

## Panorama Brazil



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Ranked seventh in the world (and the second largest emerging economy) by GDP size, Brazil is the archetypal emerging country. It brilliantly passed the test of the major 2009 crisis, demonstrating the strength of its economic fundamentals and the maturity of its political institutions. But, the Brazilians' legendary optimism has been sorely tested for the last two years: weak growth, loss of industrial competitiveness and, more recently, massive protests by a population that is becoming restive .... Can the Brazilian economic engine be repaired?

This panorama offers an overall focus, dealing with economic challenges, socio-political issues and a sector by sector analysis. The weak growth and the social tensions are the result of structural problems relating less to classical economic policies than to reforms affecting infrastructures and education, matters which, as Cristiano Souza of Santander emphasises, "cannot be resolved in the short term". According to Luiz Rabi of Serasa, low growth means there will be no decline in the company bankruptcy rate. On the one hand, businesses are benefitting from healthy household demand, but on the other hand, interest rates and the weakness of global activity are affecting their performance.

In all the sector analyses presented in this panorama (chemicals, steel, automotive, retail, agro-food) the notorious "Brazil cost" comes up again and again as a decisive disadvantage. For example, the cost of energy is a burden on the steel industry; upward pressures on wages are eroding the competitiveness of the chemical industry. The small producers in the agro-food sector suffer from a lack of access to new technology. However, Brazil's entrepreneurial fabric benefits from two key strengths. First, the heavy involvement of the authorities is a constant - even to the extent of adopting protectionist measures. Fernando Figueiredo, Executive President of the Chemical Industry Association, analyses the competitiveness council given to the chemical industry - initiated by the executive - as "a final push in the right direction" towards recovery. Another strength: admittedly, the growth in middle class incomes contributes to the rise in prices, but it sustains the automotive industry and retail trade, two key sectors. The Brazilian middle class, which is equipping itself, is attracting profit-seeking international investors, as evidenced by the interest of Korean and Chinese car manufacturers. In short, the country holds all the cards needed to inspire the hope that this immense market will take off again...

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By Rémy Carasse

Economist, Coface

Yves Zlotowski

Chief Economist, Coface

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## Brazil's economy: Worrying weaknesses?

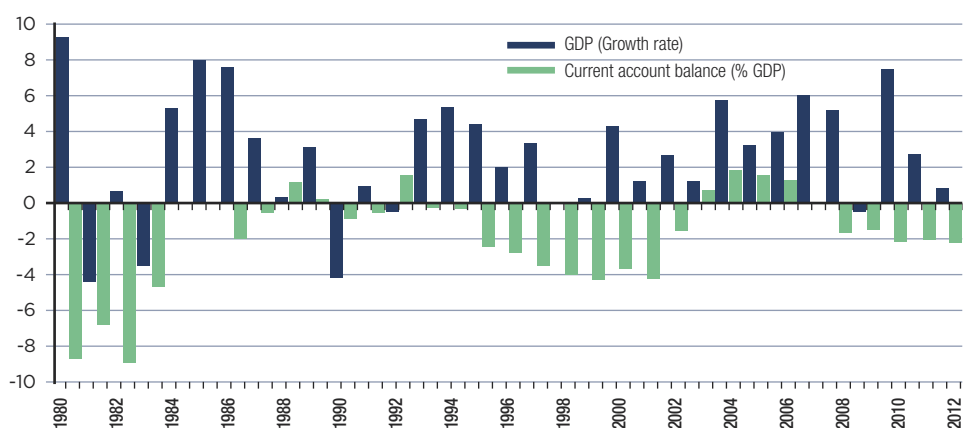
The growth figures continue to put a damper on the legendary optimism of the Brazilian people. In 2012, activity was the weakest registered among the BRICS<sup>(1)</sup> States at 0.9% compared to an average of 4.8% for all emerging countries. Q1 2013 was again disappointing, especially as all observers were counting on a clear upturn: activity grew by a meagre 1.9% over one year. These disappointing growth numbers were exacerbated by persistent inflation: consumer prices rose by another 6.5% in May 2013. This quasi stagflation is one of the reasons – among others – behind the widespread social unrest that has taken hold of the country since mid-June 2013. Stagflation brings with it a dilemma for monetary policy: should one encourage the recovery and accordingly lower interest rates, or wouldn't it be better to do the opposite and increase them, to combat inflation, which is being felt particularly strongly by the population of a country that has a painful history when it comes to rising prices? Finally, Brazilian stagflation is affected by structural factors – the notorious “Brazil cost” – which have become economic issues: labour market tensions, loss of competitiveness, infrastructure shortcomings ... all reasons for Brazil's economic woes.

### Stagflation – a worrying cocktail

Contrary to the legend and especially as regards the other emerging countries, Brazil is characterised by potentially limited growth: GDP grew by an average 3.6% between 2000 and 2011, far behind China (10.2%), of course, but also Russia (5.3%). This comparatively modest growth is explained by structural factors typical of Latin America: low rate of investment compared with the Asian economies (18% of GDP against 45% on China). Brazil's growth is, moreover, volatile, as dynamic internal demand tends to aggravate the current account deficit, which then sharply readjusts

itself. In short, Brazil is accustomed to booms and busts, as shown in chart 1, which links the GDP growth rate with the current account balance since the 1980s. As we can see, following a record boom in 2010 – with growth touching 8%, which looked like a clear overheating of the economy – 2011 and 2012 were, as expected, years of more subdued activity. In essence, a typically Brazilian cyclical component explains the observed slowdown.

CHART 1:  
GDP growth (%) and current account balance (% of GDP)



Source : IMF

(1) Brazil, Russia, India, China, South Africa

Nevertheless, Brazilian performance is worrying: despite the impressive interest rate cut made by the central bank, activity has failed to pick up. Between August 2011 and October 2012, the Bank of Brazil was able to cut its key rate from 12 to 7.25%, a remarkable effort but with on the whole disappointing results: in Q4 2012, the economy grew at an annual average rate of 1.4% in an overriding context of a persistent contraction of investment. As for inflation, this blithely crossed the 6% barrier. Behind this failure to revive the economy lies a fundamental problem for Brazilian growth. Throughout 2012, household consumption remained vigorous, while business investment shrank. Consumption – boosted by falling unemployment and a steady rise in real household income – buoyed activity. But supply failed to keep up with the resulting demand. This dilemma is illustrated clearly in chart 2 comparing retail sales (reflecting Brazil's appetite for consumption) and industrial production (which shows the many constraints hampering supply); retail sales held up in 2011 and 2012 while supply was in decline. This combination of a seeming disconnect between supply and demand is typical for stagflationary situations. The GDP data for Q1 2013 show a trend reversal (consumption collapsing, investment taking off) but it is difficult to say whether this points to sustainable change in the pattern of growth and in any case the economic growth rate continues to disappoint.

**CHART 2:**  
Retail sales and industrial production (year-on-year, %)



Source: IBGE (Brazilian Institute of Geography and Statistics)

(2) During the period of strong appreciation, between 2009 and 2011, the authorities reacted by introducing a tax on capital inflows; the impact on exchange rates has in the end turned out to be limited. It is thought, nonetheless, that this tax made it possible to change the type of incoming capital in favour of less speculative foreign direct investments. This point is dealt with in detail in Coface's Country Risk Panorama, Changes in emerging country risks, March 2013; see pages 7 and 8 for capital controls in Brazil.

## Are the central bank and the real to blame?

It is interesting to note that a large part of Brazil's growth problems have been laid at the door of the monetary indicators: interest rates deemed too high and an unacceptable appreciation of the exchange rate. Interest rates can no longer be relied on as a tool for kick starting the economy in 2013. The central bank thinks it has done enough and that inflation has now gone beyond acceptable limits (its target is 4.5% with a margin of +/-2%). At 6.5%, inflation has reached the upper range of the central bank's target. This began to rise again from April 2013 (with a further rise in May) with the rate now standing at 8%. Looking at bank lending, one can see that it has been extremely dynamic since 2009; annual lending growth climbed from 15 to 20%, and was still growing by +17% in April 2013! Bank loans were limited relative to GDP (around 50% compared to 130% in China), but there is no question that financial intermediation has grown substantially. The supply of credit has, however, a special feature which relativizes the appetite of the banks, because it is actually the state-owned banks which are at the origin of this remarkable dynamism. This is because the growth rate for lending by public entities stood at 41% in April 2013 against 7% for the private sector (or close to 0% in real terms). Currently, lending by state-owned banks represents 47% of total lending, of which 20% is for the BNDES (Brazilian Development Bank) alone. The major role played by public sector lending has its disadvantages. Some observers think that the BNDES has lent too much to the great industrial champions without really playing its role as lender of last resort. Further, the swollen balance sheet of the BNDES is a contingent liability for the State. But, in any case and considering its continuous dynamism, lending has bolstered activity since the crisis.

With regard to the exchange rate – an intensely debated subject in Brazil – its path has been astonishing. Between 21 November 2009 and the end of July 2011, Brazil's currency has appreciated by almost 60% against the dollar, so it is relatively easy to understand why the Brazilian authorities racked up their declarations against “currency wars” and against the US Federal Reserve's action, which was seen as devastating<sup>(2)</sup>. However, since July 2011, the currency has lost 30% against the dollar. By mid-June 2013, influenced by announced changes to American monetary policy and massive demonstrations, the speed of the Brazilian currency's depreciation has become a concern. The level of interest rates is a highly sensitive topic in Brazil: industry represents almost 23% of GDP and 40% of exports. Automotives, aeronautics, chemicals, or orange juice ... the country is present in many sectors. The threat of deindustrialisation is a crucial issue both for jobs and for sustained growth. The performance of Brazil's trade balance is increasingly disappointing: according to forecasts by Santander, the surplus will tumble from \$19.4bn in 2012 to \$1.8bn in 2013 and will post a deficit in 2014. The current account balance has, moreover, been in deficit since 2007 and this is constantly increasing. The balance is likely to be below -3% of GDP in 2013.

