Brazil-U.S. Business Council Brazil Bulletin

Interview: Marcelo Odebrecht, President of Odebrecht

--*"Brazilian industry is tied to the BNDES's apron strings. Nobody goes to the capital market for financing."*—

Brazilian industry, hobbled by cheap imports and high taxes, faces daunting challenges, both home-grown and international, according to Marcelo Odebrecht, president of one of Brazil's largest conglomerates. Odebrecht holdings cover the waterfront, ranging from construction to energy and petrochemicals. At a recent conference sponsored by Credit Suisse, Odebrecht noted the need for carefully calibrated government policies, including intervention in some areas and freedom for market forces in others. Excerpts follow:

- **On the market for electric power:** "Electric power is a segment that should see significant growth in the next few years, but the big problem is taxes. Half the cost of generating power is taxation. As for rates, it makes no sense for the government to set rates. Rates should be determined by demand in the market."

- **On development of the pre-salt oil reserve:** "The pre-salt (oil drilling) region is a reality. Its development is only a question of time. Brazil's option—to develop the entire production chain from beginning to end—is the right one. I think there's a lot of lobbying going on against this idea."

- **On pre-salt investments and Petrobras:** "The biggest challenge for Petrobras right now is the volume and timing of its investments. These are huge investments, which are very important for the country's growth. Things would be easier for Petrobras if the investment schedule were less daunting."

- **On price controls and Petrobras:** "Brazil has always had price controls. This isn't the first time Petrobras has confronted the price control problem."

- **On the ethanol market:** "Ethanol has become a headache. The main problem has a name—CIDE (a R$0.50 tax once charged on gasoline but later dropped). Once CIDE goes back to 50 *centavos* per liter of gasoline, we'll have ethanol investments again."

- **On the role of the Brazilian Development Bank (BNDES):** "As long as the BNDES offers subsidized interest rates, businesses are going to have to go to the BNDES. Brazilian industry is tied to the BNDES's apron strings. Nobody goes to the capital market for financing. Borrowers should be paying for these loans, not taxpayers."

- **On the U.S. shale gas boom:** "U.S. shale gas is a dagger pointed at the Brazilian petrochemicals industry. (Cheap natural gas, a key cost in petrochemicals, makes U.S.

petrochemicals more competitive than the Brazilian-made products). Petrochemicals is an industry that is still running up a huge trade deficit for Brazil."

- **On Brazil's image overseas:** "Currently, all the news about Brazil seems bad. People must think Brazil is the worst place in the world."

Top News of the Week

Fourth-quarter GDP surprises on the upside, closes out year at 2.3%. Strong performance by agribusinesses and an unexpected rise in capital investments produced a solid fourth quarter performance for gross domestic product, elevating annual GDP growth to 2.3%, the Brazilian Census Bureau (IBGE) said last week. Fourth-quarter GDP expanded 0.7% against the third quarter, led by a record grain and oilseeds crop and a sharp increase in purchases of capital goods. The quarterly and annual figures were both higher than analyst expectations and helped produce a genuine rebound from 2012, when growth was only 1.0%. In 2013, growth was led by agriculture, which expanded by a robust 7.0%. Services advanced 2.0% while industry continued to languish, growing only 1.3%. Investments were up 6.3% from 2012, led by capital goods purchases and raising hopes for continuity of the overall expansion in 2014. Economists said the 2013 figures tend to reduce the risk of a sovereign credit downgrade this year.

Supreme Court votes to knock down conspiracy convictions in *mensalão* case. In a stinging blow to prosecutors, and a rebuke to Chief Justice Joaquim Barbosa, the Brazilian Supreme Court last week voted 6-5 to knock down conspiracy convictions for eight defendants in the sweeping bribery and malfeisance case known as the *mensalão*. The eight are part of a group of 25 defendants convicted on various counts at a spectacular Supreme Court trial in 2012. By overturning the conspiracy convictions, the court did not set any of the eight free, since all were also convicted of other crimes. However, all eight will have prison sentences reduced and some will be eligible for parole later this year. The reversal of fortune was possible because of the presence of two newly appointed justices, Teori Zavascki and Luis Roberto Barroso. Chief Justice Barbosa, who championed prosecutors throughout the case, called the ruling "a sad day for the court." He intimated that the two new justices may have been appointed by President Dilma Rousseff for the specific purpose of overturning the conspiracy convictions. "In an instant, all of our exemplary work of 2012 has been laid in ruins," Barbosa claimed, in an unusually blunt post mortem statement.

Mercosur-European Union trade deal no closer after Brussels summit. A summit featuring Brazilian President Dilma Rousseff and leaders of the European Union, in Brussels last week, brought harsh words and no progress on a proposed trade accord between the EU and South America's Mercosur group. In a speech during the summit, and at a news conference afterwards, President Rousseff was critical of an EU move questioning Brazilian government subsidies under the nation's industrial development policy. The EU has asked for formal consultations on the subsidies via the World Trade Organization. Rousseff said specific targets of the EU critique, including the Manaus Free Trade Zone and an auto industry program called Inovar-Auto, should be off limits since both policies favor participating companies, many of which are European multinationals. Asked if friction over the WTO inquiry was causing a slowdown in the Mercosur-EU trade talks, the president said, "One thing has nothing to do with the other." However, officials for both sides admitted there was virtually no progress in the trade negotiations.

