



Interview: National Confederation of Industries (CNI) Chief Economist Flávio Castelo Branco and CNI Economist Marcelo Azevedo

--“Investment needs to be the engine of growth in Brazil over the next few years.”—

Brazilian manufacturers pulled back on investments last year because of soft consumer demand, economic policy uncertainties and scarce credit, according to a report by the National Confederation of Industries (CNI). The coming year may not be any better, say CNI economists Flávio Castelo Branco and Marcelo Azevedo. They met reporters recently to discuss the 2015 investment outlook. Excerpts follow:

- **Flávio Castelo Branco:** “Last year was the lowest, in terms of investments by manufacturers, in five years. A majority of investment programs were not completed. Many were postponed and some were abandoned altogether. Brazilian industrial output, in general, was down in 2014. Utilization of industrial capacity declined steadily. With excess capacity, manufacturers don’t see a need to expand plant and equipment.”
- **Marcelo Azevedo:** “Uncertainties about the economy were the main reason cited by manufacturers in explaining their reluctance to pursue investments. They also noted that it was hard to find loan money in 2014 and, when they found it, it turned out to be very expensive. Most investments last year were directed not to expansion but to improved productivity. Increasingly, investments are being financed by profits not by borrowing. So, if profits fall, so will investments.”
- **Castelo Branco:** “As for 2015, confidence among manufacturers has declined in recent months and that does not auger well for the coming year. Confidence has been hurt by the persistence of inflation and by an increase in deficit spending by the government. Reversing these two tendencies is crucial for reversing the slide in business and consumer confidence. We need to bring down business costs by cutting taxes, reducing interest rates and offering incentives to improve productivity. Investment needs to be the engine of growth in Brazil over the next few years.”
- **Azevedo:** “In 2015, manufacturers expect to reduce their purchases of capital goods. They will maintain the trend of investing in productivity gains rather than plant and equipment expansion. As interest rates rise, they will increasingly rely on profits not loans to finance their investments. Manufacturers are telling us they will be slightly more focused on exports this year than in 2014, perhaps because of a more favorable exchange rate, although most will continue to focus mainly on the domestic market.”
- **Castelo Branco:** “Overall, prospects for 2015 are not good. Economic uncertainties continue. The outlook for economic growth is poor and credit is likely to remain scarce.”

Top News of the Week

President asserts need for ‘fiscal correction’ at first Cabinet meeting. Speaking at the first Cabinet meeting of her new term of office, President Dilma Rousseff last week asserted the need for a ‘fiscal correction’ this year. The statement came as members of her new economic team labored over their own correction in a dispute over figures related to cuts in labor and welfare benefits. Earlier this year, newly installed Finance Minister Joaquim Levy announced reductions in benefits paid to widows, widowers, low-income and disabled workers and the unemployed. The reductions were designed to save the government some R\$18 billion this year. However, government lawyers later disputed that figure, saying some of the benefits can only be reduced as of 2016. Remaining reductions would save the government only R\$11 billion this year. Further compounding the problem is the fact that any cuts must still be approved by Congress, where resistance is highly likely. Despite such obstacles, President Rousseff’s speech to Cabinet members was seen as an endorsement of Levy’s approach to austerity, which includes selected tax hikes as well as spending cuts for line-ministries and other government agencies. The government is aiming at a primary budget surplus this year of R\$66 billion. The president said a degree of fiscal austerity was necessary in 2015 “in order to assure a return to economic growth as quickly as possible.”

Petrobras finally releases third quarter earnings, omits decline in asset values. Brazilian state-run energy giant Petrobras last week released its third-quarter 2014 earnings report after a delay of more than two months. The company has been plagued by a sweeping corruption investigation, a process that has raised questions about asset values and scared off investors. In its report, the company posted third-quarter earnings of R\$3.1 billion, down 38% from the second quarter and 9% from the third quarter of 2013. But the report was unaudited, precisely because of the dispute involving various independent auditing firms and Petrobras itself over how to evaluate the effects of the corruption probe on asset values. Press reports indicated that some auditors were putting the asset write-off at only R\$4 billion while others suggested the write-off could rise as high as R\$67 billion. In the face of the dispute, Petrobras decided to omit any asset write-off, at least for the time being, and promised to file a more complete earnings report for the entire 2014 calendar year no later than June. The confusion over earnings left investors with little guidance. Petrobras’ preferred shares shed more than 10% of their value on the day of the report’s release, throwing Petrobras shares for a loss of more than 40% over the previous 12 months. Later in the week, Moody’s Investors Service announced a downgrade in Petrobras’ credit rating to Baa3, the lowest investment grade level. Moody’s said the company was under observation, with another downgrade possible for later in the year.