Although there has indeed been a loss of Brazilian industrial competitiveness, the exchange rate cannot be held solely responsible, since the crazy appreciation of the rate has been halted for nearly two years. The reasons, meanwhile, have to be found elsewhere: since mid-2010, unit labour costs have exploded (+10% over one year in April 2013), while industrial productivity has declined (-0.5% over the same period)<sup>(3)</sup>. The strong appreciation in the exchange rate has overall had the disadvantage of accentuating the loss of industrial competitiveness. At present, the fall in the rate could contribute to inflationary pressures. However, rising prices and weak activity are the result of more far-reaching factors than excessive movements of the real – what is known as the “Brazilian cost”, starting with labour costs.

### The labour market is tight...

Brazil’s unemployment rate has fallen sharply since the early 2000s, dropping from 12.4% in 2003 to only 5.5% in 2012, and stabilising at 5.8% in May 2013 (cf. Chart 3). While it is true that this situation of near full employment buoys household consumption (cf. Chart 2), nonetheless it could push up wages and thus add to inflationary pressures, and at the same time put company profits under pressure. On top of this, the minimum wage was again increased by 9% on 1 January 2013, and the unemployment rate, continues to be below the so-called natural unemployment rate – i.e. at a level compatible with low inflation – estimated at about 6%. Tensions on the labour market do not seem to be easing, despite the context of weaker growth that has characterised the country since mid-2011. Productivity is also still disappointing, due, notably, to the lack of a qualified workforce and the preponderance of underperforming service sector jobs<sup>(4)</sup>, which accordingly contribute little to the country’s growth.

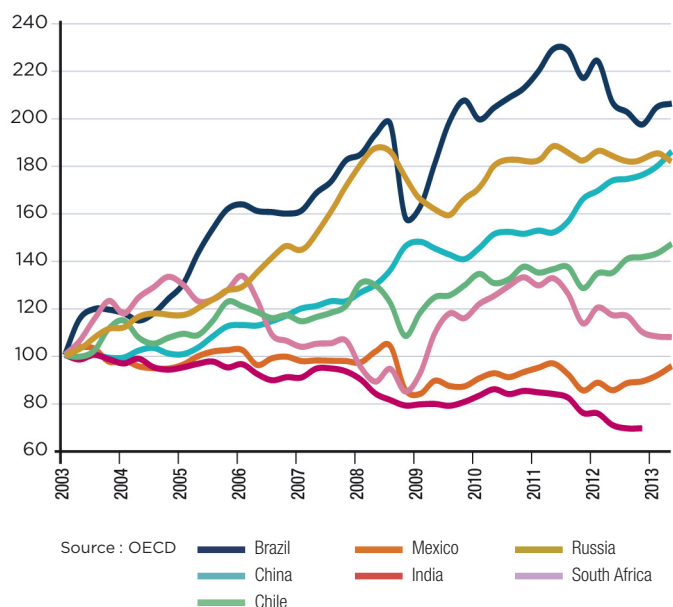
**CHART 3:**  
Unemployment rate (%) and real wages (Jan-03 = 100)



### ... costs are rising...

These wage increases have had a major impact on costs. Costs in Brazil are on a long-term upward trend, which significantly affects industry. Accordingly, industrial production shrank by 0.8% in 2012 (and again contracted by 0.3% QOQ in May 2013) while the services sector grew by 1.7%. The reason is simple: non-tradable services are better suited to adapting to rising wages, as they are more able to transfer higher costs in the form of higher prices. Brazil’s past experience clearly shows that periods of sustained growth in the country have often been accompanied by significant industrial dynamism (cf. Charts 1 and 2). Numerous measures adopted in 2012, both on the fiscal and monetary level<sup>(5)</sup>, were, however, intended to limit the loss of industrial sector competitiveness. But, this substantial 83% increase in unit labour costs between 2003 and 2012 (cf. Chart 4) undeniably caused the country to suffer a loss of competitiveness against its neighbours and other major emerging countries. The difference between hourly labour costs is, as a result, pretty spectacular: in 2012, while these were limited to only 2.2 dollars in Mexico, 4.7 in Chile and 3.17 in China, they were a whopping 11.1 in Brazil! These unfavourable unit cost dynamics have weighed heavily on Brazil’s productivity and growth, which have been slowed further by patently deficient infrastructures.

**CHART 4:**  
Unit labour costs (Jan-03 = 100)



(3) Pinheiro T. (2013), Brazil: exchange rate regime under pressure, Santander, Strictly Macro, June 20.

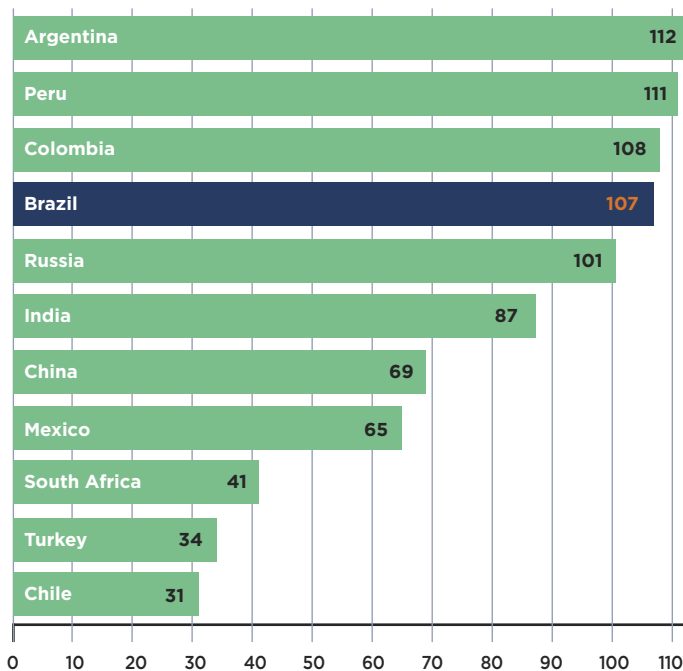
(4) The services sector has, in particular, benefited from a fall in informal employment: formal jobs accounted for 66% of total employment in 2012, compared with 57% in 2005.

(5) VAT reduction on domestic appliances and automobiles; reduction in payroll expenses in labour-intensive sectors; monetary stimulus; depreciation of the real, etc.

## ... and infrastructures are deficient

The cost of labour is not the only obstacle to Brazilian growth. According to the last BRICS figures regarding infrastructures (cf. Chart 5), Brazil is struggling to improve them despite the many projects in the run up to the Football World Cup in 2014 and the Olympic Games in 2016. This is because the quality of roads, port, air and rail infrastructures is still poor. The authorities are, however, committed to increasing expenditure further and are trying to encourage large-scale infrastructure investment, linked especially to the two major sporting events on the horizon. In 2012, President Dilma Rousseff unveiled a massive stimulus package based on public/private partnerships and the opening up of road, rail and airport concessions. Investors are still hesitant though, in the face of burdensome bureaucracy and administrative red tape, excessive and ineffective taxation, exacerbated by a desire for greater State control over the economy. There are, therefore, persistent doubts as to the country's internal capacity to implement the investment projects announced, especially as major investment projects have to date not progressed at the desired rate, as shown by delays in the major projects launched by former President Lula or progress on the Growth Acceleration Program (PAC2)<sup>(6)</sup>, on which only 30% of the planned budget was disbursed in 2012. These chronic infrastructure shortcomings thus continue to substantially impede the country's growth.

CHART 5  
Infrastructure rankings out of 144 countries



Source : World Economic Forum

(6) PAC2, launched in 2010, is the continuation of the first Growth Acceleration Program inaugurated by Lula in 2007, aimed at investing in infrastructure, public works and purchase of equipment.

## Conclusion

The renowned “Brazilian cost” has become a pressing problem for the country: the tense labour market situation, industry weakened by its lack of competitiveness and struggling infrastructure development. The Brazilian growth model, to date driven by consumption, has broken down. Meanwhile, the ever-increasing cost of living and infrastructure bottlenecks have generated huge discontent, evidenced by the mass demonstrations in mid-June 2013. The cure for Brazil's stagflation lies, not in economic policy, but in reforms to improve education and thereby increase the number of qualified workers. Furthermore, there must be a drive to improve infrastructures, if the country is to avoid bottlenecks. However, this is difficult medicine to take and the results will only become apparent in the long term. In the meantime, the population is becoming impatient...

By **Dominique Fruchter**  
Senior Economist, Coface

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## A Society under stress

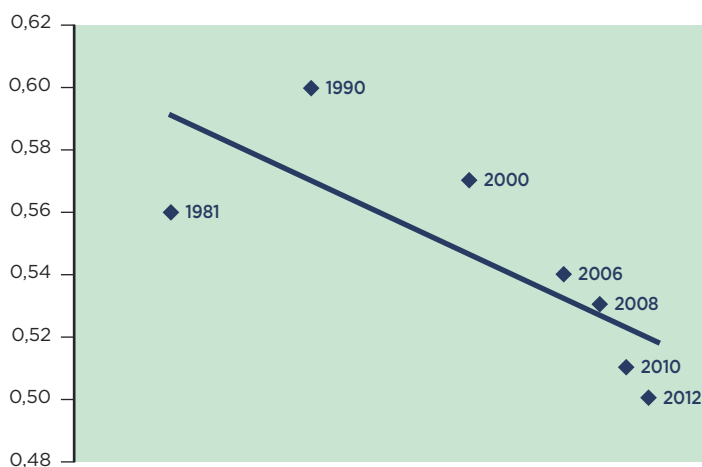
Poverty and inequality have decreased in Brazil over the last two decades. However, the big demonstrations in the summer of 2013 show that the reasons for discontent have not gone away, as there are still high levels of inequality. The political parties are struggling to provide a response to the demands of the middle class, which is no longer satisfied with the consumer society alone. With the prospect of several major international events (WYD, World Cup, Olympics), President Dilma Roussef is showing a readiness to listen. She has sufficient popularity, particularly among the middle class, which is now the majority, to allow her, at least partially, to impose the changes necessary to meet expectations.

