Brazil-U.S. Business Council

Brazil Bulletin

Interview: Pedro Passos, President of the Institute for Industrial Development Studies (IEDI)

—" We need trade agreements with the big players—the United States and the European Union."—

The past decade has been one of the worst for Brazilian industry in history, according to Pedro Passos, President of the Institute for Industrial Development Studies. The problems have to do with more than just international financial market volatility and domestic macro-economic difficulties. There are deep-seated structural issues that need to be addressed in order to put Brazil on the road to sustainable economic development. Passos shared his views with industry leaders and reporters at a recent meeting in São Paulo. Excerpts follow:

- **On the crisis in Brazilian industry:** "The last decade has been the worst in memory for industry. Clearly, we need a paradigm shift for Brazilian industry. The current model is not sustainable. From 2008 to 2013, production declined 5.1%. In 1980, Brazil accounted for 2.7% of global industrial production. Today, that figure is 1.6%. We went from 7th in the world to 11th in industrial production. We are only the 22nd biggest exporter and, when it comes to manufactured exports, only the 31st in the world. We are losing ground and we need to do something about it."

- **On reasons for the decline:** "There are many reasons for the decline. The cumulative nature of taxation is one. Poor infrastructure is another. Restrictive labor laws are a third. Even labor unions today are aware of the need for reform. Workers understand they will lose their jobs if Brazil fails to become more competitive."

- **On the macro-economic dimension of change:** "After experiencing a long period of overvalued currency, we are now seeing some movement on the foreign exchange front. This will help, but it's not enough. High interest rates are another problem. If we don't resolve these macro-economic problems, there is no export or industrial policy that is going to reverse Brazil's industrial decline."

- **On industry and innovation:** "We need to link innovation with productivity. We are falling behind our competitors when it comes to investing in research and development. Brazilian companies have to do their part, not just the government. From 1995 to 2002, we scored an annual increase in productivity averaging 3.2%. But, from 2003 to 2009, we witnessed an average annual decline in productivity of 1.7%. Our competitors, by contrast, have made consistent gains, so we are falling back in real terms."

- **On the role of industry within the overall economy:** "There is no contradiction between growth in industry and growth in agriculture and services. The three grow together. They are integrated. Greater demand for commodities, for example, will bring greater demand for agricultural machinery. There needs to be greater integration of development policies, for example, industrial policy with trade policy. In today's world, you need to import in order to export. Brazil needs to integrate itself more into global supply chains. We should ask multinational companies installed here to export more, not just rely on the domestic market. And we need trade agreements with the big players—the United States and the European Union. We need to pick winners, not losers."

Top News of the Week

Back payments, foreign exchange losses produce big February deficits. Brazil's public sector registered worrisome deficits in February as the government struggled to meet back payments to suppliers and the Central Bank racked up major losses on foreign exchange contracts. The public sector clocked a monthly primary deficit of R$2.3 billion as modest state and municipal surpluses were overwhelmed by a federal government deficit of R$7.8 billion. Federal spending was shadowed by back payments owed to suppliers of goods and services, in many cases dating back to 2014. The February figures contributed to a 12-month primary budget deficit of R$35.8 billion. Brazil's government is aiming for a 2015 calendar-year primary surplus of R$66 billion. Primary figures do not include debt service payments. Such payments were inflated in February by Central Bank payouts of futures contracts linked to the foreign exchange rate. The rapid strengthening of the U.S. dollar against the Brazilian Real in February brought losses for the Central Bank of R$27.3 billion, contributing to an overall nominal deficit during the month of R$58.6 billion.

