies, such as products from butadiene and isoprene, which are used in the tire industry, and polyurethane derivatives. As Gomes summed up the new direction: "The focus of BNDES is to stimulate new fronts to strengthen demand for petrochemical industry products."



Bitter fruits of fiscal disorder

Aggravation of political and fiscal tensions weakens the country, delaying expectations that the economy will recover.

Solange Monteiro

SINCE THE BEGINNING OF THE YEAR it has been clear that 2015 was not looking promising. Still, at that time few foresaw the failure to achieve political consensus on the necessary fiscal adjustment and the further deterioration of public finances, which in recent months have pushed the economy onto a faster downward trajectory. Analysts warn that the outlook could even worsen unless the government overcomes the decision-making paralysis that is now alarming markets. In the IBRE Seminar on the Brazilian Economic Outlook in early September, economists pointed out how the political tensions and the gloom over public finances are depressing expectations of Brazilian growth this year: GDP is expected to contract by another 3%, rather than the 1.8% estimated as recently as June. For 2016, the forecast for GDP has been revised from modest growth of 0.5% to a drop of 2.1%. Yet despite the recession, inflation is still high: the IBRE forecast for 2015 has been revised up from 8.8% to 9.6%. Although that takes into account increases in gasoline and diesel prices announced late in September, it does not consider possible tax increases.

IBRE economists estimate that economic activity will contract by 0.8% in the third quarter of 2015 and another 0.6% in the fourth. Silvia Matos, technical coordinator of the IBRE Macro Bulletin, said that the main factors weighing on the economy are climbing industry inventories, the labor market slowdown, particularly in the service sector—IBRE is projecting total unemployment of 9% by yearend—and a continuing lack of business and consumer confidence. Aloisio Campelo, IBRE Deputy Superintendent of Economic Cycles, said that although some sectors are benefiting from a more competitive exchange rate through exports and import substitution, that has been largely offset by the lack of domestic demand. For 2015, manufacturing

is expected to fall by 9.7% and construction by 8.4%. On the demand side, household consumption is expected to decline 2.4%, investment by 13.6%, and imports by 10.8%.

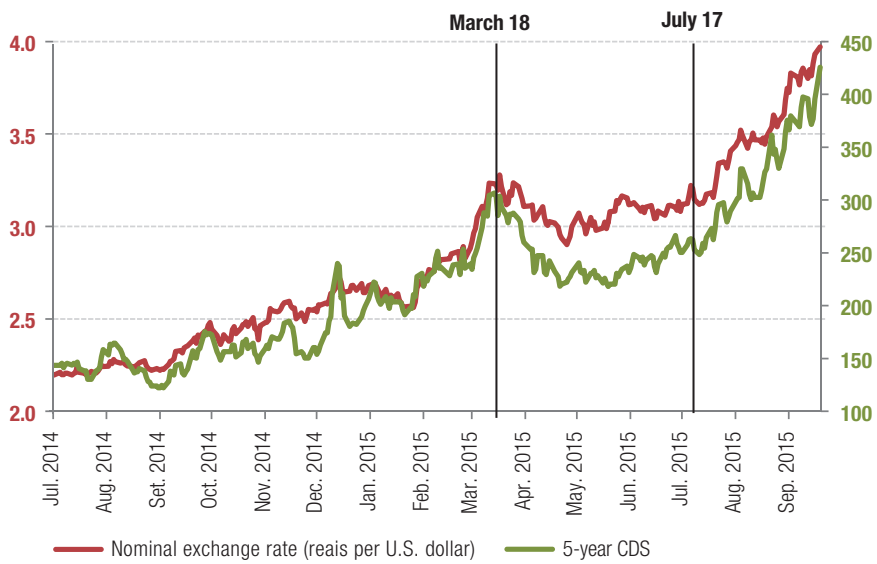
Armando Castelar, IBRE Coordinator of Applied Economics, noted that such problems as the economic slowdown in China, the deterioration of the fiscal situation, and the need to adjust controlled prices are not new: "We have been highlighting these factors for at least two years. What is striking now is the speed and magnitude with which things are happening."

