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Brazil: Economic Focus: July 2012

British Embassy Brasilia

August 2012

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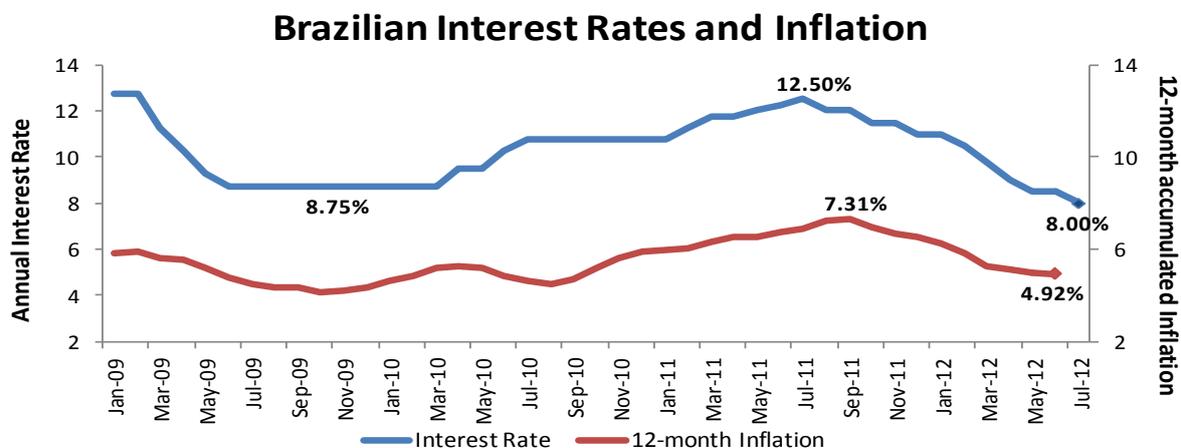
Brazil Economic Focus

JULY 2012

- Economic activity contracted 0.02% in May leading markets to reduce their 2012 GDP forecast to less than 2%. IMF expects growth to pick up during the next half of the year.
- Measures to boost growth include further monetary easing and an upcoming economic stimulus package focused on encouraging private sector infrastructure investment.
- Brazil received almost US\$30bn in FDI January to June, compensating for the smallest trade surplus for 10 years, and underlining the long term potential of Brazil for investors.
- Venezuela's rapid entry into Mercosul after Paraguayan suspension from the bloc raises questions about the future of the region's trade and political relations.

Brazil's economic Groundhog Day continues: stagnant growth, monetary easing and falling inflation

1. **Brazil's economic performance remained stagnant in May, with economic activity contracting 0.02%**, according to the Central Bank's index (an indicator of GDP). This followed growth of just 0.20% in April. Industrial production continued its negative trend, decreasing by 0.90% in May which, combined with a surprising 0.80% contraction on retail sales, pushed the index down. The fall was associated with high indebtedness levels which caused households to reign in consumption.
2. **May's decline was less than many analysts had expected, however, financial markets continue to reduce their growth outlook for the year.** The Central Bank's weekly survey of market analysts showed the average projection for this year's GDP growth fell to 1.90%, well below last year's growth rate of 2.7%. The market also lowered its projection for 2013 from 4.3% to 4.1%. Even the Ministry of Finance – ever optimistic about growth - reduced its official 2012 GDP projection to 3%.



3. **The subdued economy resulted in the Central Bank cutting the basic interest rate (SELIC) by 50bps to a record low of 8%** (see graph above). This is part of a continued

effort, stretching back to August 2011, to use monetary easing to stimulate growth. The decision was widely expected as the economy shows no signs of picking up from its current sluggish state. Although one more cut is already expected, it is not clear how much longer the easing cycle will continue.

4. **The decision was underpinned by the continued decline in domestic prices**, which dropped sharply in June leaving inflation over the last 12 months at 4.92%, closer to the 4.5% target centre. Falling transportation costs were a major factor, with IPI tax reductions to stimulate car sales seeing average prices fall by over 5%. However, markets increased their 2012 inflation forecast to 4.98%, with an expectation inflation will increase to 5.5% in 2013.
5. **Optimistic, the International Monetary Fund expects Brazil's economic growth to pick up in the last two quarters.** In its annual report on Brazil's economy, it predicted growth will accelerate, reaching a 2.5% expansion in 2012. The report highlighted the European crisis, a reduction in international liquidity (which would reduce financial flows) and a decline in commodities prices the main risks to Brazilian growth this year. The Fund also warned that Brazil cannot continue to rely on stimulating domestic consumption, urging the Government to concentrate more on incentives to increase investments and exports.