### Distinct reduction of inequality and poverty...

The rise in GDP per capita has been remarkable (from \$7221 in 2007 to \$11490 in 2012) thanks chiefly to the substantial increase in real wages (average annual growth of 11% between 2007 and 2011), to the even greater increase in the minimum wage (+66%), to the growth of formal employment, to the development of social security and to macro-economic stability. The rapid expansion of credit has also played an important role. The improvement has been greatest for the regions and groups which had been furthest behind: the North East, the peasants, large families and the black population. The reduction of inequality has been significant: The Gini index (measuring income inequality) improved distinctly from 0.57 in 2000 to 0.51 in 2012. This has enabled a larger segment of the population to access consumption.

Poverty reduction began 12 years ago in 2001 with the first measures adopted during Cardoso's presidency. The flagship "Bolsa Familiar" programme of conditional aid established in 2003 by President Lula allows the most impoverished families to receive an average sum of 120 real every month (between 32 and 306 reals depending on the household income and composition), on condition that the children go to school and follow the compulsory vaccination programmes. The sums allocated were increased in 2011 by President Roussef as part of the Brasil sem Miséria (Brazil without extreme poverty) plan, then again in 2012 with the Brasil Carinhoso (Brazil that cares) programme. The number of beneficiaries is estimated at 36 million in 2013, or a fifth of the population. Another programme, the Benefício de Prestação Continuada is a non-contributory pension paid to poor older people and to the disabled.

CHART 1:  
Reduction of income inequality  
Changes in the Gini coefficient

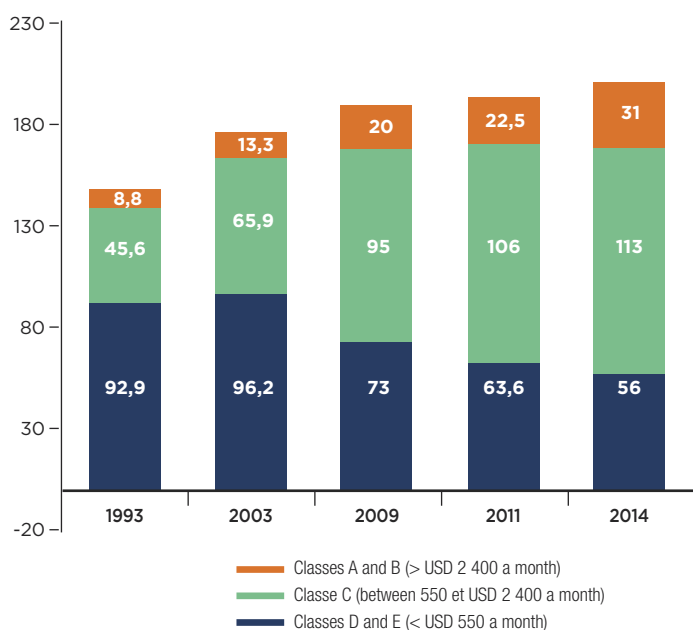


Sources : SEDLAC, World Bank

Extreme poverty (people living on less than 70 reals a month) has dropped sharply: in 2002, according to the Brazilian Economic Research Institute (IPEA), 14% of Brazilians lived below the extreme poverty line; in 2009 only 9% did so. With the extension of the aid programmes, the government estimates that all those registered under the Cadastro Único (Single Registry), another flagship measure for combatting poverty, have been taken out of extreme poverty. There are, however, still thought to be 700,000 unrecorded low-income families. Two thirds of these are thought to be in the North West and half are thought to be young.

The last decade saw the emergence of a large middle class called class C, or lower middle class (in Brazil income is divided into five levels from A to E). Between 2003 and 2012, some 35 million Brazilians went from income levels D and E to level C. This last category represents 55% (against 34% in 2005) of the country's population, with a monthly family income of between 500 and 1000 euros, whereas the minimum wage amounts to only 678 reais (230 euros). The surge in employment has been the deciding factor; the official unemployment rate has fallen and has stabilised slightly above 5% of the economically active population. Moreover the low cost housing programme called "Minha casa, minha vida" (my house, my life), introduced at the end of 2009, aims to reduce the housing shortage and is a means-tested subsidy intended for households earning less than 5,000 reais a month. At the end of 2012, one million families had moved into housing financed by this programme.

**CHART 2:**  
Population distribution by income class (in millions)



Sources : IBGE, Minister of Finance

## ... But grounds for social discontent persist

The demonstrations in the summer of 2013, bringing together several million people in the country's major towns and the biggest since those which had led to the departure of President Collor de Melo in 1992, are a good illustration of the persistence of social tensions. The traditional calm of the Brazilians, their supposed acceptance of inequalities and their unflinching good humour had their limits after all. Far left activists did indeed participate but the immense majority of the demonstrators belonged to the middle class, which now represents the majority of Brazil's

population. Students were well represented. Full employment, access to the consumer society, sporting events are no longer enough for them, particularly as growth is slowing, household debt is reaching its limits, inflation, a bad reminder of the nineties, is accelerating and certain incomes are hardly sufficient to keep up with price rises, which have been especially sharp for food and services. Deficient public infrastructures - transport above all - one of the major factors complained about, moreover, vie to frustrate the daily life of the middle classes.

What sparked it was the increased cost of public transport in Sao Paolo (from 3 to 3.2 reais) and Rio. The harshness of the police repression in the first few days with the use of tear gas, rubber bullets and water cannons strengthened the determination of the demonstrators. That the protests persisted after the announcement of the abolition of the transport price rise indicates that the discontent goes far beyond the cost of transport. The cost (17 billion dollars) of constructing the sports facilities needed for the big sporting events, the Football World Cup and the Olympic Games, which the country is to host respectively in 2014 and 2016, is judged to be excessive, while the education and health services are desperately short of funds to the detriment of their quality. They question the usefulness of the big stadiums which could turn out to be white elephants like that of Manaus, planned for 63,000 spectators, while local football matches attract only a few hundred people.

Public higher education, which drains off a large part of the public money devoted to education, is of high quality and very selective, but, to be able to get in to higher education, you need to have had excellent primary and secondary education. But the public primary and secondary education system is mediocre. Teachers are badly paid, so talented people are not attracted into the profession. The results of Brazilian pupils in the tests conducted in the context of international surveys are not conclusive. There are private schools but they are too expensive for most families. The public health system is affected by the same problems. These deficiencies are all the more surprising, since public spending accounts for 40% of GDP, which is high for an emerging country. All this raises questions about the effectiveness of public spending.

Another cause of discontent lies in corruption and more generally in the inadequacies of governance. The country's performance is only slightly better than the world average. After having improved, its rating has stabilised in an intermediate position. Corruption has declined but remains nonetheless significant. So despite the controls, the Minha casa, minha vida programme is not exempt from corruption, construction defects, mediocrity of the sites and lack of skilled labour. High-ranking politicians found guilty in 2012 in the context of the mensalao scandal have still not been imprisoned.

World Bank 2012 indicators	Voice and accountability	Political stability	Government effectiveness	Regulatory quality	Rule of law	Control of corruption
<b>BRAZIL</b>	<b>78</b>	<b>115</b>	<b>95</b>	<b>94</b>	<b>96</b>	<b>79</b>
CHILE	41	75	35	15	26	18
URUGUAY	34	50	65	76	63	30
MEXICO	100	159	78	84	131	116
COLOMBIA	119	187	80	83	112	114
ARGENTINA	91	99	109	159	143	123
INDIA	88	186	97	127	102	138

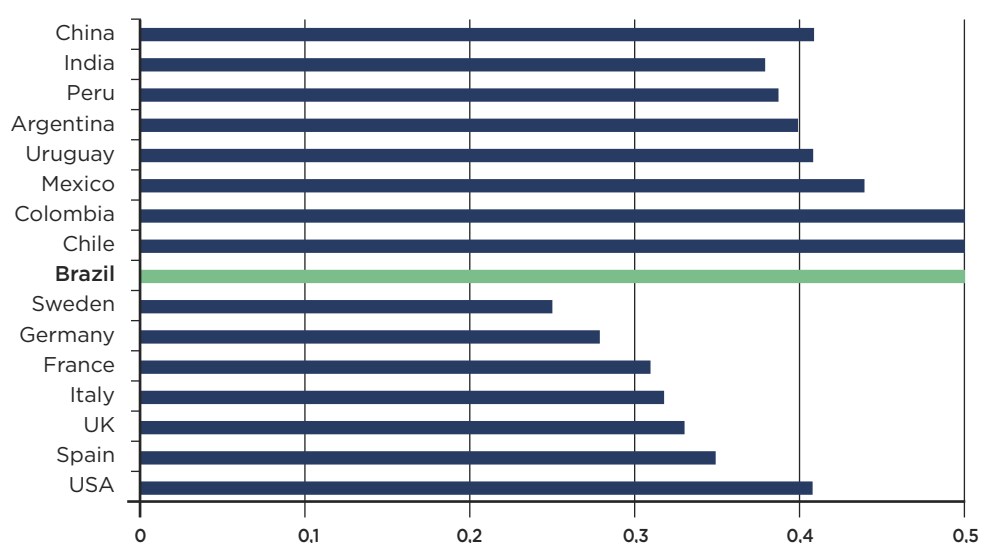
Despite their reduction, inequalities remain significant. The Gini coefficient, though improving, remains one of the highest among emerging countries. The richest 10% receive 45% of income while the poorest 10% have to be content with 1%. Inequalities exist both in the private market and in the public sphere, where some high officials earn more than their counterparts in advanced countries. A large part (38% in 2012) of obligatory deductions (VAT, social security contributions) does not rise as income rises and VAT is regressive. The poorest benefit little from the Minha Casa minha Vida social housing programme, which explains why 11 million people still live in favelas. Only 45% of the clauses concern families earning less than 1,600 reais a month. The inequalities lead to significant violence in urban areas, largely linked to drug trafficking. This is no longer limited to the favelas of São Paulo and Rio de Janeiro, where, moreover, it has significantly declined (one must doubtless see a link with police action in the favelas closest to the tourist areas with a view to the World Cup and the Olympic Games) and is taking over the economically less developed Northeast of the country, where the murder rate per 100,000 inhabitants can reach 50 or 60 (national average: 26).