Octavio Amorim, professor at the FGV Brazilian School of Public and Business Administration, listed political events that have undermined the prospects for economic reforms: The decision of Eduardo Cunha, Speaker of the House of Representatives, to join the opposition after being involved in the investigations of corruption at state-oil company Petrobras; the resignation of Vice President Michel Temer as the administration's political coordinator; and the plunge in President Rousseff's popularity. Amorim believes that any possible political scenario—transferring power to the PMDB party and Finance Minister Levy; presidential resignation or impeachment—will involve a loss of power for the president and the Workers' Party, and will make it even more difficult to dispel the tensions.

"We have a historical imbalance between public expenses and revenues that needs to be addressed, preferably by creating clear rules for increased spending. Fiscal imbalance brings uncertainty, devaluing the exchange rate and postponing growth."

Octavio de Barros

Brazil's risk as measured by Brazil's 5-year CDSs has been the main determinant of the exchange rate devaluation since March 2015.



Source: Bloomberg.

Although some sectors are benefiting from a more competitive exchange rate through exports and import substitution, that has been largely offset by the lack of domestic demand.

Brazil risk

José Marcio Camargo of the Catholic University of Rio de Janeiro explained that the political gridlock has led the government to hesitate between carrying out the fiscal adjustment or opting to keep popular support, which would mean accommodating the fiscal deficit by letting inflation rise. "Today the president does not know which way will keep her in power, so she opted for the middle way. This means that the government is not picking a direction, which leaves us under the threat of complete paralysis," he said. Such uncertainties have heightened the perception of risk, as was reflected in the exchange rate at the end of September hitting over R$4 per U.S. dollar. José Julio Senna, head of the IBRE Monetary Studies Center, thinks that the worsening of the political situation since July was a decisive factor in the steep depreciation of the real against the dollar. "Between December 2014 and March this year, the Brazil exchange rate reflected the recovery of the U.S. economy; as the U.S. dollar has strengthened, the prices of commodities have fallen, increasing the Brazil risk because it is an exporter of commodities," he explained. Since March, however, the Federal Reserve Bank has come to believe that the performance of the U.S. economy has not been as good as expected and the dollar has weakened slightly—yet devaluation of the Brazilian currency continued because of Brazil's political gridlock. "Brazil's risk measured by Brazil's 5-year CDS [credit default swap] has risen from about 150 points in 2013 to 400 today. In an economy like ours, the country's risk determines the exchange rate," he said. "The problem now is entirely ours."

For Senna, unless there is a political U-turn and measures to control public debt, monetary policy will not be effective and can contribute little to economic recovery: "A bad fiscal scenario affects the country's risk, which devalues the exchange rate, which increases inflation, leading the central bank to increase interest rates, which raises the public deficit, which increases the public debt, which in turn increases country risk—and the cycle is perpetuated."

The government's announcement on September 14 of R$26 billion in cuts in public spending and tax increases of R$40.2 billion was not applauded by economists: "It's a small adjustment, focused on postponing spending. ... To give an order of magnitude, the Social Security deficit alone is projected at R$200 billion in 2016," Matos said. Octavio de Barros, director of the Department of Research and Economic Studies of Bradesco Bank, noted that carrying out fiscal adjustment during

a recession is complicated because when economic activity is reduced, so are tax collections. "We have a historical imbalance between public expenses and revenues that needs to be addressed, preferably by creating clear rules for increased spending. Fiscal imbalance brings about uncertainty, exchange rate devaluation, and postponed growth," he said.

