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Opens its eyes to Brazil

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from enemy of the state to thriving entrepreneur

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Interviews: Carmen Reinhart and Charles Goodhart
Anne Grant spoke separately to Carmen Reinhart, Professor at the University of Maryland, and Charles Goodhart, Professor at the London School of Economics and former member of the Monetary Policy Committee of the Bank of England, to get their views about how the global financial crisis is unfolding. The risks to the global economy remain significant (page 4).

Cover story: Iron weighs heavily in mining sector expansion
Investors today are attracted to Brazil by commodities that have become precious because of their value for industrial development, particularly iron ore but also phosphate, potassium, nickel, gold, and even uranium. Construction for the World Cup and the Olympics is pushing up domestic demand even as places like China are buying ever more heavily. Laws the government is drafting would set up a whole new system for regulating mining and metallurgy; some provisions are causing controversy. The Growth Acceleration Program calls for federal investment in infrastructure, though some states are moving forward on their own. Liliana Lavoratti looks at the whole picture, and Kalinka Iaquinto analyzes the debate over the new regulations (page 10).

International
China opens its eyes to Brazil
In less than a decade, China has overtaken the US to become Brazil’s biggest commercial partner, and Chinese multinationals are now investing heavily in Brazil. But manufacturing exports from China are also competing with Brazilian goods not only in Brazil but also in markets that are important for Brazil, especially the other countries in Latin America. Angélica Wiederhecker explains the risks and opportunities the new situation presents, and profiles a legendary Chinese businessman who has turned his attention to Brazil (page 22).

Brazil and China: Status report on an emerging relationship
Riordan Roett analyzes both the economic and the political implications of the April 2010 BRIC summit in terms of issues ranging from trade to climate change. His conclusion is that the BRIC states, led by Brazil and China, are increasingly important players in international relations today (page 29).

Elections
Rethinking government’s role
How can the Brazilian government do a better job? The question must be faced by the president to be elected in October. Liliana Lavoratti reports on a roundtable on the elections (page 32).

Brazil: Economic and financial indicators (page 38)
The immediate gains generated by the commercial relationship between Brazil and China may be wearing out. Ties between the two countries are entering a new phase that presents risks and opportunities. The bad news is that Brazil’s manufactured goods are facing fierce competition from Chinese manufactured goods both at home and in Brazil’s Latin American markets. The good news is that the long-awaited wave of Chinese investments in Brazil has finally begun to materialize. The crucial question is whether Brazil will have the ability to fully realize the potential of these investments.

Angelica Wiederhecker in Beijing, China, profiles Yin Mingshan, a legend in Chinese business. After being labeled as an enemy of the state during the regime of Mao Zedong, he was dispatched to a forced labor camp. Years of hardship followed, but finally Yin managed to save enough to establish Lifan, a Chongqing-based maker of cars and motorcycles. Today Lifan is the largest exporter of Chinese motorcycles to Brazil and is considering opening a car factory in Brazil.

“Brazil is very promising, with a vast territory and large domestic market,” Yin says. He adds: “There are Chinese entrepreneurs who commit the folly of ignoring trade with Brazil, but I’m not a fool.”

The cover story for this issue analyzes the Brazilian mining sector, which is receiving a growing wave of investment, especially from Asian countries, especially in iron ore. The government’s project of establishing a new regulatory framework for the sector is generating uncertainty, although some entrepreneurs favor setting up an agency to regulate mineral activities. The issues are discussed by Liliana Lavoratti and Kalinka Iaquinta.
Global financial crisis a year later: Still a lot to worry about

Anne Grant, Washington D.C.

A year after the outbreak of the global financial crisis, Charles Goodhart, emeritus professor of banking and finance at the London School of Economics, says we’ll be “jolly lucky” if the global crisis winds down smoothly. One point he makes here is that even in advanced economies, the pace of recovery will differ and must be re-evaluated whenever the economic data are updated. Also, economic decisions are often influenced by the social and political climate. The fact that the main danger has moved from banks to public entities is a factor that some recent proposals do not seem to have taken into account. On the other hand, Carmen Reinhart, author with Kenneth S. Rogoff of This Time It’s Different: Eight Centuries of Financial Folly, points out the recovery this time has already taken far longer than any other since World War II. She attributes many of today’s economic problems to the opacity of the balance sheets of financial institutions, although she notes that bank failures “have been as much a result of poor enforcement — supervisors looking the other way — as of poor or nonexistent lending standards.” Both professors support the proposal to charge a levy on the largest banks to make financial institutions lend prudently.
The Brazilian Economy — A year and a half after the outbreak of the financial crisis, there seems to be hope that the worst is over. What is your take on the current situation in world financial markets?

Charles Goodhart — The situation keeps changing. The crisis has taken many twists. The main danger has moved on from banks to public bodies — not only sovereign debt per se, but also liabilities to public bodies, such as subsidiary states and municipalities. This raises a new problem, because the difficulties of public bodies can feed through to banks.

In a recent book, Ken Rogoff and Carmen Reinhart maintain that recoveries from recessions caused by financial crisis are slower and shallower than recoveries from other recessions, and that the US subprime financial crisis is hardly unique. With banks still repairing their balance sheets, recovery in the advanced economies is slow, with little credit expansion to the private sector. Is the recovery in advanced economies going to be protracted?

Carmen Reinhart — The recovery already has been protracted. Since World War II recoveries have tended to average less than a year. This time subprime problems arose in August 2007, economies deteriorated throughout 2008, and we’re still not back on track. The signs of recovery may be everywhere, but how sustainable are they? There are still a lot of issues to be resolved.

Charles Goodhart — It’s extremely difficult to tell. For instance, as a commodity economy, Canada is on a different track from the US, the UK, Japan, and the EU economies. Also, in the US, for instance, the recovery looks to be reasonably broad-based, but there was only a brief upturn in Japan and the UK. We must constantly evaluate the latest figures as they appear.

On this side of the Atlantic US states, such as California, are in a dire debt situation. On the other side, things are equally dire in EU countries like the PIGS (Portugal, Italy, Greece, and Spain). How should these debt crises be addressed? And should the IMF play a role in resolving the problems of the PIGS?

Carmen Reinhart — What’s been done in Europe is a reasonable step in the right direction, because it buys some time for its economies to adjust and to digest what’s happened and what needs to happen. Financial markets don’t like surprises. Greece will have to restructure its debt. That cannot be avoided, but the steps taken to delay it may mitigate the contagion. Surprise and high leverage are an unholy combination.

The restructuring debt in Argentina in 2001 was death by a thousand cuts, but there was no real surprise because what ultimately happened had been widely anticipated.

Charles Goodhart — The circumstances of each country make a difference. A number of countries have decided on internal devaluation; they have cut wages and prices.

“The main danger has moved on from banks to public bodies — not only sovereign debt per se, but also liabilities to public bodies, such as subsidiary states and municipalities.”

Charles Goodhart
This path is painful: Among the Baltic states, for instance, Latvia has been willing to take this route. Ireland also moved early adopting tough fiscal measures. The resulting fall in nominal incomes naturally has a negative effect on output and employment. The social and political climate in southern economies in Europe is not conducive to this solution. Political elites there have been influential in diverting the fiscal and monetary authorities from considering such options. Of course, the only result for them in the end is more internal devaluation, because tax revenues are going down.

Many emerging market economies are experiencing a fast recovery to the point of overheating and inflation surges. In particular, China is booming and may be experiencing a real estate price bubble. Is there a chance that if its real estate bubble bursts, the boom in China could brake to a halt?

Carmen Reinhart — Any boom can crash, but there are more imminent things to worry about. The recovery in advanced economies is fragile; the amount of debt accumulated by the world’s largest economies is scary. Keep in mind that China is a tightly controlled, very closed economy. It’s in a reasonably good position to manage the consequences of a bursting real estate bubble.

Charles Goodhart — There are always risks and there have often been sharp reversals in Chinese asset markets. The general belief is that Chinese economic power will carry it through even if the bubble bursts.

Niall Ferguson has called it a delusion that creating more debt and spending can resolve a crisis that resulted in the first place from excessive debt. The bailout of large banks has translated into large public debt that raises fears about fiscal sustainability in many advanced economies. Ferguson suggests that a single huge debt restructuring that would give bondholders of insolvent institutions equity, and put the institutions under government administration (as happened in the banking crisis in Scandinavian countries). Would this have been a better alternative for handling financial crises?