Levy backs compromise on state, municipal debts, expands welfare taxes. Finance Minister Joaquim Levy advanced his fiscal austerity program with two important steps last week. The administration and congressional leaders agreed to effectively postpone steep reductions in interest payments on debts owed the Federal Treasury by state and municipal governments. Levy argued that the Treasury needs the continued payments in order to meet stiff budget surplus targets this year. A long-planned reduction in interest charges on the state and municipal debts will only take effect in 2016, under the new plan. Separately, the government announced new rules for collecting the PIS/Cofins social welfare tax. Under the new rules, companies earning financial market gains on capital deposits will pay a 4.65% PIS/Cofins tax over such profits. The new rule will go into effect July 1 and is expected to bring in additional revenues of R$6.5 billion per year. The administration is aiming for a primary public sector surplus this year of R$66.3 billion, reversing a 2014 deficit. So far, the effort has been frustrated by continued spending pressure and declining tax receipts (see item above).

Public support for Brazil's President slips to lowest level since 1989. Plagued by a weak economy and a spreading corruption scandal, Brazilian President Dilma Rousseff last week saw her popularity slip to its lowest level since taking office in 2011. Indeed, a poll released by the Public Opinion Research Institute (Ibope) showed the lowest level of popular support for any Brazilian President since José Sarney confronted hyper-inflation in 1989. The nationwide Ibope poll, conducted for the National Confederation of Industries (CNI), showed public approval for President Rousseff at just 19%, a stunning decline from 52% in a similar poll in December. The ruling PT (Partido dos Trabalhadores) fared even worse, sinking to 12% from 40% in December. The administration is facing a spreading bribery and money laundering scandal at state-run oil company Petrobras. Meanwhile, Brazil's economy has retreated into zero growth with rising inflation.

Business News

Investment News:

Brazil is the third most vulnerable emerging market country among 22 surveyed by the **Institute of International Finance** (IIF), according to a study released last week. Brazil falls in behind Ukraine and Argentina and just ahead of Russia. Least vulnerable emerging countries were Chile and South Korea. The study cited the weakness of Brazil's currency and the rise of overseas debt exposure by many of the country's leading corporate borrowers. Persistent inflation and rising government deficits are other factors making Brazil more vulnerable to domestic and international market volatility.

Company News:

The state-run **Brazilian Development Bank** (BNDES) posted a 2014 net profit of R$8.594 billion, up 5.4% from the previous year, the bank said last week. But auditors added a footnote, saying the figures included only R$1.0 billion in estimated losses from the bank's stake in Petrobras. In fact, auditors said, losses were on the order of R$2.6 billion. The BNDES is a major shareholder in Petrobras, having expanded its stake in a 2010 stock offering. Petrobras shares have suffered huge losses over the past year because of declining oil prices and a spreading corruption scandal. Auditors said share price losses were likely to be permanent.

State-run oil company **Petrobras** last week announced a $3.5 billion loan from China's State Development Bank. Terms of the loan were not released. The loan will help Petrobras meet heavy upcoming loan and bond payments at a time when the company's credit rating has declined. Market sources estimated Petrobras faces some $56 billion in obligations by June. The company said the Chinese government-run bank will extend additional credits in the near future.

Brazilian Calendar

Wednesday, April 8, National Motor Vehicle Manufacturers Association release of monthly production, sales and export figures, Hotel Mercuré, São Paulo

Wednesday, April 8, Brazilian Census Bureau (IBGE) release of monthly IPCA inflation data, Rio de Janeiro

Friday, April 10, Americas Summit, Panama City, Panama

Indicators

Foreign exchange rate: **R$3.13 = $1.00**

Brazilian **industrial production** took a 0.9% dive in February against January and 9.1% against February of 2014, the Brazilian Census Bureau said last week. February performance contrasted with a modest 2.0% month-on-month advance in January. Industrial output is falling on a combination of factors, including rising interest rates, stubborn inflation and a steep decline in government spending on public works projects.

Brazil registered its first monthly **trade surplus** of 2015 in March, a solid $458 million. But economists noted that both imports and exports were down sharply from year-ago levels. Export revenues are falling on lower international commodities prices while imports have declined because of sluggish domestic demand. Brazil's posted a first quarter overall trade deficit of $5.557 billion, down from $6.078 billion for the first quarter of 2014.