## Tensions remain equally strong in the rural and forest areas.

Episodic conflicts occur between the armed militias of the landed proprietors and peasants belonging to the Landless Peasants Movement (MST). The search for new land in the north close to the future ports, while that situated in the Centre-West is already occupied by cattle farmers and expensive, is a further cause of dispute. The Chinese desire to buy land to cultivate soya and maize which would be processed in China could make the situation even worse. However, up to now, the federal and local authorities are proving reluctant.

The arrival of farmers and mining companies in Amazonia where 900,000 indigenous people are concentrated is also a source of conflict. Their reserves, which cover 100 million hectares (1/8 of the country's surface), are highly coveted. The galloping rate of deforestation has, however, slowed markedly with the adoption of more protective legislation, protection which is, however, relative because, if a business does not meet its obligatory quota of land left virgin, it can make up the difference by buying a certificate from another which has a surplus. This trade leads to great disparities between federated states.

CHART 3:  
INCOME INEQUALITY - GINI COEFFICIENT



Sources : SEDLAC, World Bank



## A difficult but real political response

The demonstrations are spontaneous and are not a response to any political instructions. No leader seems to have emerged. Their growing scale is explained by the use of social communication media. The demonstrators are expressing particularly their disillusionment with the administrative, political and financial institutions, accused of favouring the elite. Despite the coming into power of a centre-left government, in 2003, and the appointment of former trade unionists and women to the government, the political figures have scarcely changed. The lack of change is due to the electoral system (proportional representation for the deputies) and private funding of campaigns, which favours those with substantial financial resources or family backing. No party seems able to profit from the movement. Moreover, their reactions, including those of the opposition, are embarrassed and discreet.

Dilma Roussef, elected in the second round of the presidential elections of 31 October 2010 with 56.5% of the votes, quickly declared that she sympathised with the demonstrators and expressed her determination to take their demands into account. Besides her convictions as a former combatant in the civil war, the holding of World Youth Day in Rio at the end of June, organised by the Catholic Church, with its cohorts of young people from all over the world, may have played a part in her attitude. She has committed herself to ensuring that oil revenues will be devoted to education and the health system, reinforced by recourse to more foreign practitioners. Already before the protests, the authorities had indicated their intention to hire 6,000 Cuban doctors to fill the unfilled positions in the North East and Amazonia. 50 billion real will be devoted to public transport. A plebiscite may be held about institutional reforms in order to be adopted by the Congress, especially in electoral matters. It remains to be seen if the coalition in power will support these new policy directions that are rather vague. For now, only the first commitment has received a positive vote in the Senate.

The President has a big majority in both houses of Congress: 72% in the Chamber of Deputies (or 73 seats out of 51) and 76% in the Senate (62 senators out of 82) in the framework of a coalition of 11 parties, among them that of the President, the Workers' Party (PT), the PMDB and the PSD. The opposition is reduced to the Brazilian Social Democracy Party (PSDB), the Democrats (DEM) and the Popular Socialist Part (PPS), the three of them represented by 111 deputies and 18 senators. The Green Party, whose candidate, Marina Silva came third in

the first round of the presidential election with 20% of votes, remains independent. The presidential majority rules 16 federated states out of 27. The opposition has, however, held onto those of São Paulo and Minas Gerais. The October 2012 municipal elections did not challenge this situation. The Sao Paulo mayoral election was even won by Fernando Haddad (PT), beating Jose Serra.

## A fragmented presidential majority, but Dilma remains popular

After an easy start to her term in office, the President suffered a series of setbacks. The most significant is the so-called "Mensalão" case before the Supreme Court, in which some forty leaders of the Workers' Party who had since become parliamentarians or ministers were prosecuted. Most of those charged were finally convicted during October 2012 of having bought parliamentary votes thanks to money from state enterprises during the Lula presidency. Dilma Roussef thus had to separate herself from several ministers implicated. However, at the end of June 2013 no one has yet been imprisoned.

The President has also plenty to do to preserve the unity of her coalition, which brings together a dozen parties in which discipline is limited and the participation of women tiny. She has to bear in mind sensitivities when sharing out the posts in her government. The lobbies, particularly the agricultural ones, are powerful. Passing a law is frequently difficult. This has recently been the case with the forestry law and the new distribution of oil revenues among the local governments. The latter will have to be modified to correspond to a new commitment made by the President.

Will Dilma Roussef be able to use her personal popularity to persuade? His approval rating has fallen with the rise of the social unrest. But in the next presidential elections in October 2014, she will be able to count on the support of the middle class, which owes a good deal of its enrichment to her. Moreover, 51% of people stated that they intended to vote for her, her main opponents, Marin Silva of the ecological party, third in the last election, and Aécio Neves, of the PSDB gaining less than 15% of voting intentions. The opposition has no credible candidates for the imminent elections. The risk of seeing a competitor rise from within her coalition is also slight since, for the time being, Dilma remains the Workers' Party's best re-election trump card.

## Conclusion

The demonstrators' demands are both qualitative and quantitative in nature. They concern political practice, education, health, transport and housing. Though the President says she is determined to respond to the demands, the responses made will inevitably take time.

# INTERVIEW

**Cristiano Souza**

Economist, Santander

*« A balance of payments crisis does not seem likely »*

**Brazilian GDP has been growing in a weak pace, 0.9% in 2012 and 0.6% in the first quarter of 2013 compared with the quarter right before. What is the main reason for this performance?**

GDP performance has been impacted due to the weakness of two components: investment and household consumption. The first one contracted by 4% in 2012 thanks to the reduction in investor confidence and the rising cost of the imported machinery, as a result of the exchange rate depreciation. The second one suffered with the slowdown in the credit growth (in response to the higher delinquency rate) and showed some loss in strengths in 2012. Investments rose in early 2013 as a consequence of the truck production recovery. On the other hand, household consumption has additionally decelerated, associated to the higher inflation rate. At the same time, imports have grown, reflecting negatively on GDP growth.

**What is your outlook for GDP growth in 2013 and 2014?**

We forecast a growth of 2.3% in 2013 and of 2.1% in 2014.

**Inflation surpassed the target ceiling of 6.5% a few times this year. What is the perspective for the second half of 2013 and for 2014? What explains this behavior?**

In our opinion inflation may show some slowing in the second quarter of 2013, as food prices continue in a weakening trend. However, the demand for services should continue exerting pressure on industry prices, something that should be magnified by currency depreciation. Both effects should ensure inflation at 6% this year and 6.4% in 2014.

**Concerning macro policies, government is intervening on the economy (with trade protectionism and tax relief measures on sensitive sectors). Are those politics efficient to boost investments?**

The recent interventions have generated uncertainty and it could be noticed with the fall in investor confidence. On the other hand, there are signs the government intends to boost investment in infrastructure through the private sector (concessions). This would be an efficient mechanism in the medium and long term to reduce costs in Brazil and boost productivity.

**How do you think the government might behave, in terms of macro policies, in the second half of 2013 and in 2014?**

The government must focus on monetary policy, increasing the Selic rate (reference interest rates) to 9% at the end of this year in an attempt to contain inflation. In view of the effect of tax exemptions on income tax, fiscal policy should not reverse its expansionary trend. In this scenario, the concessions should play an important role for investment, since they are managed in the most efficient possible way.

**The ratio Investments/GDP closed 2012 in only 18.1%, value below the one reported in 2011. What was the main reason for this contraction?**

The investment fell by 4% in 2012, thanks to the reduction in investor confidence and the rise of the imported machinery cost, due to exchange rate depreciation.

**Which would be the ideal investment ratio so that the country could grow in a higher and sustainable pace?**

Our studies show that every 4 percentage points in the ratio investment/GDP, the potential product grows by 1 percentage point. Therefore, if we want to match the performance of our Latin American neighbors who have shown consistent growth between 5% and 6% in recent years, we would need an investment rate of 25% to 26% of GDP.

*Inflation may show some slowing in the second quarter of 2013.*

**The lack of qualified workers is a recurring complaint of the entrepreneurs. How to raise the educational level in the short term?**

Education is not a issue that can be solved in the short term. The countries that have experienced growth acceleration due to investment in education, like South Korea and Taiwan, took two decades to reap the rewards of investments in the sector. The lack of qualified workers might be solved, in the short term, as it has always been in the country: with training in the workplace, which is costly for companies.

## INTERVIEW

### **Which are the main promising sectors of the economy in the short term?**

The sectors that are most protected from international competition, like services, can maintain their profitability. In addition, heated labor market should be the main factor driving its growth. If the infrastructure projects are well underway, related sectors should also show better performance.

### **Which sectors may face difficulties?**

In view of the external uncertainties, with lower Chinese growth too, sectors that rely more on exports or from industries facing hard competition from imported products must be the most negatively affected.

**The trade balance performance has been falling in the last months, due to a higher growth of imports in comparison with exports. Which is the main reason of this behavior? Furthermore, deficit in the services account increased in the same period; therefore we have been verifying record deficits in the current account. In your opinion, is there any chance of facing a balance payment crisis?**

There are three reasons that explain the fall in trade surplus. The first is the low Chinese growth, which has contributed to falling commodity prices and stagnation in terms of trade (ratio of export prices and import prices) of Brazil. Secondly, the demands for Brazilian products do not show itself robust, due to of low global growth. There is then the special case of Argentina, which has created imports barriers. Thirdly, demand remains strong, despite low GDP growth. With domestic absorption (sum of household consumption, government consumption and investment) growing above GDP, there is a part that

is offset by imports. These three factors have contributed to the weaker trade balance results in more than a decade.