Carmen Reinhart — What the Scandinavian countries restructured was private debt. Restructuring public debt is not so simple. Keep in mind, too, that restructuring is equivalent to a partial default.

Charles Goodhart — If, as it appears, the main danger is no longer banks but the debt of public bodies, how would you turn public sector debt into equities? This is especially apparent in the PIGS, where the threat to solvency clearly comes from the debt of the governments. There is also the question of who bears the burden. Bondholders have entered into a contractual relationship in good faith. How do you tell them, in effect, that you are going to take away their money?

“Greece will have to restructure its debt. That cannot be avoided, but the steps taken to delay it may mitigate the contagion.” Carmen Reinhart
What is the origin of the “too big to fail” policy? It seems to create a fundamental obstacle to a sound banking system by providing incentives to banks engaging in risky activities.

Carmen Reinhart — Too big to fail is not a policy, it’s a reality. Since World War II there have been frequent banking crises, but there has seldom been major government intervention. Through the 1970s crises were few, but they have been much more common since the 1980s because there are not so many capital controls. There have been more and more crises requiring institutional — systemic — bailouts. Another reason for the new scale of intervention crises is the increasing opaqueness of balance sheets. It’s the interconnectedness that makes institutions “too big.” Also, because balance sheets are so opaque, it’s hard to understand what’s really happening with them. It’s very unfortunate.

Charles Goodhart — We’ve moved away from “too big to fail.” Yet there is still the problem that big financial institutions can’t be closed because the ripple effects could be severe. There might be a haircut on creditors, but there are simply too many people involved in the transactions of international financial institutions who would be affected. That is not to say that a form of bankruptcy might not be possible, where shareholders lose and management goes but the entity keeps on operating. Closure and liquidation are more problematic. What would happen if a big bank’s assets were dumped on the markets?

Should central banks have a procedure for intervening quietly in insolvent banks? For instance, the Central Bank of Brazil can close them down without lengthy legal procedures and without disrupting the banking system. Is there any reason why, after rescuing the financial system, insolvent banks should be closed?

Carmen Reinhart — Yes, there should be procedures. But one problem is that not just central banks but even the manager in private institutions do not understand the implications of the opacity of balance sheets and the interconnectedness of institutions. They’re finding out the hard way nowadays.

Charles Goodhart — Yes. Central banks are supposed to have responsibility for resolving bank problems, but most of them can only provide liquidity. They need to be equipped for countercyclical regulation.

“The time for the idea of a bank tax has probably come ... However, such tax ought to relate to systemic dangers, such as the size and riskiness of positions determined ex ante.”

Charles Goodhart
regulation should be countercyclical to dampen asset booms and smooth bursting bubbles.

*Carmen Reinhart* — The main job of central banks is to manage inflation. It’s hard for them to systematically burst bubbles, but it might behoove them to enhance policy to make it more eclectic and to be more aware of what’s happening with credit aggregates, what’s happening when credit is piling up frantically. One reason there were fewer crises earlier was that the central bank would move faster to increase margin requirements.¹ We haven’t seen that instrument used lately.

*Charles Goodhart* — This question is similar to the previous one in a sense, because again the answer is yes, and again the problem is that Basle II and mark-to-market have indeed made regulatory systems more procyclical. Financial regulation in general needs considerable rethinking.

What do you think about the proposed (Paul) Volcker rule for limiting the proprietary activities of banks? Volcker said that “adding further layers of risk to the inherent risks of essential commercial bank functions doesn’t make sense, not when those risks arise from more speculative activities better suited to other areas of the financial markets.”

*Emerging markets need to be very careful… . Prudence in borrowing is the lesson to take to heart, or it will all end in tears.*

*Carmen Reinhart* — If the intent is to try to make institutions smaller, it’s a step in the right direction. But big v. small is not the only issue. Opaqueness is also a big problem, and I’m not sure the proposed rule will help there. Limiting size and limiting interconnectivity will take real expertise. You have to understand the interconnections to set the lines. And if we go into panic mode, smaller institutions may also have to be bailed out. Institutions can set up shadows and third parties to appear smaller. To return to my theme: We really need more transparency. We really need to get rid of opaque balance sheets. But the default position of policymakers has been to blink and bail out.

*Charles Goodhart* — Applying the Volcker rule will require making some very difficult distinctions. At one extreme, it might be easy to prohibit bank involvement with hedge funds, but beyond that it may be much trickier.

Unlike Volcker, who thinks the problem is structural and better supervision is not enough, Alan Blinder does not believe bank regulators need to wait for new legislation from Congress. They should use the authority they have to raise banks’ capital and supervise more closely trading in riskier assets. Is this enough to prevent another financial crisis?

*Carmen Reinhart* — Realistically, failures in the run-up to crises have been as much a result of poor enforcement—supervisors looking the other way — as of poor or nonexistent standards for lending, where lenders weren’t following the most basic rules for granting credit and focusing on debt-to-income ratios, for example in plain vanilla transactions.
Charles Goodhart — Supervision must involve some kind of sanctions. The general outlines of the sanctions, though not the specifics, must be agreed on through the legislature. It’s no good to simply impose sanctions on their own. The rules must be set within the boundaries of the general democratic system.

Where do you think financial regulation is heading? And what do you think about the proposal endorsed by the IMF to charge a levy on the largest banks for the cost of any future government rescue and a tax based on bank profits and compensation? Are these the right incentives for financial institutions to not take excessive risks?

Carmen Reinhart — I’m all for preprovisioning. Because too big to fail is a reality, institutions expect to be bailed out, which induces risk-taking and negative behavior. If they take on more risk, there’ll be more crises. Preprovisioning would make institutions internalize their responsibility.

Governments today have to look everything they can to raise revenue because they have huge deficits and huge debt. Relative to other areas, financial institutions have not been heavily taxed.

Charles Goodhart — The time for the idea of a bank tax has probably come, especially since most governments need cash, and bankers are deeply unpopular. However, any such tax ought to relate to systemic dangers, such as the size and riskiness of positions determined ex ante. It should, in other words, be more preventive of systemic risk. A tax on assets and liabilities would apply ex post — it would be backward-looking. You can’t get rid of that kind of risk by cleaning up afterward. There’s too much likelihood of contagion. In sum, we’ll be jolly lucky if we’re really on the way out of the crisis. There may be many more twists to come.

And the emerging market countries?

Carmen Reinhart — Emerging markets need to be very careful. At the moment they’re the darlings of the financial industry. They weathered the crises because they had already reduced their dependence on debt before the subprime crisis. But financial markets make borrowing very enticing. Prudence in borrowing is the lesson to take to heart, or it will all end in tears.

1 The amount that an investor must deposit in a margin account before buying on margin or selling short, as required by the Federal Reserve Board’s Regulation T.

(Translation: Pinheiro Ronci)
Two centuries after Brazil’s gold rush, the country is still considered an Eldorado for the extraction of mineral wealth. Unlike the settlers attracted mainly by gold, however, investors today are attracted by commodities that have become precious because of their value for industrial development, such as iron—a raw material for steel, which are used in a wide range of products, from heavy construction equipment to durable goods. For example, a metric ton of iron ore, which in 2002 cost US$15, now is worth about US$100—a six-fold increase.

The exponential increase in consumption of these commodities by emerging economies like China, together with growth of the Brazilian economy by 6% a year, has raised 2010 production and investment prospects for minerals mining to levels that prevailed before the global financial crisis. Despite the uncertainty caused by proposed new regulation—which envisages creation of a regulatory agency and more government interference in mineral exploration—Brazil’s resources make it one of the most attractive countries for mining investment in Latin America.
America, behind only Chile and Mexico.

“Over the next five to ten years there will be a boom in iron ore, lithium, and gold, which have already reached record levels of appreciation,” says Tim Chen, CEO of Top Ventures Investments SA, a Brazilian investment and management projects holding company. The company recently signed an agreement with Georadar Levantamentos Geofisicos SA, a provider of technical services to mining and oil, for gold exploration in Paracatu (Minas Gerais state), which has had known gold deposits since the 18th century, and contains estimated gold reserves of more than 20 million ounces.