Chamber of Deputies elects ‘independent’ speaker in defeat for administration. The Rousseff Administration suffered a stunning defeat Sunday night as the new Congress took office for the 2015-2016 session, electing self-styled “independent” Eduardo Cunha as speaker. Cunha won on the first ballot and the vote wasn’t even close, with the São Paulo congressman garnering 267 votes against only 136 for administration-backed candidate Arlindo Chinaglia. Cunha is a dissident member of the PMDB (Partido do Movimento Democrático Brasileiro) while Chinaglia belongs to Rousseff’s PT (Partido dos Trabalhadores). While declaring himself an independent, Cunha stopped short of outright opposition to the administration, saying he will speak for Congress as an independent branch of government in its relations with the executive. In the Senate, the administration fared better. PMDB Senate President Renan Calheiros was easily elected to a second two-year term, defeating PMDB independent Luiz Henrique by a vote of 49 to 31. Calheiros has favored the administration on most issues.

Business News

Investment News:

Poland's **Synthos** last week signed an agreement with the state government of Rio Grande do Sul to build a R\$640 million synthetic-rubber factory at the Triunfo petrochemicals complex near Porto Alegre. When operational in 2017, the plant will produce 90,000 metric tons per year of rubber. The company is currently in talks with Braskem and Petrobras for supplies of raw materials for the factory.

Net Brazilian **mortgage lending** rose by a disappointing 3.4% in 2014 to R\$112.9 billion, the National Savings and Mortgage Credit Association said last week. The association is predicting 5% growth this year on hopes that improved salaries will counterbalance rising interest rates. Brazil's Central Bank recently raised its base interest rate for the third time in a row. The rate now stands at a punishing 12.25%.

Brazilian developer of inland waterways **Hidrovias do Brasil** last week obtained \$300 million for mainly Amazon region projects by signing up new equity partners. Hidrovias will continue to be controlled by a consortium formed by two Brazilian companies, Pátria and Promon. The new partners will be the International Finance Corporation, Blackstone and the Brazilian Development Bank through its BNDESPar holding company. The ambitious projects seek to link productive agricultural lands in the interior of Brazil to Atlantic ports via the Amazon River and its many tributaries. Projects include river ports, grain terminals and dredging operations.

Company News:

Brazil's largest private bank, **Itau**, last week obtained loans worth a total of R\$1.05 billion from a consortium of international institutions for re-lending to 'green' projects in Brazil. Lenders were the International Finance Corporation, Bank of America, Mizuho and Commerzbank. The loans carry terms of three-to-five years at Libor plus a spread of 1.2% to 1.4%. Itau, in turn, will loan the money to Brazilian projects in areas such as renewable energy sources, sewage treatment and development of water resources.

Brazilian Calendar

Monday, February 2, Trade and Development Ministry release of monthly foreign trade figures, Brasília

Tuesday, February 3, Brazilian Census Bureau (IBGE) release of monthly industrial production figures, Rio de Janeiro

Friday, February 6, Brazilian Census Bureau (IBGE) release of monthly IPCA inflation data, Rio de Janeiro

Friday, February 6, National Motor Vehicle Manufacturers Association release of monthly auto sales, production and export figures, Hotel Mercuré, São Paulo

Indicators

Foreign exchange rate: **R\$2.68 = \$1.00**

Brazil began 2015 on a sour note for consumers. The Getúlio Vargas Foundation's **ICC** consumer confidence index dropped sharply from 89.8 points in January from 96.2 in December, exhibiting its lowest level since the index was first released in 2005. The index runs from 1 to 200, with 100 as neutral. The 89.8 level represents an overall

negative outlook for the economy among consumers, who are increasingly worried about job security, inflation and high interest rates. Brazilian inflation is running at 6.4% while the base interest rate is 12.25%.

Total lending by the Brazilian financial system increased 11.3% in 2014 to R\$3.022 trillion. Although beating the 2014 inflation rate of 6.4%, expansion clocked its slowest pace since 2003, according to Central Bank figures last week. Average interest rates rose during the year to 20.9% from 19.7% at the end of 2013, dampening demand. Private institutions, in particular, became more selective in awarding credit, underwriting an expansion in their segment of only 4.7%. According to economists, the growth rate in 2015 may be even lower as the Central Bank continues to tighten credit.

Brazilian **tax revenues** turned in a disappointing performance in 2014, dropping by 1.8%, in inflation-adjusted terms, against the previous year, the Brazilian Tax Authority said last week. It was the first such decline since the recession year of 2009. Revenues weighed in at R\$1.19 trillion in 2014. The year-on-year decline came on a sluggish economy and a series of government tax breaks for consumers. The tax breaks reduced government revenues in 2014 by an estimated R\$104 billion. Most of the tax abatements lapsed at the beginning of 2015.

Brazil posted an average **unemployment rate** in 2014 of 4.8%, down from 5.4% in 2013 and the lowest rate since the current methodology was created in 2002. But economists noted that comparatively low unemployment was due many to young people dropping out of the workforce in the face of a sluggish economy. The total number of registered wage and salary earners in 2014 was 23.1 million, the same as 2013.

The Brazilian Central Bank last week posted figures on 2014 public sector **budget performance**, showing the first primary budget deficit under methodology first used in 2001. The deficit amounted to R\$32.5 billion, reversing the 2013 surplus of R\$91.3 billion. Performance was hurt last year by a series of tax breaks for manufacturers and consumers. Meanwhile, spending at all levels of government rose ahead of October elections. The government is committed to a 2015 surplus of R\$66 billion.