Even with higher deficits in current transactions and the fear of a reversal of monetary policy in the U.S., a balance of payments crisis does not seem likely. Investment flows continue to more than offset the current account deficit and foreign reserves remain at historically high levels.

### **Finally, how do you expect the exchange rate to behave in the second half of 2013 and in 2014?**

We estimate the exchange rate to end 2013 in R\$2,10/US\$ and in R\$2,30/US\$ in 2014. Part of this pressure comes from the external accounts, although it is not a sign of balance of payments crisis, they no longer show the abundance of resources that it use to in recent years. Another factor causing the depreciation must be the change of direction in U.S. monetary policy, which should continue appreciating the dollar as the Federal Reserve reduces its purchases of assets.

*If we want to match the performance of our Latin American neighbors who have shown consistent growth between 5% and 6% in recent years, we would need an investment rate of 25% to 26% of GDP.*

# INTERVIEW

**Luiz Rabi**

Economist, Serasa Experian\*

*« Considering businesses delinquency rate<sup>(1)</sup>, there is a little room to fall from the already 3.6% »*

**After its growth in 2012, the delinquency rate for individuals fell in the first months of 2013. What does such behavior assign to?**

The delinquency rate on individuals peaked 8.2% in October 2012 and has been decreasing since then, achieving 7.5% in April 2013. In 2010 credit access was really easy and people got very leverage. After a while, delinquency grew significantly so that the financial system decided to become more restrictive. The new context in addition to the job market condition (low unemployment and stable real wages) allowed the rate to assume a declining tendency.

**Should the reduction also imply on a lower delinquency rate for businesses?**

The fall in delinquency for individuals tends to impact on the businesses, but the historical average of this indicator is of 7% (we do not expect it to decrease a lot more). Furthermore, other indicators impact more on the delinquency for businesses: economic growth and cost of credit (interest rate). The first one is performing relatively better (comparing with the last year), but it is still low. The second one has been increasing in the last months, due the higher Selic rate (Brazilian government reference rate). Summarizing, there is not much more room to a decrease in delinquency. One effect tends to cancel the other.

**Is delinquency concentrated on a specific size of a company?**

Micro and small size companies account for 90% of the cases that Serasa receives. Those are the ones with turnover up to 4 million reais (1.8 million USD) per year.

**Serasa has recently launched a new index, Educação Financeira do consumidor (Consumer Financial Education). What were the main results achieved?**

This index was obtained through interviews and it is a constituted by 3 components: a - credit knowledge, financial education; b- the attitude that the person said to have, how it stands and c- the real behavior. From 0 to 10, knowledge got the best grade, an 7.5. Attitude got a 6 and, finally, behavior got a 5. In addition, some interesting results were verified like: men and women have the same behavior and this is independent of the wage range. Finally, overconsumption is associated with Brazilian culture.

**Brazilian credit Market is very recent, it has significantly boosted after 2005. Is the income percentage committed with funding (wage/credit installment) still acceptable?**

No, the percentage is substantially high and is around 21%, according to Brazilian Central Bank. Regarding borrowing per individual, it doubled after 2005. This is a result of the increase of payment terms and lower interest rates. The peak in delinquency verified in 2011-12 was caused by the heel in three percentage points in wage commitment. This warned the Central Bank that it had achieved the maximum acceptable, in other words, it was already time to turn the credit more restrictive.

**Nowadays we can only know if an individual is in default or not. With the launch of Cadastro Positivo (Register Plus) however, it will be possible to observe the consumer's indebtedness. What will be the main gains?**

With Cadastro Positivo we will know the wage percentage that is already committed. The requirement of the pay slip will be replaced and will benefit people which are not able to prove its income. The person will have the chance to follow its score and the spread tends to decline to the good payers.

**What were the effects observed in the countries that have adopted a similar tool?**

From the 20th richest countries in the world, Brazil was the only one that did not count with a Register Plus tool. This product is already mature in many countries and this will change the Brazilian credit culture. Outside people follow its score on a regular basis, in order to hire loans with lower interest and also reflect positively on the timely payment.

**Finally, should the average delinquency rate in 2013 be lower than the verified in 2012?**

Delinquency for individual could fall up to 7% until the end of the year, closing 2013 with an average rate of 7.3%. Considering businesses delinquency rate, there is a little room to fall from the already 3.6%.

*Delinquency for individual could fall up to 7% until the end of the year, closing 2013 with an average rate of 7.3%*

\* Credit bureau

(1) Only on bank credits

# INTERVIEW

**Fernando Figueiredo**  
Executive President, Abiquim\*

*«I'm sure we are now starting to build industry of the year 2030»*

## **What is the size of the chemical industry in Brazil and its position in the global context?**

The latest consolidated figures in global terms refer to 2011. The Brazilian chemical industry with a turnover of 157 billion USD held the 6th largest position in the world. In the same period, the local market (production plus imports less exports) had an estimated value of 183 million USD. The difference between what the industry produced and what the market had effectively demanded has therefore created a deficit of 26.5USD in 2011. In 2012 the deficit reached 28.1 million USD and in 2013 it is expected to surpass 30 million USD. Nowadays around one third of the chemical market is occupied by imported products.

## **What are currently the main challenges of the chemical industry?**

The chemical industry has four key challenges: the price of raw materials, the cost of energy, the high cost of investment in machinery, equipment and engineering services and low investment in research and development.

Certainly, the main challenge for the chemical industry is the high cost of raw materials. The gas in Brazil, for example, costs 4 times more than in the United States, and almost 50% more than the price in the European market. Furthermore, it is estimated that the investment in a new factory in Brazil is 25% higher than the cost in Asia and 10% higher if we consider the United States. Finally, Brazilian companies invest approximately 0.7% of sales in R & D, while the global average is around 2%.

## **How should this industry perform in 2013?**

Over the past 20 years, with few exceptions, the chemical market in Brazil has been increasing by 25% over the local GDP. In 2012, the market was stagnant, but production increased by 2.8%, replacing part of the volume imported. However, in the first quarter of 2013, the market grew by impressive 7.1% (despite low GDP performance), but production fell by 1.3%. Our forecast is that we will return to normal levels in 2013 and expand 25% above GDP, with production following this performance.

\* Brazilian Chemical Industry Association

(1) Pre-salt: Discovered in 2007, the pre-salt layer is a large deposit of oil located beneath the seabed, with a volume of approximately 50 billion barrels, and comprises a range of 800 km between the states of Espírito Santo and Santa Catarina, away from 100-300 km from the coast.

## **The chemical industry is known as very energy-consuming. Has the recent reduction on electric power tariff promoted by the government caused any relevant impact over the companies' costs?**

Yes, cost of energy reduced between 17% and 25%, however, as I mentioned before, it is still 50% higher than the United States.

## **The USA has further consolidated its leadership position through the exploration of shale gas, which has cheapened the energy cost. Could the adoption of this model improve local competitiveness in Brazil?**

The technological improvement that allowed the economic exploitation of shale gas in the United States is revolutionizing the petrochemical industry worldwide. Experts are divided between those who believe that the phenomenon could be repeated in other parts of the world and those who think that shale gas is a uniquely American phenomenon.

Many articles have been written on the subject and will continue to be written, but one thing is absolutely true: the American shale gas has revolutionized the global petrochemical industry.

The news in Brazil is good: we do not know if we have shale gas, but the National Petroleum Agency (ANP) will bid in October the first areas to companies interested in your exploration.

However, better than this is the production of natural gas resulting from the pre-salt<sup>(1)</sup>: Experts estimate that natural gas production will more than double by 2020, if the fields located in the pre-salt get exploited.

*Certainly, the main challenge for the chemical industry is the high cost of raw materials. The gas in Brazil, for example, costs 4 times more than in the United States, and almost 50% more than the price in the European market.*

## INTERVIEW

What Brazil needs to do is follow the American example: Using the discovered gas to stimulate the production of chemicals that add value corresponding 6-7 times the amount of gas.

Simply exporting the gas is not in the plans of the U.S. and should not be in the plans of Brazil.

With respect to Europe, there is a paranoid view that the exploitation of shale gas is harmful to the environment and its exploitation is still under discussion. The Americans have shown that the environmental issue can be resolved. Moreover, investments in the environmental sector have grown much in the United States. It would not be a surprise to me that one day Poland began producing shale gas, as they hold this natural resource, making them independent of Russia.

**Beyond the high cost of electricity and natural gas, the scarcity of skilled workers is also a reality in Brazil. In our opinion, what would be the best way to deal with it?**

For the current size of the chemical industry, there is no shortage of specialized workers. The problem would only arise if the investments estimated by the Pacto Nacional da Indústria Química<sup>(2)</sup> (National Pact of Chemical Industry) of \$ 167 billion were made. Chemical industry currently employs 400 thousand employees. If investments are made, we will need more than double the number of labors, which do not currently exist in the market.

*The technological improvement that allowed the economic exploitation of shale gas in the United States is revolutionizing the petrochemical industry worldwide.*

We are talking to Senai<sup>(3)</sup> and to the Brazilian Agency for the Industrial Development to carry out a detailed study of the effective demand and the profile of the professionals needed to achieve the qualification. Furthermore, there is no lack of financial resources to conduct a training program of this size, because the Federal Government has allocated resources and Senai is technically very well prepared to implement such a program. It is big challenge, but I think we can overcome it.

*Simply exporting the gas is not in the plans of the U.S. and should not be in the plans of Brazil.*

**On April 23<sup>rd</sup> the Government announced a reduction in taxes over raw materials. Should this measure boost investments or the resumption of projects that had been postponed?**

The exemption of taxes on the purchase of raw material from the first and second petrochemicals generation was a crucial decision for the chemical industry, however, it should not cause an immediate effect on investment. Let me explain: the chemical industry has been operating at low capacity utilization (about 80% in the last six years), when the ideal is to operate at 95%. Thus, this tax will raise the capacity utilization to levels above 90%, which, when achieved, will encourage companies to think about new investments.