The Brazilian Mining Institute (IBRAM) foresees higher mining production for at least three years. Gross fixed capital formation in the mining sector is projected at US$57 billion between 2010 and 2014, comparable to levels before the crisis. This estimate is confirmed by the National Bank for Economic and Social Development (BNDES), which forecasts that through 2013 R$16 billion (US$8 billion) a year will be invested in the production of ferrous and nonferrous metals.

“The prospects are good that production is returning to pre-crisis levels, which bodes well for the near future,” says Pedro Sergio Landim de Carvalho, manager of the BNDES Department of Basic Petrochemicals. BNDES disbursements for the mining industry also provide a measure of what is happening: they increased from R$362 million (US$180 million) in 2004 to R$4.5 billion (US$2.5 billion) last year — a fourteen-fold increase. “The data indicate that the market for minerals is recovering. Also, there is a very good level of confidence for investment in mining in Brazil,” says Miguel Nery, director general of the National Department of Mineral Production (DNPM) of the Ministry of Mines and Energy.

Healthy investments in mining and metallurgy are not new. From 1996 to 2007, the metallurgy industry’s share in total investments in mining and processing nearly tripled, from 5% to 13%, according to a study by Regis Bonelli, an economist at the Brazilian Institute of Economics (IBRE) of the Getulio Vargas Foundation (FGV). Extraction of metallic minerals jumped from 3% to 8% of the total.

A metric ton of iron ore, which in 2002 cost US$15, now is worth about US$100 — a six-fold increase.

### Mining sector

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Source: IBRAM.
China and the World Cup

“The mineral ore markets will become increasingly heated, driven mainly by the Chinese,” says Antonio Lannes, IBRAM manager of economic data. “Domestic demand is also up and will consume about 15% of total production. The rest will be exported.” If Chinese steel consumption already approaches the standard of developed nations, it is impossible to even imagine the demand for metals when every Chinese has a car in the garage, suggests Geraldo Mellone, analyst at Bresser Resources Administration. He points out that out of 1.3 billion Chinese, 800 million still live in rural areas.

The expansion in supply and investment in minerals has also benefited from the public works of the Growth Acceleration Program (PAC) and infrastructure projects related to the 2014 World Cup and the Olympic games in 2016. These will push up demand for iron ore, nickel, and copper.

All this makes current mining and metallurgy growth sustainable. This year mining production in Brazil is expected to reach US$35 billion, well above last year’s US$24 billion. From 2000 to 2008, the sector recorded growth of 250%. Mining and metallurgy are already responsible for 5% of gross domestic product (GDP), according to IBRAM.

“Brazil is a major producer of mineral commodities that has established itself as a global player and has attracted the attention of foreign capital,” Nery notes. “This year we expect to see new investments in mineral surveys. We are confident that mining will be a very important sector for the Brazilian economy.” Another reason for the increasing interest of foreign investors is the insufficiency of domestic phosphate production, one of the few minerals Brazil still imports — about two million metric tons a year, half of domestic consumption. Although it is one of the largest grain producers in the world, Brazil is not self-sufficient in extraction of the phosphate and potassium used in the production of fertilizers. Although there are projects underway in the states of Goias, Santa Catarina, Minas Gerais, Ceará, and Tocantins, phosphate production is still not sufficient to meet domestic needs. “Self-sufficiency in potassium will be a little harder because we have only one active mine in Sergipe state, though there are untapped reserves in the Amazon,” says Lannes.

Ranking High

In its ranking of the most attractive countries for foreign investment in mining, the Fraser Institute, a Canadian economic research unit, shows Brazil as in second behind Chile, though Mexico, Peru, and Colombia are almost equally well positioned. “Venezuela, Bolivia, and Ecuador have been wiped off the map for investments, mainly
because of excessive government interference. And Brazil has become even more attractive, increasing the chances of new foreign investment in the sector. Unfortunately, it is hard to understand why the government wants to radically change the rules for the sector, including increased taxation of mining companies and more red tape for renewing concessions,” says Helio Botelho Diniz, vice president of operations for Forbes & Manhattan in Brazil, a Canadian consortium of 10 companies that has been in Brazil since 2004, mainly investing in nickel, potassium, phosphate, and gold mining, though more recently in oil and gas.

Undoubtedly, Brazil has immense potential to expand the mining and petroleum business. “The stability of the economy and the rules attract more projects,” Diniz said. With geology similar to that of Canada and Australia, two other mining giants, Brazil is far from receiving the same volume of foreign investments. But, for Diniz, “so far everything is going the right way. We hope that the regulatory framework does not spoil everything.”

Forbes & Manhattan raised funds abroad to start the Potássio da Amazônia company, its biggest project in Brazil, which starting in 2016 is expected to produce two million tons of potassium a year — one quarter of the country’s needs; Brazil currently imports 90% of the eight million metric tons it needs annually. The total cost of the project along the Amazon River is estimated at US$2 billion. The consortium’s second largest project is a gold operation in Altamira (Pará state), a US$300 million investment that is projected to produce three to six tons of gold a year by 2013. Two other company projects, in Minas Gerais and Paraíba states, deal with phosphate.

Brazil’s abundance of mineral reserves, and business opportunities, partly offsets a significant downside, which is the lack of infrastructure to transport what is produced.
“We are lagging behind in ports and railways. This makes life very difficult for small mining companies, almost forcing them to sell what they produce to the Vale company, which has its own logistics to get products to ports,” Tim Chen says. Therefore, the Chinese, although their interest in Brazil’s iron ore is growing, will also seek partnerships in Chile and Peru. “While product quality there is not as good as Brazil, those neighbors have access to the Pacific ocean, which benefits the flow of production,” Chin says.

The federal government is seeking to solve the infrastructure problems, especially those related to the flow of production, Nery emphasizes. The PAC calls for expansion of railways, ports and dams, he says, and “the BNDES is financing several projects to ensure the transport needed.”

Search for Quality
Another factor that will benefit the expansion of iron ore mining and processing in Brazil is the likely closure of inefficient steel plants in China and Russia, BNDES manager Carvalho thinks. Internationally Brazil is already highly cost-competitive in the production of long and flat steel, and it has become even more attractive for new steel mills because of the high quality of Brazil’s iron ore. It is estimated that about steel production could fall by some 300 million metric tons for lack of competition and excess production; global production capacity is 2 billion metric tons, but demand is just 1.4 billion tons. “Units that operate on the margin are being closed and more efficient ones are being opened,” Carvalho says.

Accordingly, BNDES will finance about R$5 billion (US$2.8 billion) of new projects in the steel
Undoubtedly, Brazil has immense potential to expand the mining and petroleum business.

Steel production will rise from 43 million metric tons in 2009 to 49 million tons in the first half of 2011 with the inauguration of both stages of the Atlantic Steel Company (CSA), which Vale is building with Germany’s ThyssenKrupp in Rio de Janeiro state. It is projected that by 2014 steel production in Brazil should reach 53 million tons.

High Prices
Prices should remain high and markets tight, analysts estimate. Mellone, for instance, says, “The mines opening are farther away and therefore the trend is that prices will stay high. Prices will hardly go back to US$20 a metric ton. Soon there will be ore shortages as steelmakers in Europe and the US recover gradually.” After a pause in new mining projects due to the global crisis, in recent months such projects have resumed and will begin to produce results in about four years.

Therefore, ore supply will return to normal only in 2013 and 2014, when prices should fall.
“Meanwhile, demand remains greater than supply and prices will continue high, around the current US$100 a ton,” Mellone says. The fact that little additional supply of ore is expected this year and next will benefit Brazilian mining companies, especially Vale, which lost market share during the crisis to its international competitors, BHP and Rio Tinto.

Confident of the promising scenario for mining and metallurgy in both the short and long term, Vale has announced that it intends to close 2010 with production of 315 million tons of iron ore, slightly above the 300 million tons in 2008 and considerably better than the 250 million tons in 2009. The company also plans to raise its output by almost a third — adding 90 million tons in Carajás (Pará state) alone starting in 2013. Within six or seven years, Vale also expects to have in production the Simandou mine in Guinea, the company’s first investment in West Africa and one of the best sources of iron ore.