New measures expected, but now focused on investment

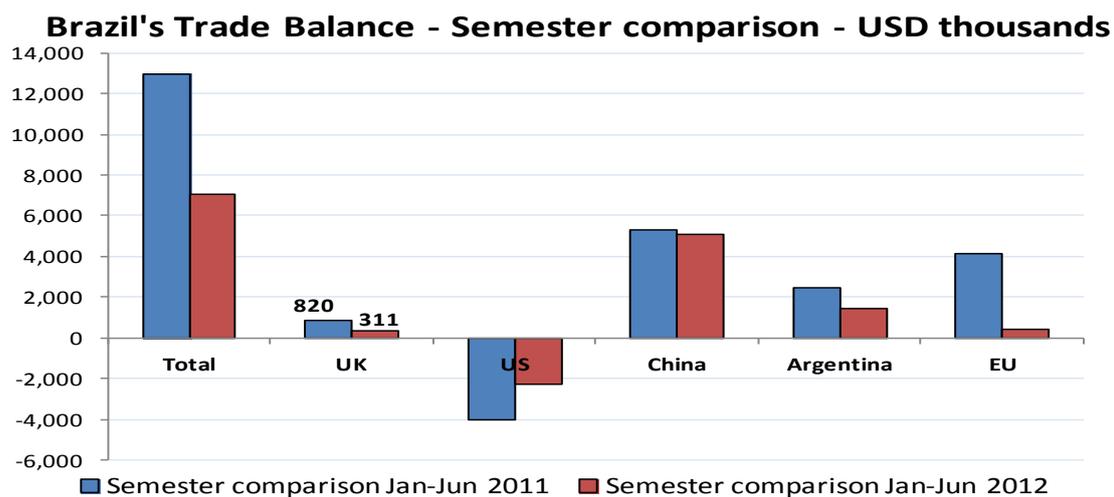
6. **With the economy still not showing signs of improvement, President Dilma is preparing another stimulus package, this time centred on infrastructure.** The Government will announce in August a plan to attract private sector investment through new concessions and Public Private Partnerships on ports, airports, railroads and energy (to take effect in 2013). Complementing the existing PAC Investment Programme, the August plan will aim to tackle Brazil's well-known infrastructure bottleneck while boosting competitiveness.
7. **In a further boost to industry, the Government also announced it will reduce the country's high energy prices by at least 10%.** To promote a reduction in costs for energy users, the Ministry of Energy is keen to renegotiate energy concession contracts' tariffs expiring in 2015. Moreover, the Government announced that it will cut several taxes on electricity to intensify the effect of price reductions, resulting in an estimated fall in electricity costs for industry of 15%-30%. President Dilma is also negotiating with State Governments to reduce their ICMS (VAT equivalent) tax to lower energy costs further. While some industry representatives welcomed the reduction, others considered it irrelevant to boost competitiveness.
8. **Reflecting on previous stimulus measures released under Brasil Maior Plan, Dilma showed dissatisfaction with car companies' threats to fire hundreds of employees.** Tax reductions have incentivised car sales, sustaining revenues for the struggling Brazilian auto sector, however, during her visit in London Dilma said that maintaining the reduced IPI tax on automobiles for the rest of the year will depend on car manufacturers keeping jobs. She argued that this is valid for all sectors which are receiving tax incentives. Negotiations on IPI tax are still being conducted but it is expected that the government's decision will be released within the new stimulus package.

Shrinking trade surplus compensated by record foreign investment

9. **Brazil closed its first semester with the lowest trade surplus in ten years (US\$7.073 billion).** This was due to a 5% increase in imports (mainly from China and the EU), and declining exports due to the economic crisis in Europe, Argentine

protectionism and the strong Real. Brazil's overall exports to Argentina declined by 16% in the first semester - falling 31% in June alone - while exports to the EU declined by 7% over the same period. Within the EU, the UK, France, Germany and Spain benefited most from increased Brazilian imports (see graph below). Analysts expect that Brazilian exports will increase in the following months as a result of the weaker Real (now US\$/R\$ 2.05).