**How has the scenario of lack of competitiveness, high interest rates and soaring imports impacted on companies' balance sheets**

It has impacted in several ways. It has been increasingly difficult to manage the rising costs associated with the maintenance of productive activities and the operating margin has also been pressed. Regarding the interest rates, as the industry is capital intensive, this becomes a very important variable and worrisome for two aspects, burdening those who have made investment in recent years and discouraging new investment.

As the chemical has the need to operate at full load above 90%.and the world has not recovered from the financial crisis of 2008 yet, there is a lot of surplus. This has been placed in Brazil at marginal prices, rising imports and jeopardizing the financial position of companies in the domestic market.

**Could you quantify the sector delinquency rate and its evolution?**

ABIQUIM do not follow the delinquency in the sector.

(2) Pacto Nacional da Indústria Química- study conducted in 2010 by Abiquim. It defines the commitments of the industry with the economic and social development of the country and points the main obstacles that slow decisions of investors, national and foreign, to expand business in the Brazilian chemical industry.

(3) Senai is a private institution in Brazil, but with public interest. Its main objective is to develop and implement professional training courses to better prepare people for the market.

## INTERVIEW

**The entrepreneurs have claimed for the exemption of investments (by reducing taxes over engineering, machinery and equipment). What is the status of this proposal?**

When President Dilma Rousseff ordered the creation of the Plano Brasil Maior structured in the form of Competitiveness Councils, it was established one directed to chemical, petrochemical and plastics.

The work was coordinated by National Bank of Economic and Social Development (BNDES) and the Brazilian Ministry of Development, Industry and Foreign Trade (MDIC), in meetings with employers, workers and government representatives. The report covered all the real issues for the chemical industry and, recently, the President directed the publication of the Plano Brasil Maior Agenda.

### **Short-term strategic agenda:**

- Raw material exemption - already implemented.
- Encouraging investments - to be implemented by August 2013.
- Encouraging innovation - to be implemented by August 2013.
- Policy for use of gas as a raw material - to be set up in December 2013.

### **Schedule structuring:**

- Schedule technological sector for renewably sourced products - in progress, and discussed with employers, employees and members of the Academy.
- Training of human resources: Being initiated through discussions with Senai and the Brazilian Agency for Industrial Development.
- Improvements in infrastructure: The return of the privatization of the railways and highways is a significant advance and the new regulatory framework for ports allows us to provide improvements substances in the medium term.
- Regulating pesticides: This month shall be scheduled a meeting with representatives of government and industry to talk about.
- Study diversification of the chemical industry: The BNDES formalized hiring consortium BAIN Company / Gas Energy and the study has been initiated and is expected to complete in 12 months, from May 1.

I'm sure it will be the final stimulus to the resumption of investments in the chemical industry. As you can see, many things are starting to happen and take some time to materialize. This, however, is not a problem for the chemical industry. It is a long-term industry. I'm sure we are now starting to build industry of the year 2030.

We Brazilians like to have things ready for yesterday, the chemical industry thinks about tomorrow.

By **Patricia Krause**  
Economist, Coface Brazil

## Chemicals: An impressive growth but a weak competitiveness

The chemical industry is the 4<sup>th</sup> largest in the country, represents 9% of Brazil's industrial GDP and 2.3% of its overall GDP, according to 2012 figures. Local industry is specialized in four areas: Chemical products used as input by the industrial sector (mostly for the automobile, electronic and textile industries), pharmaceuticals, chemical products used as input by the agriculture sector and cosmetics. Net revenue has increased by 236% in 10 years allowing Brazil to become the 6<sup>th</sup> bigger chemical producer in the world. Despite that, the industry's growth is slowing down since 2011, due to frail competitiveness in the international stage.

Gas is an essential raw material and its cost is not competitive. For instance, prices are around 33% higher than in the US or Canada. The scenario has also aggravated, due to the rise in the consumption of natural gas derivative from the use of thermal power plants in the country, in order to save water in the reservoirs of hydroelectric plants. According to the Petroleum National Agency, expenditure on natural gas imports rose by 77% between January-April 2013 compared with the same period in 2012. As the purchase is made on the spot market, the country is subject to gas international prices volatility (Brazil does not hold long term contract). Moreover, the recent appreciation of the dollar tends to negatively impact the price of the imported natural gas. It is also worth mentioning that the exploitation of shale gas by the United States had also impacted the industry in a global context. Its cost is much cheaper than any other available resource.

The industry is also known as a very energy-consuming one and is impacted by its high prices in Brazil. In the beginning of 2013, the government decided to reduce the power tariff between 17% and 25%. Nevertheless it is still high if compared with other countries, like the United States where cost is around 50% lower. The lack of qualified worker is also an issue to be solved, as it pressures the wages up and, consequently, impacts the profitability of the businesses. Infrastructure is also underdeveloped, as the cost to invest in the country is still very significant (Brazil used to have the highest interest rates in the world).

In face of the facts presented above, the chemical trade balance has gone through a dangerous tendency. Nowadays 30% of the products consumed in Brazil are imported. Brazil's exports of chemical products increased by 41% between 2007 and 2012, but its imports (see chart below) grew almost twice faster, during the same period of time, registering an 81% increase. The country closed 2012 with chemical trade deficit of 28 billion USD and is estimated to be above 30 billion in 2013.

The government is already aware of this threat and seems to be working together with members of the industry. They have structured a council called "Plano Brasil Maior" and were established to cover the chemical, petrochemical and plastics sectors. The aim is to raise all points that do not allow the industry to continue growing. A first result was already achieved: the government reduced the taxes on the raw materials and many others are on the agenda to be voted.

It is also relevant stressing out that the fertilizers and pesticides segment is very vulnerable to the agriculture market conditions. The last one usually works with higher payment term and has a significant level of risk inherent in the business, as a negative supply shock may occur unexpectedly (like a drought). Those cases most often involve long reschedule plans.

The outlook for the chemical industry is challenging. According to a study conducted by Brazilian Chemical Industry Association (Abiquim) it would be necessary to invest 167 billion USD until 2020 to meet the rising national demand and to improve its trade balance. However investments are expected to achieve only 2.3 billion USD until 2015. To get closer to these figures in a context of high interest rates, the government needs to be really committed to reach this target. Furthermore, in 2007 it has announced the discovery of a large deposit of oil located beneath the seabed, a range of 800 km between the states of Espírito Santo and Santa Catarina, away from 100-300 km from the coast. The field was named as Pre-Salt and its exploitation could raise significantly the production of natural gas and, by consequence, reduce its price.

### Brazilian Chemical Imports 2012

Description	Million USD	% of total
Inorganic 11623	27	
Pharmaceutical Products	9537	22
Organic 8335	19	
Resins and Elastomers	5371	12
Pesticides 3308	8	
Various Chemicals	2457	6
Artificial or synthetic fiber, wire, cables and filaments	984	2
Soap, detergent, cleaning products and perfumery	853	2
Paint and Varnish (including enamels and lacquers)	514	1



# Steel: Assets to reverse disappointing results

Brazil is the main steel producer in Latin America and the 9th in the world. The industry is heavily concentrated in the Southeast region of the country (94%), mainly Minas Gerais e Rio de Janeiro. It counts with 29 plants belonging to 11 business groups. The real estate, automotive, machinery and equipment account for 80% steel consumption in Brazil. From 2009 to 2011 its production grew by an annual average rate of 8%, but since the mid of 2012, production and sales are slowing down. In 2012 production contracted by 1.5%.

This industry is characterized by a high concentration of market share, the four main producers account for over 80% the market. The Indian group ArcelorMittal, the world's leading producer, also holds this position locally. The following positions are occupied by Brazilian companies, respectively, Gerdau, Usiminas and Companhia Siderurgica Nacional. According to 2012 figures, the local production of steel was composed by flat steel (45%), long steel (32%) and semi-finished (23%). In the recent years long steel has gain representativeness due to the development of the local real estate market.

The poor performance observed in 2012 is a result of lower growth rate in China, the moderate activity level in the United States and the recessionary scenario still present in Europe. In addition, Brazilian GDP grew only 0.9% last year and, worse, the industry contracted 2.7%. As a consequence of this outlook, there is a global oversupply of steel, which has pushed the prices down. Consumption in Brazil increased only 0.5% in the same period of time, in line with the weak performance of the main markets. Automobile production contracted by 2%, real estate grew by only 1.4% and machinery and equipment performed negatively in 2012 (gross fixed capital formation felt 4% YoY).

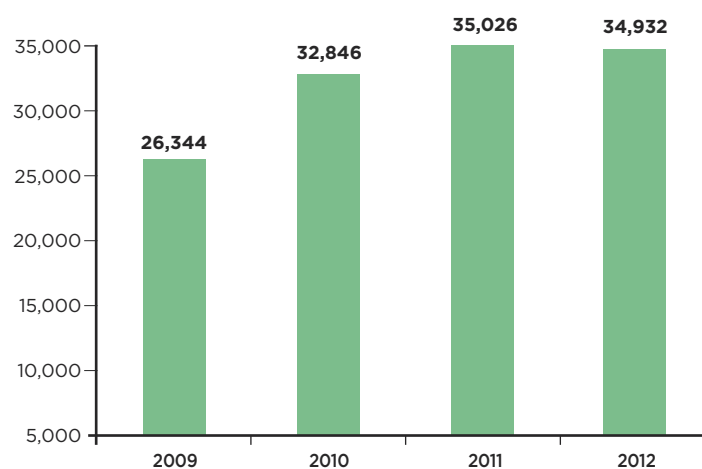
Furthermore, the main raw materials for the flat steel are, respectively, coal and iron ore. Despite the declining tendency of both commodities, Brazil imports 100% of the consumed coal, so the plants structure cost are strongly vulnerable to exchange rate variations. In 2012 the real (Brazilian currency) devaluated by 17% against the dollar and in recent weeks has verifying a significant appreciation. Fortunately, iron ore is not a problem, as Brazil is major producer.