“If mining companies were already profitable when iron ore was US$20, imagine how they are doing at US$100 a tone,” Mellone says. The extraction cost per ton in Brazil is about US$15 to US$20 per ton, so “At the current price, iron ore is an excellent investment. Mining companies want a ride on that high profitability.” Investors have clearly noticed: the price of Vale shares has risen from R$3.50 in 2001 to today’s R$44.

**Mining concessions**

Brazil

**Place for All?**

Carlos Eduardo Mellis, who is responsible for project financing for the Itau BBA investment bank, has a slightly different take on the near-term market for iron ore: “It seems a very positive scenario, but it remains to be seen whether there will be room for all in the boat.” The 10 or so new projects have the potential to add about 200 million tons to current production of iron ore, not counting the 90 million ton increase Vale plans.

Although the growth rate since the late 1990s has been 8% a year — twice the rate of the global economy — trade in iron ore is driven mainly by economic development in emerging countries, particularly China. Weeks

Source: National Department of Mineral Production (DNPM).
ago, the Anglo-Australian BHP Billiton and Rio Tinto, second and third largest producers of iron ore in the world, took another step toward creation of a joint venture worth US$116 billion. Their plan is to produce together more than 350 million tons of iron ore, surpassing Vale, the world’s largest producer. That would amount to more than one-third of global trade in iron ore and about two-thirds of China’s imports, China being the largest buyer of iron ore in the world. One of the goals of the partnership is to cut costs.

Momentum in the States
The mining industry is expanding into places that had no tradition in mining, such as Bahia state, currently the fifth largest mineral producer in Brazil and soon to reach the fourth position with the entry of new projects planned through 2012.

Four years ago the Company Bahia Mineral Production (CBPM) targeted development of metallic minerals, particularly gold, iron, nickel, and zinc. Bahia has the most potential for new mines, says Rafael Avena Neto, CBPM technical director. Besides the recently inaugurated Mirabela nickel mine, which will be the third largest open sky nickel mine in the world, CBPM is expanding production at the mine in Caetité that is the sole producer of uranium in Brazil. In 2012, the largest iron mine in the state will also begin operations in Caetité, in Santa Luz the Yamana gold mine will begin production, and in Maracas the Largo vanadium mine will open, both of the latter in areas leased by CBPM.

The government of Bahia state has been investing in infrastructure. For example, the East-West railway is strategic for mining development in the state. Its 1,500 kilometers of track connect 32 municipalities, several of them producers of minerals. The corridor will transport 18 million tons of iron ore alone.

Pará is by far the state that attracts the most investments in minerals. By 2014 it is expected to have pulled in US$40 billion in investments in mining, mineral processing, and transportation. Vale will be doubling iron ore production in Carajás; according to the Federation of Industries of Pará (FIEPA), Vale’s Canaã mine will reach its production peak of 90 million metric tons in 2015. Another project already underway is the US$6 billion Aços Laminados do Pará (ALPA) plant in Maraba, which will have the capacity to produce 2.5 million tons of rolled steel plates. Operations should begin by the end of 2013. According to Vale, the project will add value to the iron ore extracted from mines in Carajas. ALPA will be an integrated system with rail access to receive iron ore from Carajas, and a river terminal being built on the Tocantins River.
By 2014 Pará state is expected to have pulled in US$40 billion in investments in mining, mineral processing, and transportation.
Controversial new institutional framework

Kalinka Iaquinto, Rio de Janeiro

Divided opinions — The Ministry of Mines and Energy has been working on three bills that will be sent to Congress in 2011. Together, they constitute a new regulatory framework for the sector. They envisage the creation of the National Mining Agency (ANM) and the National Council of Mineral Policy (CNPM), and would set out a new policy on royalties that promises to be highly controversial.

“The regulatory framework will enable serious, capitalized businesses to thrive,” says the CEO of Top Investment Ventures, Tim Chen. “The new rules will help to discourage speculation. Well-structured mining companies will develop projects, and production will bring revenue to the country.” The current rules date back to 1967, when the Mining Code was adopted (Decree-law 227).

Miguel Nery, director general of the National Department of Mineral Production (ANP) of the Ministry of Mines and Energy, says the government’s intention is to stimulate competition between companies and attract new investment. He believes that the new National Mining Agency will be in a better position to press holders of mineral exploitation rights to follow the law, including investing in mine prospecting and establishing productive enterprises. He says, “Whoever fails to comply could lose its rights, and the agency will re-open bidding for that area so that someone else can invest. Thus, the state will stimulate competition among economic agents operating in the sector, and should reduce the concentration of areas in the hands of a few.”

Despite these arguments, raising the tax burden by increasing the Financial Compensation for Exploiting Mineral Resources (CFEM) tax is causing dissatisfaction. Those active in the mining sector fear excessive taxation, and as a result foreign companies may move to other countries.

The vice president of operations at Canadian consortium Forbes & Manhattan in Brazil, Helio Botelho Diniz, believes that “one should not tinker with a winning team.” “The government wants to control things better,” he says, “but we must understand the reality. Everyone talks about increasing taxes on mining due to the good results, but it is shooting yourself in the foot because more taxes will make investments in mining less attractive.”

Chen, on the other hand, says, “I don’t see this as an obstacle. If as investors we have the support and partnership of government, with legislation that gives us support to work and to carry out projects, we will grow and have profits consistent with the tax burden.”

In fact, the tax on mineral extraction will indeed rise if Congress approves the bills as drafted by the government. There is a rumor that the government’s intention is to align the tax burden and royalties policy for mining activities with those for oil activities. Mineral law expert and lawyer Roger Targino thinks this could affect the sector.

Maurilio Monteiro, secretary of development for Pará state, believes that the government proposal should incorporate some positive points of the new regulations for oil exploration now pending in the Senate. He says, “When you purchase rights at auction for oil exploration, dates and deadlines are set for both prospecting and production. In mining, there are no such constraints or guarantees. A company can win the concession and almost indefinitely postpone prospecting and production. This complicates planning, investment, and government actions.”
According to Nery, the Ministry of Mines and Energy has not yet finalized the proposal for royalties, and he believes the adoption of a new framework should not increase the tax burden: “It is incorrect to say there will be higher costs, though more fines may occur for mining companies in default. The penalties should be harsher to deter violation of the law and keeping large areas unproductive.” Today, out of 160,000 fields for which prospecting and mining rights have been granted, only 8,000 are producing. In an increasingly competitive environment, this translates into lost opportunities for companies that operate here and lost revenues for the country.

The new regulatory framework will insist that granting mining rights take into account the financial viability of the investor. This can be considered an advance; since that is not the case under current rules. In Targino’s opinion, in the current concession model, “speculators become ‘mining landowners’ who have acquired a huge number of permits but are not doing any mineral exploration, bringing great harm to the population and serious mining companies.”

The new legislation will facilitate the sanctioning of those who do not meet deadlines. “The Mining Regulatory Agency and the National Council of Mineral Policy will bring autonomy to the government,” Targino emphasizes. “The time for prospecting will be reduced, which will require a greater commitment by companies to both complete prospecting and start production. This will certainly keep away speculators.”

This probable change is causing anxiety, though. “The stage of greatest risk is mine prospecting. The new procedures are worrisome because the government takes up to two years to grant a permit,” Diniz says. He said each drilling for prospecting costs US$1 million. “I cannot be subject to licenses renewed annually. There is no legal security on which to raise funds,” he says. Today’s authorization for prospecting lasts three years, without proof of investment. The proposal provides five years, extended for three more, but with annual demonstration of investments in exploration.

**CFEM revenues**

Financial Compensation for Exploiting Mineral Resources

(Millions of Reais)

<table>
<thead>
<tr>
<th>Year</th>
<th>CFEM Revenues (Millions of Reais)</th>
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<tbody>
<tr>
<td>1997</td>
<td>69</td>
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<td>1998</td>
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<td>2007</td>
<td>582</td>
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<td>858</td>
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<td>2009</td>
<td>742</td>
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<td>2010</td>
<td>239</td>
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Source: National Department of Mineral Production (DNPM).
About CFEM — Municipalities, states, and the federal government gain from mineral exploitation. The Constitution of 1988 established the CFEM to compensate for the economic use of mineral resources in the territories. Over the years CFEM collections have been growing exponentially. In 2010, it is estimated that revenues will exceed R$1 billion (US$550 million).