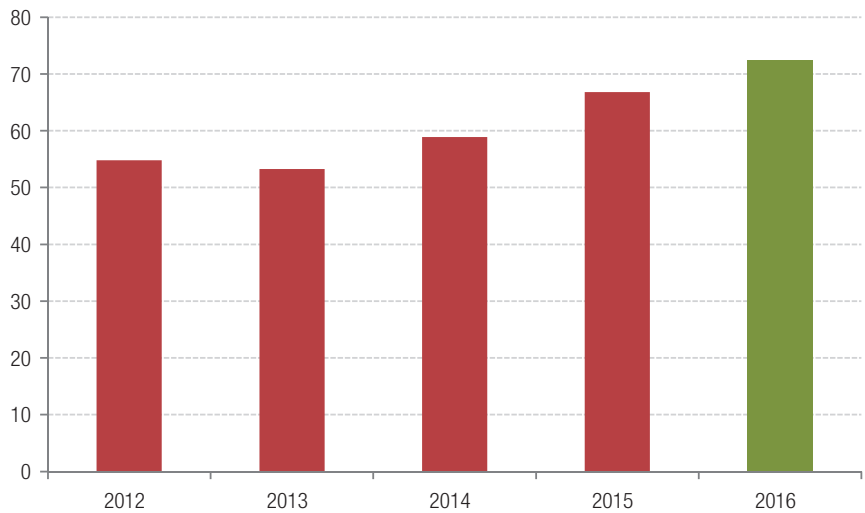
Because Congress still has to approve the fiscal measures announced, IBRE did not take them into account in estimating the 2015 fiscal primary balance. IBRE researcher Vilma Pinto said the public sector primary deficit is projected to remain at 0.6% of GDP in 2015 and increase to 0.9% in 2016. The new measures are not expected to have any significant effect on inflation this year but will push it up in 2016. "The CPMF tax [Provisional Contribution on Financial Transactions] is an increase in tax revenue that will have some effect on prices, even if it happens only once," said Salomão Quadros, IBRE Deputy Superintendent of General Price Indices. For next year, among possible pressures on inflation, he mentioned a higher CIDE [Economic Domain Intervention Contribution] tax and a new round of exchange rate devaluation.

"We have been highlighting these problems for at least two years. What is striking now is the speed and magnitude with which things are happening."

Armando Castelar

Gross public debt has increased by 20 percentage points of GDP since 2013.

(% of GDP)



Sources: Central Bank of Brazil and IBRE.

Differences of opinion

Even with the fiscal and inflation pressures on the economy in the next few years, Bradesco's Barros is hopeful that some factors may stimulate economic growth starting in 2016, such as wage stabilization reducing labor costs, and a steep devaluation of the exchange rate encouraging exports. Castelar agreed that the external balance should improve but noted that as

"Today the president does not know which way will keep her in power, so she opted for the middle way. This means that the government is not picking a direction, which leaves us under the threat of complete paralysis."

José Marcio Camargo

developed economies show signs of continuing improvement, that will increase demand for Brazil's exports but reduce external financing. Brazil will have to adapt to the new conditions. IBRE estimates that the country's external current account deficit will drop this year by R$104 billion to US$66 billion, 3.7% of GDP, then decline marginally to 3.5% of GDP in 2016. The trade balance is expected to improve as domestic demand slackens and the exchange rate is further devalued. Exports are projected to grow by 3.6% in 2015 and 2.2% in 2016, and imports to decline by 10% in both years.

Barros also mentioned as positive factors the possibility of opening a new privatization cycle and more concessions, boosting investments in infrastructure through "unequivocally attractive new terms for return on investment." To do so, however, in his opinion it is necessary to see progress in four areas: budget governance, with better public spending; the effectiveness of monetary policy in reducing over-indexing; productivity enhancement through tax and labor reforms, better education policies, and economic openness; and infrastructure, with more focused National Development Bank activities, better incentives to capital markets, and a more secure legal context. "The house did not fall," Barros said. "Brazil has sound fundamentals—and enormous opportunities."