Petrobras posts 11% rise in earnings but cuts long-term investment budget. State-run energy giant Petrobras last week posted an 11% year-on-year rise in earnings to R$23.6 billion. Revenues were up 8.0% at R$304.9 billion. Petrobras attributed the gains to a series of government-ordered hikes in wholesale prices of oil products such as diesel and gasoline. In addition, Petrobras gained from R$6.6

billion in cuts to its operational budget and R$8.5 billion from sale of assets. Looking forward, the company reduced its 2014-2018 investment budget by 6.8% to R$220.6 billion, citing higher borrowing costs and lower international oil prices. The lion's share of the investment budget, some R$153.9 billion, will go to oil exploration and drilling. The company expects to double crude oil output to four million barrels per day by 2020.

Central Bank raises base interest rate for eighth time in a row. The Brazilian Central Bank Monetary Policy Committee last week raised its base interest rate for the eighth time in a row, voting unanimously to hike it by a quarter-point to 10.75%. The rate now stands at the same level as the day President Dilma Rousseff took office in January of 2011. The bank signaled it may have to continue raising rates in order to combat inflation, still running at a worrisome 5.6%. Economists predicted one more hike, this time to 11.0%, before a pause. Brazil's official target for 2014 inflation is 4.5%. High interest rates, meanwhile, are likely to crimp growth, with most economists now predicting a GDP expansion this year of less than 2.0%.

***Financial Times* calls for shake-up in Brazilian economic team.** In an editorial last week, the *Financial Times* of London said Brazil's best interests would be served by a shake-up of the country's economic policy team, including resignation of Finance Minister Guido Mantega. The newspaper said Mantega, at the helm for nearly eight years, has lost the confidence of international investors. The newspaper cited a number of reasons for lost confidence, including persistent inflation, slow growth and the steady decline in the government's primary budget surplus over the past three years. The newspaper noted that fiscal policy has been marred by what it called "creative accounting." Last year, British weekly *The Economist* issued a similar call, citing many of the same reasons.

Business News

Investment News:

Two of Brazil's biggest private logistics companies, **ALL** and **Rumo**, last week announced a preliminary merger plan. ALL is currently controlled by three major Brazilian pension funds while Rumo is controlled by agribusiness and energy giant Cosan. The new company, to be called **Cosan Logistica**, would be created by issuance of shares, including a free float of some 40%. Cosan, a pair of domestic investment banks and the Brazilian Development Bank would effectively control the new company. ALL's current board must approve the plan. According to analysts, ALL's pension fund controllers may resist the offer.

Company News:

Federal Police last week completed an investigation into alleged lending irregularities involving beef packaging giant **J&F** and bankrupt financial institution **Banco Rural**. Police recommended indictments for 17 people, including J&F President Joesley Batista and former Banco Rural President Katia Rabello. Prosecutors are now studying the report. Police said Banco Rural lent some R$160 million to the J&F group in 2011, with the group's banking arm, Banco Original, promptly lending most of it back to Banco Rural. Banco Rural, in turn, used the new loan to boost its capital position in order to meet Central Bank capital requirements. In separate statements, J&F and Banco Rural executives denied any irregularities. Banco Rural was declared bankrupt in 2013. Its former president, Katia Rabello, is currently serving prison time in Brasília on charges stemming from the so-called *mensalão* bribery scandal.

Mining giant **Vale**, last week, posted minimal profits for 2013 of just R$115 million, a tiny fraction of the R$9.89 billion the company earned in 2012. Chief reason for the decline was a huge tax settlement with the federal government that caused Vale to make a one-time payout of R$5.9 billion in the fourth quarter. The declining value of the Brazilian Real against the U.S. dollar in 2013 also hurt profits by making debt service costs higher. Much of the company's debt load is denominated in foreign currency. The company noted that the tax settlement "relieves Vale of a great deal of uncertainty," predicting a return to hefty profits this year.

Brazilian Calendar

Monday and Tuesday, March 3 and 4, Annual Carnival holidays

Wednesday, March 5, Trade and Development Ministry release of monthly foreign trade data, Brasília

Indicators

Foreign exchange rate: **R$2.32 = $1.00**

Brazil posted record **tax collections** in January of R$123.7 billion on rising corporate income tax and import tariff revenues, the Brazilian Tax Authority said last week. Revenues were up 3.9% from December and 1.0% from January of 2013, in inflation-adjusted terms. Revenues are rising, despite a sluggish economy, as 2013 tax abatements lapse. The rise in revenues will help the government meet its 2014 primary budget surplus goal of 1.9% of GDP.

The Getúlio Vargas Foundation's **ICC** Consumer Confidence Index fell for the third month in a row in February, declining to 107.1 points from 108.9 in January. Economists said the index was falling because of renewed worries about inflation and job security. Higher interest rates, meanwhile, are making it harder for consumers to shed debt.