On average CFEM proceeds are allocated 12% to the federal government, 23% to the states where the mineral is extracted, and 65% to the producing municipality. The rates applied vary according to what is extracted. For aluminum ore, manganese, potassium, and rock salt the tax is 3% of net sales; for iron, fertilizer, coal, and other substances, 2%; for gold, 1%; and for precious stones, colored stones, and carbonaceous and noble metals, 2%. CFEM proceeds are to be invested in projects that directly or indirectly improve the living conditions and services provided to local populations.

The New Agency and Council — The purpose of creating the National Mining Agency is to better regulate the sector. To keep the process transparent, the agency will have a board and normative powers to stimulate competition between businesses operating in the mineral market. Board members must have a mandate to ensure that decision-making is not vulnerable to outside pressure. The National Council on Mineral Policy is an agency linked to the Presidency of Republic to set government policies and activities for the mining sector; several ministers of state will be members.

### Brazil: Mining sector institutional framework

<table>
<thead>
<tr>
<th>Policy</th>
<th>Current</th>
<th>Government’s proposal</th>
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<tr>
<td>Grantor of concessions</td>
<td>MME</td>
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<td>MME (Grantor) (autorização)</td>
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<td>DNPM</td>
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<td>Private companies CPRM</td>
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<td>Development, production and trading</td>
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<tr>
<td>Collection of CFEM⁴</td>
<td>DNPM</td>
<td>Regulatory agency</td>
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¹Ministry of Mines and Energy; ²National Department of Mineral Production; ³State-owned Mineral Resources Prospecting Company; ⁴Financial Compensation for Exploiting Mineral Resources.  
Source: Ministry of Mines and Energy (MME).
China opens its eyes to Brazil

Angelica Wiederhecker, Beijing, China

Brazil has been one of the biggest beneficiaries of the China boom of the last decade. At the start of the century China was not even one of Brazil’s top 10 export markets, occupying 12th place. Yet in less than a decade, the country has overtaken the US to become Brazil’s biggest commercial partner. Driven by China’s ferocious appetite for commodities, Brazil entered its own cycle of expansion in recent years, and the importance of the Chinese market was underlined during the global financial crisis. The US and Europe suffered the sort of recession that had not been seen since the 1930s, yet the Brazilian economy continued to prosper, fuelled by China’s huge program of infrastructure spending, which led to record imports.

Yet the initial gains from Brazil’s ties with China are wearing out. Instead, economic relations between the two countries are entering a new phase, one that presents both risks and opportunities. The bad news is that Brazil could be about to receive a new wave of exports from China that will compete not only in the domestic market with goods produced by Brazilian companies but also in other markets that are important for Brazil, especially the other countries in Latin America. The good news is that the long-awaited surge of Chinese investment is finally beginning. The crucial question is whether Brazil has the capacity to take advantage of such investments.

New wave

The impressive expansion in the economy in the first half of 2010 — the fastest growth in at least 14 years, according to the Brazilian Institute of Geography and Statistics (IBGE) — has allowed Brazil to return to its pre-crisis growth. In 2009 Brazil suffered six months of recession and the economy shrank by 0.2%, but this year Brazil should grow by about 5%, making it an attractive alternative for companies worried about sluggish markets in the US and Europe, which the IMF forecasts will grow by just 3.1% and 1% this year.

As a result Chinese entrepreneurs are demonstrating increasing interest
in the region: “We consider emerging markets such as Brazil to be strategic, given that they have not been so severely affected by the crisis,” says Wu Zengqi, senior vice president at ZTE, the Chinese telecom equipment manufacturer. “Our strategy is to increase our investments in Latin America, especially in Brazil.”

ZTE is one of the biggest Chinese multinationals, with sales of US$8.8 billion in 2009; it has had a presence in Brazil for about eight years. But it is not just the giants of corporate China that have their eye on the Brazilian market. Many small and medium-sized companies, which in the past would not have seriously considered trying to do business on the other side of the world, are looking at the country as an important growth opportunity.

Sichuan Great Trading, which is based in Chengdu in south-west China, makes a broad range of hand tools, such as screwdrivers, saws, and hammers. After taking part in a commercial visit to Brazil last year, the company is planning to establish itself in this market. “It is only now that we are starting to take the Brazilian market seriously,” says Qi Kejun, marketing director. Qi says that because Sichuan Trading is state-owned, it is usually more conservative in assessing new markets than a private company might be. In the past, it concentrated mostly on Europe and the US, but with the crisis the outlook changed. “We are very enthusiastic about the Brazilian market, which could be very promising for made-in-China products,” Qi says.

Shirley Woo, director of Guangdong Yulong, a medium-sized furniture company in the south of China, said there is growing interest in Latin America, especially Brazil. “It is a new market for the company, so we do not have much experience, but we see great potential,” she says.
The threat from Chinese exports is a factor throughout Latin America, where China is advancing rapidly in markets that are important for Brazil.

The company exports its own ready-made furniture for Brazilian clients but is also interested in doing contract manufacturing.

An analysis of Chinese exports shows how the crisis has led the country to accelerate geographic diversification of its exports, with emerging markets becoming increasingly important. Chinese trade figures for the first five months of 2010 show an 110% increase in exports to Brazil; Russia was in second place among major markets with a 92% increase. “The recovery in exports since the start of the year has been driven by the strong rebound in other developing economies,” says Ha Jiming, economist at China International Capital Corporation, an investment bank.

The growing Chinese presence in developing economies is partly a reflection of the slow-growth forecast in advanced economies, but it is also a result of China’s exchange rate policy. Until last week the renminbi was pegged to the US dollar. When the currencies of several other emerging economies, such as Brazil, India, and South Korea, appreciated significantly against the dollar, the renminbi depreciated by about 14% against those currencies, boosting the competitiveness of Chinese goods and services. The World Bank notes that in the first five months of 2010, Chinese exports were 10% above the level in the same period in 2008, before the start of the crisis. That clearly indicates that Chinese companies have increased their share of exports, considering that globally imports are still below pre-crisis levels.

Chinese competition
The threat from Chinese exports is a factor throughout Latin America, where China is advancing rapidly in markets that are important for Brazil. This is especially worrying for Brazilian manufactured goods, whose principal destination is South America. According to a study by Kevin Gallagher, professor of international relations at Boston University, 39% of all Brazilian exports are under threat from goods imported from China, but the competition is even more intense in the case of manufactured goods, with 91% under threat from lower-priced Chinese goods. In the case of hi-tech products, the share is an even higher 94%.

The brutal competition from Chinese goods is reflected in the relative positions of Brazil and China in the global market. China’s share in global exports of manufactured goods rose from 0.4% in 1985 to 11.5% in 2006, while Brazil’s fell from 1% to 0.8%. “China is increasingly winning the competition with exporters of manufactured goods from Latin America in the world and in regional markets, and the worst is yet to come,” said Gallagher, one of the authors of the book *The Dragon in the Room — China and the*
Future of Latin American Industrialization.

The increase in Chinese competition would not be so problematic if Brazilian companies were thriving in the Chinese market, but they have faced a range of challenges. Embraer, a Brazilian aircraft manufacturer and one of the rare examples of high-value-added manufacturer establishing itself in China, could see its plans there curtailed. Embraer, which has had a joint venture with state-owned Avic II since 2003, currently assembles ERJ-145 jets with 50 seats, and all its orders will be delivered by 2011.

The principal objective for the company now is to start producing a regional jet (in the E-190/195 family) with capacity for 120 passengers, for which it needs Chinese government authorization.

If it is not able to produce a plane suited to local demand, the company could close its activities in China. “We expect a conclusion of the negotiations and a decision on the part of Embraer about remaining [in China] in the coming months,” said a spokesman for the company, who observed that “the cultural differences between the two countries have had a big impact on the business and the strong presence of the state and the tight regulation of the market are very different from the situation in Brazil.”