It is worth mentioning that national plants are not able to pass on the rise on raw materials prices to the consumer immediately, thanks to the fierce competition of the imported products (pressing the industry margin down). Many steel producers of countries that are with low economic activity (like European ones) are trying to gain market abroad, to compensate its local poor performance. Pressured by the local producers, in September 2012 the Brazilian government raised by 25% the import taxes of various steel products.

The steel sector is also very export oriented (30% of its production) and even with a devaluated real, exports contracted by 10% in 2012. Historically semi-finished products are the most exported (68% in 2012), followed by flat steel and, ultimately, long steel. Concerning the imports, flat steel is the most imported one.

The Brazilian Development Bank (BNDES) has estimated the steel industry to investment 14 billion USD from 2013-2016, 20% less than the period of 2008-2011. The reason is the world installed overcapacity of 526 million tons of steel. Mining and steel makers are focusing their investments in the production of iron ore, that despite the recent drop in price, still has a very positive profit margin. It is relevant commenting that Brazil is a major producer of iron ore and is also the main component of your export basket.

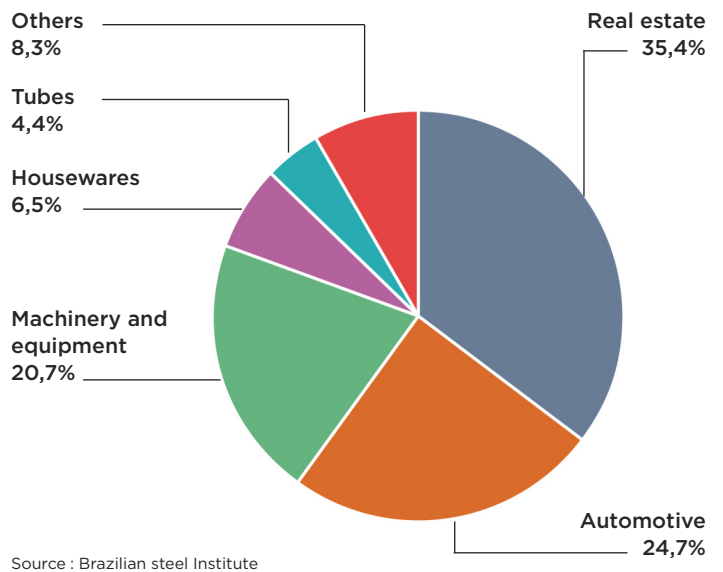
**CHART 1:**  
Steel production (ton)



Source : IBS

In short, the current industry performance is weak, but we have local opportunities to turn over this scenario. Brazilian economy might grow in a moderate rhythm in 2013 (2.7% according to Brazilian Central Bank), which is already better than the marginal increase verified in 2012. In particular, according to the figures of the first quarter of 2013, investments expanded by 4.6% compared with the quarter immediately before. Significant investments in infrastructure are also expected to the upcoming months, due to the program “Brazil Growth Acceleration Program”, the World Cup and Olympic Games investments. Moreover, the outlook for the automobile is positive, government has recently announced incentive program, which will boost investments in the sector and will raise its production.

**CHART 2:**  
Steel consumption by sector (%)

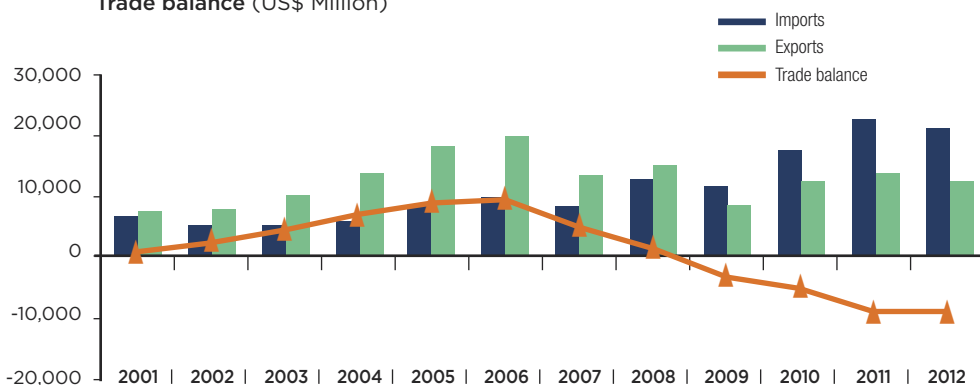


## Automotive: The fourth market in the world arouses covetousness

Brazil ended 2012 in fourth place in the ranking of world's largest domestic market and in the 7<sup>th</sup> position in terms of production. Considering the same period, it represents 21% of the industrial GDP or 5% of the total one. Indeed, the growth of the middle class in the country coupled to a low inhabitant per vehicle ratio allowed a steady increase of production. From 2003 to 2012 the number of produced units per year increased by 88%. Furthermore, automobile is responsible for employing 1.5 million people and taxes corresponds to 30% of automotive consumer prices (the highest in the world), so the government is always following this segment very closely.

The leading players of the market in terms of production are, respectively: Volkswagen, Fiat, General Motors and Ford (together they represent 75% of the total volume). Considering local sales, the main companies are the same, only changing Volkswagen and Fiat positions (total market share of 68%). Moreover, the country is attracting increasing investments and automotive holds the 2<sup>nd</sup> position as receptor in the Brazilian industrial sector of foreign direct investments. In the last 10 years finishing in 2012, the accumulated investment in the industry achieved almost 27 billion USD.

**CHART 1:**  
Trade balance (US\$ Million)



Source : Alice Web Mercosul

It is also worth mentioning that government has recently launched stimulus program, called Inovar- Auto. The aim is to stimulate new investments in factory expansion, modernization, and development of new vehicles, energy efficiency and technological content. They expect to achieve more than 23 billion USD in investments between 2013 and 2017 and it has already showed signals of adhesion. In June, Fiat announced that will invest 7 billion USD until 2016, in order to develop new products and technologies to achieve the goals set by the program. In the same line, Volkswagen also committed itself with 4 billion USD for the same period. The Japanese brands, like Toyota and Honda also decided to accelerate their expansion projects, thanks to the new incentives.

Furthermore, the major automakers that are already established in Brazil for a long time are not the only ones to show interest for Brazil. Since 2010, the country has benefited from increasing attention from Chinese and South Korean automakers. They arrived in the country with a competitive price, threatening both the main players and the less representativeness ones. Concerned with the car imports growth, the government decided in the end of 2011 to impose barriers. They raised in 30 percentage points the tax over the industrialized products for cars that do not reach the minimum percentage of 65% of domestic content (exceptions Argentina, Mexico and Uruguay). Chinese brands (like Cherry and Jac Motors) are already building its first factories in Brazil and others (like Geely) are studying the possibility.

The Brazilian automobilist industry is located on the South-South East axis of the country. The industry is focused in the production of cars and light commercial vehicles. Last year, sales of cars and light vehicles, in terms of volume, increased by 6.1%, thanks to the postponement of tax increases, favor-

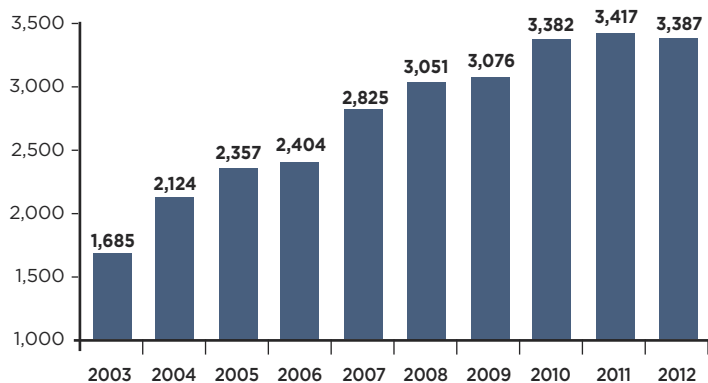
able job market, credit conditions (lower interest rates), fierce competition among automakers and gains in wages. The outlook has deteriorated a little, so sales are expected to grow at a slower pace this year. According to Tendências, a well-known Brazilian economic consultancy, the segment should expand by 3.2% in 2013.

Sales of buses and trucks reduced considerably in the same period, however, it was considered as a natural temporary result of the implementation of Euro 5. This new standard was implemented in the early 2012 and it aim is to reduce the emission level of pollutants in the atmosphere. The segment already showed recovery signals in the first months of 2013, from Jan-May grew by 8.97%.

Finally, Brazil concentrates its exports on the Mercosul area, which represents more than 60% of its sales. Argentina is the main commercial partner, but this relationship was affected by new imports rules implemented by Argentine government in 2012 (balance between these two countries remain positive to Brazil). Asia is the region responsible for the Brazilian trade deficit, as 41% of the imported vehicles comes from this region and exports none.

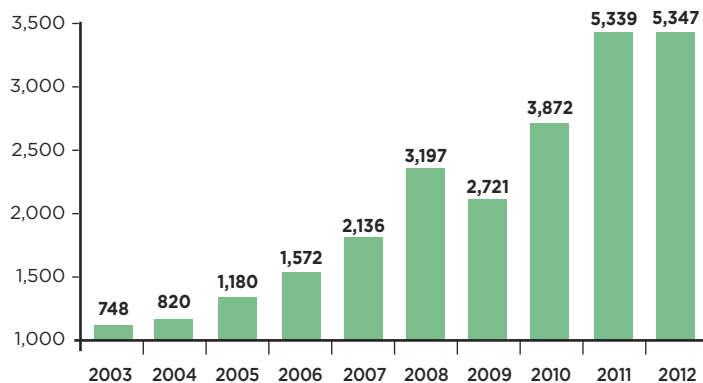
Generally the outlook is positive, based on the local and on the still low inhabitant per vehicle ratio. Investments will remain high and, as a consequence, production is expected to grow. Imports are estimated to slow down due to high tariffs and exports will continue to stagnate, thanks to the barriers established in Argentina and to the lower world economic activity.