10. **However, strong inflows of Foreign Direct Investment (FDI) compensates for weak trade surplus.** During the first six months, Brazil received US\$29.7bn in FDI showing that the country still is an attractive place for international investors. It is expected that FDI flows will be able to finance the country's chronic Current Account deficit (which includes goods and services trade).
11. **In an effort to understand the country's US\$35bn trade deficit in services, Brazil will require all service sector trade to be registered in the country's new "Siscoserv" system, as of 1 August.** The system's objectives are to correctly register service trade figures as "trade", fight tax avoidance, and to map exactly what services Brazil is importing and exporting, thus helping Brazilian trade policy makers decipher offensive and defensive interests in international service sector negotiations. According to the Brazilian Foreign Trade Association (AEB), Siscoserv is the first system of its kind. Construction and engineering service sectors will be the first required to register trade operations through the system, with all other sectors following suit by April 2013.



Source: Brazilian Ministry of Trade

Democracy (and shoes) central to South American political economy

12. **Rapid acceptance of Venezuela into Mercosul during Paraguay's suspension from the bloc raise questions not only on the legality of the measure, but also on how it will impact South America's trade relations.** Analysts pointed out that Venezuela's entry into Mercosul would offer direct economic benefits to Brazil and should reign-in Chavez's more polemic policies, such as currency restrictions and the expropriation of companies. However, Venezuela faces a difficult economic situation, making it hard to cut its tariffs to Mercosul levels. More concerning, its newly gained veto power on new trade agreements could hamper the alliance's negotiating potential, particularly with on-going EU-Mercosul.
13. **Brazil has already sent a mission to Caracas to try to conclude negotiations on Venezuela's adoption of Mercosul's Common Nomenclature by December, when Brazilian Mercosul Presidency ends.** This was seen as an attempt to guarantee that the accession process advances far enough to not be derailed by Paraguay's

Presidential elections in April 2013 (when its voting rights will likely be reinstated). In addition to circumventing Paraguay on Venezuela's accession, Mercosul's announcement of intentions to form a "strategic global alliance" and possibly begin trade negotiations with China added a further dimension to regional tensions. Paraguay, still a Mercosul member, does not have diplomatic relations with China, due to its recognition of Taiwan.

14. **The democracy-driven solidarity between Argentina and Brazil, however, has not stopped them from returning to business as usual, this time clashing over shoes.** Brazil's recent retaliation against growing Argentine protectionism seems to be paying-off, slowly. During the June Mercosul Summit, both countries agreed to accelerate the clearance of shoe (Brazilian export) and olive (Argentine export) imports, but as of 13 July, Argentina had only liberated 123 thousand pairs of shoes, of a total 1.5 million pairs that have been stuck on the border, some for more than a year. The average clearance period for Brazilian shoes in 2012 was 225 days, well past the WTO's 60 day limit, causing a 19% decline in Brazil's first semester shoe exports compared to the same period in 2011. Abicalçados' (the Brazilian Association of Shoe Industries) director-general argued that although Brazilian government does not like to talk about retaliation, it is the only language that the Argentine government understands.
15. **In addition to facing complications exporting to Argentina, Brazil's shoe industry has been calling for protection against Chinese dumping at home.** In July, Brazil's Foreign Trade Chamber (Camex) approved a measure applying a 182% surcharge on shoe parts imported from China. Since 2010, Chinese shoes have paid an extra duty of US\$13.85 per pair imported. Brazilian shoe manufacturers, however, charged that companies here were getting around this by importing more than 60% (exceeding local content requirements) of shoe parts free of extra duties from China, and then assembling them locally in Brazil.

AUGUST	
8 th	Inflation (IPCA) for July released
23 th	Unemployment rate announced
28 th /29 th	Monetary Policy Committee (COPOM) meeting
SEPTEMBER	
5 th	Inflation (IPCA) for July released
12 th	Launch of UNCTAD's Trade and Development Report 2012
13 th /14 th	G20 Finance Ministers & Central Bank Governors' Deputies meeting
20 th	Unemployment rate announced
OCTOBER	
3 th /4 th	WTO's General Council
4 th	G20 Development Working Group
5 th	Inflation (IPCA) for July released
9 th /10 th	Monetary Policy Committee (COPOM) meeting
12 th /14 th	World Bank/IMF Annual Meetings
24 th	Launch of UN's Trade and Environment Report 2012
25 th	Unemployment rate announced