The showdown between Embraer and the Chinese government is part of a broader picture of the increasing difficulties of foreign companies operating in China. Beijing has been making growing demands in terms of transfers of technology and jobs in return for access to the Chinese market. “In the last 20 years, I have not seen the foreign business community in China so disillusioned,” says James McGregor, a former director of the American Chamber of Commerce in China.

Even with raw materials, the situation is becoming more complex. The Brazilian mining company, Vale do Rio Doce, has prospered in China, but it has also come up against obstacles. The negotiations over the benchmark price for iron ore have become a delicate subject, especially after executives from the Anglo-Australian group Rio Tinto received harsh prison sentences of up to 10 years in March for taking bribes and stealing commercial secrets. The investigation and the punishment of the executives followed a complex series of events, starting when the Chinese group Chinalco was frustrated last year in its attempt to buy a stake in Rio Tinto, which infuriated the Chinese. In 2009, after prices dropped during the crisis, China also demanded a discount of 45% from the iron ore price the year before, but the company stuck to the 33% discount that it was offering the rest of the market.

As tensions in the sector have been growing, Vale has been reducing its shipments to China, although the country remains its biggest market in terms of revenue. Prices in the
Chinese market have fallen 10% since April, when the Chinese government adopted measures to contain speculation in the property sector; as a result, China accounted for 32% of Vale’s sales in the first quarter, down from 45% last year, according to the consultancy CreditSights. José Carlos Martins, Vale’s executive director for ferrous minerals, said recently in Shanghai that the company’s dependence on China would be reduced this year because other markets were growing.

**Investment**

Although the new Chinese export offensive is a sign of tougher competition ahead for Brazilian goods, China’s growing interest in Brazil could also translate into significant investments, especially in natural resources. After years of high expectations in Brazil, Chinese investment in the local market is finally becoming a reality. Last December Wuhan Iron & Steel Group (WISCO) announced it would invest US$400 million in the mining company MMX, owned by Eike Batista, in exchange for a 21.5% stake in the company. Among the projects that MMX could develop are a steel mill in the port of Açu in Rio de Janeiro state, which could cost US$5 billion, and two mines in Minas Gerais state.

In early 2010 Sinopec, the second biggest company in the Chinese energy sector, completed the construction of an 856 mile pipeline in Brazil. The project, which runs through 72 Brazilian cities and has the capacity to transport 20 million cubic meters of natural gas a day, is one of the biggest Sinopec has built. In a separate deal, China Development Bank loaned Brazil’s oil company, Petrobras, US$10 billion, which will help fund a broad investment plan, including development of the pre-salt oil reserves, considered the biggest find in the Americas in more than three decades.

Recently, the Chinese have also displayed interest in purchasing land in Brazil so that they could start cultivating soybeans. In April 2010 the daily Chongqing News in central China published a report that the Chongqing Grain Group, a state-owned company, was considering investing US$300 million to buy land in Bahia. “This is an inflection point in the relationship between Brazil and China,” says Tatiana Rosito, the economic counselor at the Brazilian Embassy in Beijing, referring to the Chinese investment wave.

The new competitive threat to Brazil from Chinese exports has reopened the old debate about whether the country will be able to take full advantage of its economic links with China. The concentration of Brazilian exports in commodities has suggested to some commentators that the relationship has a neocolonialist echo that could leave Brazil dependent on China’s development. Nevertheless, the same comparative advantages can be used in Brazil’s...
interest. China has large amounts of capital and vast experience in infrastructure building, which could help Brazil sort out some of its deficiencies.

Brazil, however, has a lot to learn about how to attract direct investment from China. “Both countries need more chances for interaction,” says Sun Hongbo, a researcher at the Center for Latin American Studies of the Chinese Academy of Social Sciences, citing the lack of mutual knowledge as an obstacle to a closer economic relationship. Sun also says that it can be confusing for Chinese companies wanting to do business in Brazil when state governments and the federal government have different demands or positions about particular projects.

Many economists and government officials believe that if Brazil and the rest of Latin America are to survive this new Chinese offensive, they will need a more coherent industrial policy. Javier Santiso, an OECD economist, highlights the importance of diversifying exports and pushing forward with reforms, especially in infrastructure. An Economic Commission for Latin America and the Caribbean (ECLAC) report published in May makes similar arguments, pointing out that to truly benefit from the Chinese boom, Latin American countries need to broaden the range of their exports, particularly higher-value-added goods.

“China is rapidly building the technological capabilities needed for industrial development, whereas Latin American countries are not paying enough attention to innovation and industrial development,” says Kevin Gallagher. “Diversification and innovation should be at the core of the debate about economic policymaking in the region.”
Yin Min-gshan is a legend in the Chinese business world. During Mao Zedong’s regime, he was sent off to a labor camp as an “enemy of the state.” Years of hardship followed before he managed to cleanse his reputation and scrape together the funds to set up his own company, Lifan, an automaker based in the city of Chongqing in central China. Yin took advantage of the gaige kaifang (“reform and opening”) period initiated by Deng Xiaoping to expand his business from what had been a small manufacturer of spare parts for motorcycles into the biggest Chinese exporter in that sector. In 2003 he decided to diversify into automobiles, just as the local market was taking off.

Yin is enthusiastic about the prospects for trade with Brazil, which was the company’s biggest export market in 2008, before the global crisis slowed the world economy. He believes that “This year Brazil will go back to being our biggest market,” and predicts that Lifan’s sales to Brazil will surpass the US$70 million achieved in 2008. In 2010 the company will attempt to expand its sales of cars as well as motorcycles. “Brazil is a very promising market, with a vast territory and a big domestic market,” he says, “Some Chinese businessmen are foolish enough to ignore Brazil, but I am not that stupid.”

The company currently has an auto assembly factory in Uruguay whose main markets are Brazil and Argentina. Uruguay was chosen as Lifan’s first base in South America because it is part of Mercosur, which enables the company to sell cars to the other member countries without incurring import duties, and because of its relatively cheap labor. “We will probably set up a factory in or around Brazil,” says Yin talking about his plans for manufacturing motorcycles in South America, although Argentina and Paraguay are also being considered. “Our decision will be made this year, or next year at the latest.”

As trade ties with Brazil grow, he says, exports must be offset by imports so as to minimize currency risks. “Otherwise, we would be seriously affected by any volatility in the currency markets, exposing our business to a lot of turbulence,” Yin says. One of his solutions is to increase imports from Brazil. On Lifan’s shopping list are food products, iron ore, and steam engines in addition to the car engines it already imports: “We want to start with these purchases gradually, expanding our cooperation with Brazil.” Yin believes ethanol is another promising prospect for bilateral trade, with a lot of room for technical collaboration, although this idea still awaits a green light from Beijing.

Yin considers the need to use the US dollar as the reference currency for their trade as the biggest hurdle to expanding the ties between Brazil and China. “If this problem is solved, our trade with Brazil would increase substantially,” he says. “This is the single biggest obstacle to doing business with Brazil today.”
Brazil and China: Status report on an emerging relationship

Riordan Roett

The April 2010 Summit in Brasilia of the BRIC countries (Brazil, Russia, India and China) provided a very useful opportunity to consider the state of play between Brazil and China. While Brasilia’s relations with New Delhi and Moscow are strong and growing, it is the relationship with Beijing that will continue to dominate BRIC dynamics for the foreseeable future.

Trade and investment are of top priority for both countries. Trade between Brazil and China rose from US$6.7 billion in 2003 to US$36.1 billion in 2009 and is expected to increase again in 2010. In 2009, China dislodged the US as Brazil’s principal trading partner. That year 77% of Brazil’s exports to China were basic products, and 98% of Brazil’s imports from China were manufactured goods. That imbalance should be a wake-up call to the Brazilian government that assumes power in January 2011 — the country must focus on adding value to its export mix, increase investment in research and development efforts, and give more attention to math and science at all levels of education. But in the short term the benefits to Brazil are obvious. China’s continuing demand for what Brazil grows and mines helps Brazil maintain a high level of reserves to cushion against turmoil in global markets.

Investment, a controversial issue for the past few years, is now beginning. In the first quarter of 2010 China invested more than US$2 billion in Brazil’s mining industry. Without fanfare China’s Petrochemical Corp. (Sinopec), China’s second largest energy producer, completed a US$1.3 billion natural gas pipeline in Brazil. The 856-mile link is the company’s largest overseas service contract. The pipeline goes through 72 cities and can transport 20 million cubic meters of gas a day.