**CHART 2:**  
Production of Vehicles per Year  
(million units)



Source : Anfavea

**CHART 3:**  
Investment per Year (US\$ Million)



Source : Anfavea

# Retail: Driving force of the economy

It has been one of the driving forces of the economy, growing at a much higher rate than the general activity. Following this behavior, restricted and extended retail (which includes vehicles and construction too) increased, respectively, by 8.4% and by 8% in 2012. Retail is mainly impacted by real income and credit conditions, both have improved greatly in Brazil recent history, but it is now showing slow down signals.

In the last decade a new middle class has emerged in Brazil, for instance, 38% of the population was in this classification in 2003 and this percentage achieved 55% in 2011, ie, many people were introduced to the consumption market. Furthermore, real income has risen significantly and unemployment dropped to an annual average rate of only 5.5% in 2012.

Gains in wages tend to be the variable with the highest impact on household consumption, but in this particular case, credit has played a really important role. In a decade the ratio (total credit/GDP) went from 24.4% to 53.8% in December 2012. It is also worth to mention that the individual credit was the one that most improved and that the real interest rate, which used to be the highest in the world, achieved its historic low of 7.25% p. y. in the end of 2012.

Moreover, real estate loans have improved in the recent years. It has contributed to boost the sales of furniture and home appliances (see chart below), so that the segment has outperformed the other ones. The government also conducted the reduction of the tax on industrialized products for this group, on a temporary basis, but is always postponing the return to the initial rate.

The forecast for 2013 and 2014 are positive, but it is expected to grow at much lower pace. We estimate household consumption to slow down due to a several reasons: 1) credit is expected to reduce its expansion rhythm (families are very leverage and individual delinquency rose in 2012); Unemployment remains low, but wage gains decelerated; 3) the minimum wage annual readjustment in 2013 was much lower (around 9%) than in 2012 (14.13%); 4) pressure over retail prices, which has been verified since mid-2012, took momentum in the first quarter of 2013 (mainly because of the food component and of the service prices). Agents forecast retail sales to increase by 4.5% this year and by 4.3%, considering the extended retail.

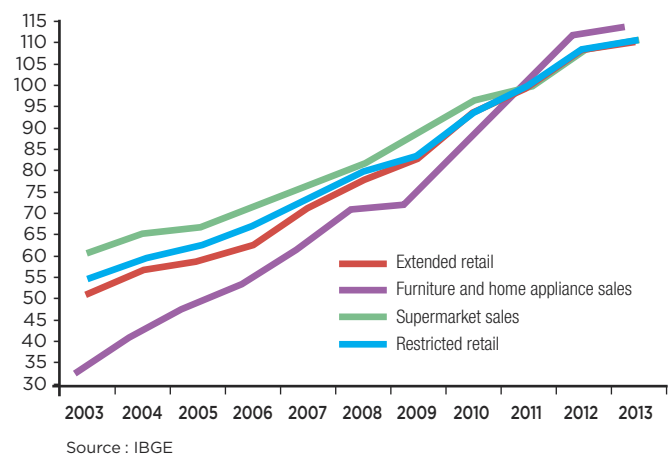
After a positive beginning of the year, many segments registered deceleration in the second quarter of 2013, like supermarkets, restaurants, textiles and personal accessories. The consumer confidence has assumed a declining tendency, as a significant percentage of its income is already committed with loan installments and, although the recent hike in the reference interest rates has yet to be felt, it is already a concern.

Despite the movement presented above, some groups are expected to outperform. Electronics will probably grow significantly, mainly in digital products, computers and LCD TV, smartphones and tablets. Furthermore, internet retailing still represents 5% of sales, but it is estimated to grow by 25% in 2013, thanks to internet connections and credit card penetration that keep growing.

Last but not least, the government announced on June 12th 2013 the approval of subsidized credit to the purchase of furniture and electronics for borrowers of "Minha Casa, Minha Vida". This is a program of the federal government that gives low-income population the chance to acquire their own homes with a special condition.

The general overview on the retail market is positive, but the growth model based on credit concession is already showing signals of saturation. Retailers may face difficulties to compete with imported products, sometimes cheaper and/or with better quality. On the other hand if the recent dollar appreciation continues, it will turn the local product more attractive. Inflation must also be kept under control, mainly the food component, which directly impacts the supermarket sales. Postpone of tax reductions may also be close to the end, as government needs to balance its budget. Finally the effect of the recent approval of subsidized credit for "Minha Casa, Minha Vida" is forecasted to generate a marginal positive effect over the retailers.

Real retail sales (index number average = 2011)



# Agro-food: A new stimulus after the setback of 2012

Brazil holds a long stretch of fertile land, being a major producer of agro commodities. It represented 4.5% of the Brazilian GDP, according to the figures of 2012. The segment is also very export oriented and accounts for 40% of the country export basket, considering the same period of time. The main exported products are, respectively, soya, meat, sugar & ethanol and coffee (represent 66% of agro exports). Brazilian agriculture GDP contracted by 2.3% in the same period, the main reasons were: the drop in soybean production (high losses in the South region) and the price reduction of various crops.

The performances of Brazilian agro sector depend on the world economic activity and on the harvest of other countries, which are specialized in the same crop. As an example, last year corn producers have benefited from crop output failure in the United States. The agriculture sector in Brazil grew by 9.7% first quarter of 2013, thanks to the recovery of the soybean production and to the good harvest of corn, tobacco and rice. Furthermore, the Brazilian Central bank has forecasted a growth of 8.4% in 2013, but it seems very optimistic. This scenario might be impacted by the downward trend observed in international prices. In the first three weeks of June, the prices of 16 of the 23 Brazilian most exported commodities fell.

The movement presented above is a result of the good prospects for the US harvest, which tends to imply in an over-supply and high inventory level. Moreover, the main destiny of the exports, China began to grow in a lower rhythm. For many years Brazil was benefited by high Chinese demand for food, but now this phase seems to be over. Because of the strong devaluation of the real (Brazilian currency) in recent weeks, the decline in prices, for the time being, has not strongly affected the revenues of exporters.

It is also worth mentioning that only a few farmers have benefited from agricultural policies and gained access to new technologies. Among small producers, the low level of education is serious hindrance to the adoption of new technologies, which also limits access to public policies, especially subsidized credit. Moreover, the policies of price guarantee and crop purchase in advance usually do not reach the small farmer. They sell their output at a much lower price and buy inputs for higher prices. As the costs outweigh the gains, technologies become unprofitable. Without profit, there is nothing that makes the farmer to modernize. The government needs to give them assistance, but the new announced program does not seem to take this priority into account.

In the first week of June 2013, President Dilma Rousseff has announced the "Plano Agrícola e Pecuário 2013/14" that will raise around 68 billion USD in investments. The value is divided by 49 billion USD in financing costs and trading and 19 billion USD for investment programs. It also focuses on investments to improve logistics and infrastructure, with the provision of 13 billion USD for the construction of private warehouses in the next five years with a payment period of 15 years.

Finally, another point that impacts the agriculture in the country is the dependence on imported fertilizers. Potassium, basic nutrient for the production of pesticides, has an importing index of 95% while the nitrogen is around 50%. It is one of the sectors which posts the largest trade deficit of the economy and lacks new investments. Brazilian Development Bank already considers the possibility of increasing funding for projects for three inputs - potassium, phosphorus and nitrogen - from the current 125 million USD per year to something around 1 billion USD in 2015. Brazil is the fourth largest consumer of fertilizers in the world, only behind of the United States, India and China.

## SNAPSHOTS OF THE MARKET:

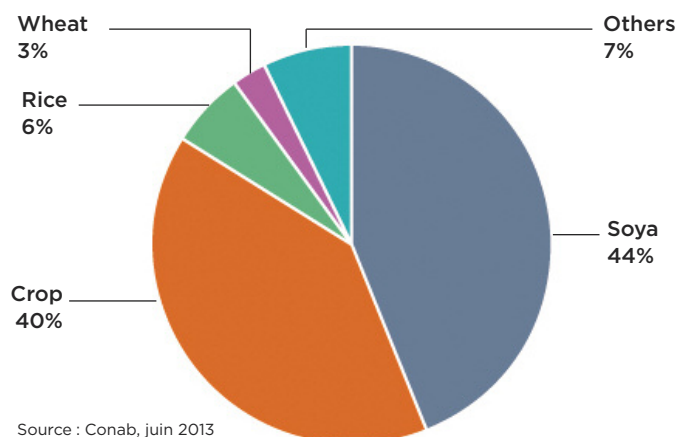
**Soybean:** the country is the second global player. The 2012/13 harvest is expected to hit a record volume of 81.5 million ton, 22.8% higher than the one before. Its price has recently presented some volatility, due to the uncertainties in the US production.

**Coffee:** it is the larger global player the 2013/14 harvest is expected to hit a record to an "off-year" in the biennial production cycle. Prices should remain low, squeezed by the global surplus in the 2012/13 period.

**Sugar and ethanol:** of the sugar cane produced in Brazil 46% is directed to the production of sugar and 54% to the production of ethanol (following 2001/12 harvest). The country is the world's biggest producer and exporter of sugar and holds the second position in the production of ethanol, only behind the US. Record harvest pressures the prices down and its low limit will be given by the production costs. Ethanol: prices should recede with the entry of the new crop, but tend to grow later, due to higher domestic and foreign demand.

**Meat:** Brazil is the main exporter, with 20% of the market. The beginning of the dry weather during the off season will push up the prices of the beef, but will be contained by the high stabilization of domestic demand by competition with the chicken.

Forecast grain and crop 2012/13 (thousand ton)



Source : Conab, juin 2013