Sounding a more negative note, Claudio Frischtak, president of InterB Consulting, emphasized, however, that there is no possibility of turning the economy around until the gridlock between Congress and the executive are resolved and the fiscal problem addressed: "Today we see very strong opposition by the population to raising taxes. Moreover, today Congress can reject tax increases, which were traditionally the government's prerogative," he said. "The risk we run if gridlock continues is that it will not only block our way out of the recession but throw the economy into an actual depression." Castelar shared his concern, noting that "IBRE projections point to a fall in domestic demand of 8% and a reduction in worker incomes of 8% in 2015–16, with industry contracting by more than 20% in the triennium of 2014–16. This means that the share of Brazilian manufacturing in GDP will be back to 1930s levels." Castelar believes that, given the difficulties of making the fiscal adjustment that the situation demands, Brazil risks kicking the can down the road only to find out in the future the bitter fruits of current tolerance of fiscal disorder.


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EGP data updated on 12/31/2014.

Photo: FCA



"The country needs major reforms"

Cledorvino Belini

President of Fiat Chrysler Automobiles (FCA) for Latin America
(as of November 1st, President for Latin America Development,
with responsibility to represent FCA in all institutional relations)

Solange Monteiro

THE automobile market is expected to end 2015 30% smaller than in 2013, when production of cars, commercial vehicles, trucks, and buses reached 3.6 million units. Cledorvino Belini, president of Fiat Chrysler Automobiles for Latin America says that despite the ups and downs of the economy, the industry previously has always ended each cycle with higher sales. "The worrying factor of the current economic crisis is that recovery should be slow, and average growth is hardly likely to be as high as in past decades," he said. Belini, who has been with Fiat for 42 years, said the sector would be positioned to be competitive in large export markets, but the problem is with the country's competitiveness in terms of, e.g., indexation—the automatic adjustment of wages, taxes, pension benefits, interest rates, etc.—depending on economic indicators such as the cost of living . He adds, "The country needs major reforms… if these do not happen now, it will be hard to grow."

In the second quarter of 2015, the net revenue of Fiat Chrysler Automobiles (FCA) fell only in Latin America, where it was 15% down from the same period in 2014. How much did Brazil account for this result?

Our company operates in four regions. In NAFTA (United States, Canada, and Mexico), we are doing well. It is a vigorous market with prices improving. Europe is emerging from crisis, also improving. Asia and Pacific is suffering a bit, but our participation

there is still small; we are investing now for the future. In Latin America … we had expected there would be a slowdown, but we never imagined it would be so large. When Brazil does not do well, you can expect all of South America to follow, with the possible exception of Colombia and Peru, which have been a little more active. In Argentina, demand has fallen by almost half. In Brazil, two years ago we sold 3.6 million units and we estimate that this year will end close to 2.5 million—a loss of 1.1 million units.

The public deficit has increased pressure to raise taxes. Do you think a heavier tax burden is inevitable?

No entrepreneur wants tax increases. What we want is more turnover to lead to more revenue and thus more income on which to pay taxes. High interest rates are a serious issue. We understand that we need to break inflation, which is a very high tax on society. But we pay an exorbitant rate of interest on public debt—close to R$500 billion. That cost is being passed on to society. … And the money ends up being invested not in production, but in financial speculation. We understand that money has to be tightened to curb inflation. But do we need to do it overnight, or can we do it more gradually so that the crisis in Brazilian society does not worsen?

Do you think we can achieve a consensus on structural reforms to reduce public spending?

Brazil needs to do that today. Starting with social security, which is the biggest hurdle. … Brazilian society cannot afford it; it is a very heavy burden that demands urgent reform. Also, public spending mandated by the constitution should be reviewed. The government says it cannot afford to cut public spending, because most of it is mandated, but we must find a solution, and that makes it a political issue.

We understand that money has to be tightened to curb inflation. But do we need to do it overnight, or can we do it more gradually so that the crisis in Brazilian society does not worsen?

A few months ago you argued for dialogue and cooperation between the private sector and government to find solutions, and you met with the president. Has anything come of those meetings?