During the BRIC summit, the governments of China and Brazil signed a Joint
Trade and investment are of top priority for both countries.

Action Plan for 2010–14 that outlines initiatives in industry, science and technology, agriculture, culture, education, and statistics. One example is the contract signed by Wuhan Iron & Steel Group and with Brazilian port operator LLX Logistica SA to build a US$4.7 billion steel plant. In 2009, Brazilian oil company, Petrobras, received US$10 billion in loans from China to help finance the development of the pre-salt Tupi oil field, and during the Chinese President’s recent visit, Sinopec signed a new package of agreements with Petrobras that builds on the 2009 agreement.

Another initiative initiated at the meeting in Brasilia was a partnership between Brazil’s EXB and Chinese state-owned WISCO. The two companies are negotiating construction of a steel-making complex in the Port of Açu, Rio de Janeiro, that President Lula stated will be the largest Chinese investment in Brazil and China’s largest investment abroad in steel.

While the summit meeting highlighted the growing trade and investment links, it had an important foreign policy component. The BRICs have begun to stake out common positions on a number of international issues; trade, finance, and climate are among the most important. This is not to imply that the grouping is monolithic, but there are commonalities that bring the four countries together. The communiqué their political leaders signed in Brasilia outlined many of the points of convergence. They called for swift reform of international financial institutions to give developing countries a greater voice, saying their group was vital to achieving a new world order (the four countries represent about 40% of the world’s population, 20% of its land surface, and about 15% of world GDP). Since the 2008–09 financial crises in the United States and Europe, the BRICs have insisted that the G-20 — which includes the world’s largest economies — be substituted for the G-7 industrial countries. In G-20 summit meetings in Washington in November 2009 and in London, Pittsburgh, and Toronto in 2010, the BRIC states urged immediate reform of the World Bank and the International Monetary Fund (IMF). Brazil has often acted as spokesman for the group. And President Lula often states that Brazil was the last country impacted by the crisis and the first to recover, due to prudent banking regulation and careful fiscal management.

The BRIC summit communiqué called for more multilateral diplomacy, with the United Nations playing the central role in dealing with global challenges and threats. The BRIC leaders

Brazil must focus on adding value to its export mix, increase investment in research and development efforts, and give more attention to math and science at all levels of education.
called for comprehensive reform of the UN, and, while not calling immediately for them to be seated on the Security Council, the communiqué stated that the four nations reiterated the importance they “attach to the status of India and Brazil in international affairs, and understand and support their aspirations to play a greater role in the United Nations.”

Trade was another priority of the Brasilia BRIC summit. Since the collapse of World Trade Organization negotiations in July 2008, the BRICs have sought to reinvigorate the talks. Their failure in 2008 was due in large part to the inability of China and India to come to agreement with the European Union (EU) and the United States on a wide variety of agricultural subsidy issues. The BRICs have stated that they will only return to the negotiating table when the developed countries become more flexible. Brazil again has been a leading advocate for a comprehensive agreement, supported by its allies, China and India.

Climate change is an issue that preoccupies the BRICs, especially Brazil. There can be no comprehensive deal on carbon emissions if Brazil and China, in particular, are not in agreement. While little substantive progress was achieved at the December 2009 Copenhagen meeting on climate change, the final communiqué was spearheaded by Brazil, China, India, and South Africa. The inclusion of the United States seemed almost to be an afterthought. There can be no international agreement on climate change without the active participation of Brazil, in large part due to the importance of the Amazon Basin. The industrial countries, as in finance and trade, need to understand the changing dynamics in international relations, where Brazil and its partners are not seeking to dictate new terms of engagement but expect respect and inclusion in all major global policy discussions and decisions in the future.

China clearly sees Brazil as its major interlocutor in South America, though the two will obviously have some differences of opinion. and the developed industrial countries, while India and China were adamant in their opposition. Given different national interests, that sort of policy difference can be expected. But as the current financial crisis has made clear, growth this year and next will be in the developing world, with Brazil and China in the lead and the United States and the EU lagging far behind. That should be one strong indication that the BRIC states, led by Brazil and China, are increasingly important players in the international relations of the 21st century.

Riordan Roett is Sarita and Don Johnston Professor and Director Western Hemisphere Studies at Johns Hopkins University.
In October, the next President to be elected — Dilma Rousseff (Workers’ Party [PT]), José Serra (Social Democrats [PSDB]), or Marina Silva (Green Party [PV]) — cannot avoid a basic question: how to improve the Brazilian government? That is because the success of President Luiz Inácio Lula da Silva (PT) will knock on his successor’s door. “The spell is going to turn against the wizard. Pressure from the 20 million Brazilians who have climbed the social ladder will increase. The new class will demand more efficiency in public services, especially education and health,” predicted Fernando Abrucio, political scientist and coordinator of graduate studies in public administration, the Getulio Vargas Foundation (FGV), during a meeting on “Politics and economics: What to expect from the new government,” sponsored by the Brazilian Institute of Economics (IBRE).

At the conference Bernard Appy, former secretary of economic policy for the Finance Ministry (2003-2009) and director of the São Paulo Stock, Mercantile and Futures Exchange, and Mansueto Almeida, researcher in the Directorate of Sectorial Studies of the Institute of Applied Economic Research (IPEA) laid out a path to greater government efficiency. Appy underlined that, “For the current good moment to be converted into widespread development, we need to solve certain structural problems, such as increasing domestic savings rates, managing fiscal policy, and dealing with the competitiveness agenda.” Almeida added that another dilemma to be faced by the next administration is how to increase public investment, which today is a meager 1% of GDP, so as to make the infrastructure improvements needed to support yearly growth of 6%.

**Government idolatry?**

Such questions are linked, in one way or another, to the central point of the inevitable debate over the next few years: the role of the government. Maria Celina d’Araujo, professor
in the Department of Sociology and Politics of Rio de Janeiro’s Catholic University (PUC-RJ), said that “There will be a big difference depending on whether PSDB’s plan is put into practice or PT’s plan is continued.” She believes, unlike liberals who consider that the government is a necessary evil, that today in Brazil there is “government idolatry:” “A new PT government will reinforce the view of the government as a good boss, despite the absence of a movement to defend a minimum government.” Abrucio added that

“In opposition to the idea defended by liberals that the government is a necessary evil, today in Brazil there is ‘government idolatry.’”

Maria Celina d’Araujo

The demand for greater efficiency in basic government services will be reinforced by another feeling that is growing among Brazilians: the quality of democracy. Abrucio pointed out that “The longest political cycle of Brazilian democracy has been consolidated. Compared to some South American neighbors and other BRICs [the bloc formed by Brazil, Russia, India and China], we are doing well. The question just economic performance; it encompasses jobs, access to public schools and hospitals, things the electors want in the short term. Today, there is a high level of satisfaction with salaries, low unemployment rates, and inflation control. All this contributes to the popularity of the president and the government. But education and public health are public policies that are still being rated badly.”

Since social well-being is higher now than it was 10 years ago and society progresses faster than the government, it might be necessary to change the ‘Brazil Government.’ The dilemma between privatization and nationalization, for example, makes no sense in the country’s new context. Well-being involves more than

Brazil: Public investment (% of GDP)

“Government-owned enterprises
Federal government

Source: Ministry of Finance.
*Accumulated 12-month trough April 2010.
is no longer to have democracy or not, but how inclusive it is. It’s a new cycle.” He believes the main concern now in Brazil’s political and electoral game is inequality: “After having controlled inflation and created the conditions for faster economic growth, today the baseline consensus of democracy is to reduce the distance between the rich and the poor.”

But how to balance the increase in domestic savings rates, management of a fiscal policy that results in an efficient government and increased investments, implementation of competitiveness measures, and pressure for increased public spending in the social sectors? According to Appy, it all begins with the fact that, in the long term, continuing consumption growth that is greater than GDP growth, such as Brazil has seen since 2005, is not sustainable. “The country’s external current account has worsened since 2005. In the short term, this model is not explosive, but long term it is doomed,” he warns.