In a way, yes. But there are always difficulties in execution—that is natural in any democracy. We think there is some consensus, except for the issue of interest rates.

What about the tax issues?

We did not discuss that in detail, though there has been an exchange of ideas.

Growth of the automotive industry in recent years has benefited from tax exemptions, which are estimated to have cost R$56 billion in tax revenues from 2009 to 2013. How will ending the exemptions affect the auto industry?

In Brazil the automotive industry has a tax burden of 32%, the world average is about 12–13%, and in the U.S. it is 6%. … In order for the majority of Brazilians to have vehicles, as in other countries, we must have lower taxes, more credit, and lower interest rates.

Brazil has the highest tax burden in the world: What the industry needs is tax cuts to sell more, so the government can collect more taxes. When one reduces taxes on cars, the increase in demand goes beyond the tax cut. In the past when the popular car program was created and taxes on cars were reduced, demand for cars went up from 600,000 in 1992 to 1,130,000 in 1998... . But in Brazil the automotive industry has a tax burden of 32%, the world average is about 12–13%, and in the U.S. it is 6%. … In order for the majority of Brazilians to have vehicles, as in other countries, we must have lower taxes, more credit, and lower interest rates. … In Brazil, we have a car for every 5 people, in Europe there is one for every 1.7 people and in NAFTA one for every 1.5 people.

The tax exemptions stimulated expansion of production capacity which, according to Anfavea [the National Association of Vehicle Manufacturers], is currently 4.5 million units. Since the Brazilian car market has never approached that number, is the expansion sustainable?

The expectation was that the market would be 4.5 million. This market did not materialize, but … what we have now is great production capacity for export. There are two factors here: the exchange rate is favorable to export, but costs have also risen, and productivity is low. Our factories are competitive, but when the product leaves the factory, we have problems with the roads; we have no railways, no coastal shipping for distribution, but we do have bureaucracy, high interest rates—all this pushes up costs and makes it harder to export. It is not about creating incentives. It is about making the productive sector competitive. For example, we export 10% of taxes, taxes embedded in the production chain, of which exporters are reimbursed only 1%.

What are the prospects for exporting Brazil's excess vehicle production?

I am cautious. We have to be competitive in major markets: The U.S. market is 17 million vehicles a year and in Europe 15 million—these two alone add up to 32 million vehicles. Mexico is great, and we are already there. The Colombian market is 400,000. … We have excess capacity of 2 million vehicles. To export 2 million vehicles, we need to focus on major markets; Latin America is not enough.

Do we have export-quality products for major markets?

The idea that we are lagging behind is an old concept. Of course some products are not

adequate for large markets, but we also have global products, technologically compatible for export. Fiat has the Jeep Renegade, which is manufactured in Pernambuco state. Today it is being exported from Italy to the United States. Now that we have started production in Brazil, we expect to manufacture 120,000 vehicles a year, and we have the capacity to expand for export.

What about the exchange rate?

The exchange rate is good where it is. The big problem is its volatility. We have to have stability to understand at what level the exchange rate will stay. This volatility means it is necessary to hedge foreign exchange transactions, and that is expensive.

You participate in the Business Movement for Innovation (MEI). What initiatives does MEI think are necessary to drive innovation in Brazil?

MEI is a movement to stimulate innovation in the country. Today Brazil has favorable conditions in every way. In Minas Gerais there are mountains of iron, which is basically what an automobile is made of. We have the basic conditions that should allow us to compete. But the producers of steel and other basic materials for cars do not produce at a large-enough scale and therefore cannot be globally competitive. Furthermore, capital costs in Brazil are exorbitant—in no other country in the world is the cost of capital as high as here.

To what extent has the government's Innovate-Auto program helped to make the industry more competitive?