**Savings**

Increasing domestic savings is crucial to the expansion of infrastructure investments necessary to maintain economic growth rates of 6% a year. It is almost unanimously believed that domestic savings rates would have to rise from the 14.5% of GDP Brazil recorded in 2009 to at least the 18% seen in 2008, which was the highest level of recent years; and that investment rates, which are presently 19% of GDP, would have to rise to at least 25% so that economic growth does not cause higher inflation. “With low domestic savings, the country will have to finance itself with foreign capital for a long time. This may cause an imbalance in foreign accounts,” Appy said.

Appy does not think that the need to adjust the growth model necessarily means there would be a slowdown in current positive trends. “To make these adjustments is not complicated, but it demands changes in how the public finances are managed. And some characteristics of the Brazilian fiscal...
structure bring risks and opportunities to the medium-term growth,” he says. The first one is the increase in the tax burden as the economy becomes more formal — from 2004 to 2008, the annual increase averaged 0.9% of GDP — and the structural increase in the tax burden is likely to continue for a long time, at the rate of 0.5% of GDP each year, Appy estimates, adding that “In 20 years, this would add 10 percentage points to GDP, increasing the total tax burden to approximately 45% or 50% of GDP.”

“Successmania”
IPEA researcher Almeida sees little room to decrease the public spending-to-GDP ratio: “The government’s room has increased, since the market can cope with more spending and a ‘heterodox’ fiscal balance. The ‘Successmania’ goes against today’s logic. But the next government’s fiscal management may even improve, since we are reaching the rock bottom,” he argues. Other reasons: the social contract has not yet changed, the active role played by public banks — especially the National Bank for Economic and Social Development (BNDES) — will probably continue, and there are few, if any, cost-benefit analyses being made by Brazil.

Still, according to Almeida, the growth pattern for public spending has held steady since 1999: increase in income distribution fueled by actual growth of the minimum wage. Meanwhile, federal public investment has not gone over 1% of GDP since 1999.

The figures clarify this situation: from 1999 to 2009, the government’s total spending (excluding interest payments) rose 4 percentage points (from 14% to 18% of GDP). Of the total growth, 3 percentage points (70% of the total) are attributable to increased spending by the Social Security (INSS) and other social agencies. Education and health spending have also increased since 1999. The total cost of the Unified Health System (SUS), for example, jumped from R$11 billion to R$35 billion, almost doubling its share in GDP.

“The PT government sees the increase in public spending as normal,” Almeida

<table>
<thead>
<tr>
<th>Year</th>
<th>BNDES’ disbursements for Capital Formation (a)</th>
<th>BNDES’ total disbursements (b)</th>
<th>(a)/(b) (%)</th>
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<td>9.7</td>
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<tr>
<td>1998</td>
<td>9.1</td>
<td>19.0</td>
<td>48</td>
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<td>2009</td>
<td>71.4</td>
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Source: Mansueto Almeida.
“The nontransparent relationship between the National Treasury and public banks may worsen. For example, the terms of the most recent loan the Treasury granted to BNDES are not known; neither are the terms of Banco do Brasil’s capitalization by the Sovereign Fund.”

Mansueto Almeida

stressed. The Ministry of Finance adopted the concepts of net tax burden and net public spending (excluding income transfers and social expenditure) in order to evaluate public income distribution results. “The assumption behind this is that public spending does not grow because society is being benefited,” he added. The result is a “more-of-the-same” scenario. “In general, Dilma Rousseff will maintain this situation. But, as to José Serra, I have doubts. The opposition criticizes the size of the government, but won’t say how it would cut expenses. The rhetoric of the elites is dubious: businessmen criticize the tax burden and at the same time welcome the increase in resources for the Investment Sustainability Program of BNDES, which offers interest rates subsidized by the National Treasury,” Almeida pointed out.

He believes that the demand for BNDES resources to finance exports, infrastructure, and purchase of machines and equipment will increase because of pre-salt oil exploration. He also raised some concerns: “The principal candidates running for president defend the industrial policies. The nontransparent relationship between the National Treasury and public banks may worsen. For example, the terms of the most recent loan the Treasury granted to BNDES are not known; neither are the terms of Banco do Brasil’s capitalization by the Sovereign Fund.”
Certainties and Doubts

In a tough race polarized by two candidates, the presidential elections raise questions about what will be changed, maintained, or reinforced by the next government. “The approach to dealing with problems that still have to be resolved may give rise to alternative courses of action by the presidential hopefuls,” says the economist Regis Bonelli of the Brazilian Institute of Economics (IBRE) of FGV. Bonelli commented on the following themes:

- **The new role of the government** — “The answer to the 2008 crisis involved an arsenal of anti-cyclical measures that turned out to be very effective. A group of analysts affirms that some were already in place, or ready to be, despite the crisis. This points to a trend inside the current government to expand the role of the government in the economy, not only concerning public spending but also in financing and regulation of economic activity. In this sense, several questions may be raised: how would the attitudes of both candidates on this question differ? Should we expect a future government more focused on regulation? Or would it be more involved with providing credit, goods, and services? In other words, should we expect a more regulating or a more providing government? And what would be the role of the regulatory agencies?”

- **Infrastructure bottlenecks** — “Inadequate infrastructure continues to limit growth and the limitations tend to become more pronounced as economic activity grows. The lack of adequate management, especially, has been blamed for the poor performance of infrastructure projects carried out by the public sector. To what extent is that true and how would a new administration deal with complex problems of administrative continuity caused by a change in government? And what is the future of concessions and public-private partnerships?”

- **Institutions and economic policies** — “The pace of the fiscal adjustment and the subsequent transition to a domestic benchmark interest rate compatible with international interest rates have been very slow, and inflation has been more resilient than expected. At the height of the subprime crisis, as the world experienced a generalized deflationary crisis, the change in the broad consumer price index (IPCA) was never less than 3.5% a year. What will be the position of the candidates regarding the fiscal costs of the policy that guarantees monetary stability? Are there risks of default or restructuring of domestic public debt?”

- **Social programs** — “Part of the success of the outgoing federal administration is due to a variety of social programs. It would be interesting to evaluate the possibilities of increasing, reducing the importance, or even eliminating some of them, especially considering that a large part of poverty reduction recorded in the past years was mainly due to the labor market, not income distribution.”

“Should we expect a more regulating or a more providing government in the future? And what would be the role of regulatory agencies?”
**Consumer confidence gap**
The risk of a slowdown in the global economic recovery has risen considerably, but governments should continue planning to tighten fiscal policy, says the IMF World Economic Outlook released on July 8. “In the near term, the main risk is an escalation of financial stress and contagion, prompted by rising concern over sovereign risk,” it says. Europe’s weakened economy is now the central threat to global recovery as its countries struggle with heavy public debt, undercapitalized banks, and slowing growth. The faltering global economic recovery is reflected in the growing consumer confidence gap, with confidence higher in emerging markets (China and Brazil) and lower in developed economies (Europe and the US).

**Uncertain inflation outlook**
Official consumer prices (IPCA) were flat in June (4.84% year-on-year), although the markets had expected a 0.11% increase (4.96% year-on-year). The annualized rate is the lowest since February. The main driver of the downward surprise was a steep drop in food prices. Core inflation also slowed in June, according to analysts. FGV’s general price index (IGP-DI) also increased less than expected at 0.34% month-on-month. Market analysts viewed the decline as temporary and still expect inflation to accelerate as the year progresses.

**Competitiveness and rising wages**
Rising real wages are partly responsible for the loss of competitiveness of manufacturing exports even though the industry has become significantly more productive over the past 10 years. Following the international crisis, Brazil’s economy began to grow much faster than the world average. At the outbreak of the crisis at the end of 2008, devaluation of the currency brought about a short-lived improvement, but by mid-2009, as the domestic market began to recover wages rebounded and the exchange rate appreciated, causing a loss of competitiveness.

**Is Brazil becoming less competitive?**
The volumes of commodities exported have been growing strongly in the last 10 years partly to meet China’s needs. However, manufacturing exports began to stagnate in 2005 and have actually declined since 2008, partly as a result of exchange rate appreciation but more recently because of competition from China. Brazilian manufacturing exports have lost market share worldwide and become increasingly dependent on the South American market.
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