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The Innovate-Auto is a program of incentives for engineering to create better technological conditions for Brazilian industry and bring it forward into the world market. New products manufactured here are all aligned in terms of technology with the world market. Innovate-Auto brought engineering expertise to Brazil. Here at Fiat, before we had 800 engineers and today we have almost 2,000 … developing national engineering capacity. We have drawn on technology centers, Brazil's Technological Institute of Aeronautics (ITA), foreign companies, and universities. We are organizing a seminar in November with scientific panels of projects developed with partners, with 80 different presentations already scheduled.

So today, if you ask "do we have vehicles for export?" the answer is yes. Thus we created a global product, the most technologically advanced in the world … In my opinion, we really took a leap. On the personal side, I am very happy to have worked hard for this project. [When Innovate-Auto was established in 2012, Belini was the Anfavea president.]

Do you see an improvement in the government's infrastructure program?

Brazil is a country with great possibilities, and cycles of growth. Every time there is a new up cycle, the car market reaches higher sales. What we do not know is where we are in the business cycle—if there is still more downside to come.

I see good design, but no results. Look, for example, at the railways concession program. It is wonderful in theory, but slow in practice. The ports program is going slowly; it lacks regulations, such as for coastal shipping. Roads are still going through big cities. Here in Belo Horizonte city, for example, there are delays in completing the beltway. The design is good, but between design and results there is a big gap.

How has Fiat managed its employees during the current slowdown? What do you think of the Employment Protection Program (EPP)?

We have been making adjustments in production for some time, such as collective vacations. We are not hiring workers to fill natural turnover, which is one way to adjust. This is not ideal, but it is one alternative. ... With regard to EPP, each region has its own characteristics, each company has its own characteristics; one policy cannot be effective for all. Each must choose the best alternative. What is necessary is to ease the program conditions so that in the future companies will not be confronted with labor litigation. Regulation is necessary, but so is free bargaining and an end to indexation. … For contracts, for example, indexation is nonsense. Rigid contracts indexed to the future economy are terrible, they increase costs. .... The economy should be allowed to adjust freely. Otherwise, competitiveness is lost.

Does the current economic outlook affect Fiat's investment plans?

The auto industry always looks 10 years ahead. Once an investment starts, we are not able to stop. However, we are being very cautious. … We have excess production capacity, but investments in products continue; upgrading products is necessary, especially considering what the competition and markets are doing in product technology, process technology, and final product design. This is inevitable. But it all this requires a positive and predictable cash flow. This is the great challenge: How to generate cash to make investments. On the one hand we have our internal programs; on the other, we need to be aware of the economy's outlook. What is causing great distress in Brazil is the lack of structural reforms.

The investments of R$16 billion we planned for 2013 to 2016 are already almost done. As to production of the Jeep Renegade, we have to wait and see what direction the country will take before deciding on new investments.

How does Fiat headquarters see the Brazilian situation?

Our CEO Sergio Marchionne was in Brazil in early September and met with President Dilma Rous-

seff, Vice President Michel Temer, and Ministers Joaquim Levy and Armando Monteiro. He sees the Brazilian situation as temporary. Investors do not look at short-term issues of inflation, unemployment, and interest rates; they look at the long term. Brazil is a country with great possibilities, and cycles of growth. Every time there is a new up cycle, the car market reaches higher sales. What we do not know is where we are in the business cycle—if there is still more downside to come.

Do you think the current crisis will worsen because recession is combined with political crisis?

I have seen many crises ... I have been with the Fiat Group for 42 years, and in the industry for 52. Recently I gave a presentation in which I recalled the Brazilian crises since President Getulio Vargas in 1954: The crisis of President João Goulart in 1964 was serious; the President Collor crisis in 1992 left everyone baffled. Of course we feel the latest crisis is the worst. … My concern now is that the previous crises were followed by rapid growth and after the current one it seems that the economy will recover slowly and not grow as fast as in recent decades. The country needs to be rebuilt. It needs major reforms that were not made in due course as we were learning to deal with the democracy. If the reforms do not happen now, Brazil will have a hard time growing. We need a shock to rebuild. But to rebuild, political will is necessary. I do not think that is yet emerging.

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