Investment in Brazil

An Economic Analysis

Ed Vallorani

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# Table of Contents

## Section I  Introduction  1

## Section II  Economic and Historic Background  2

## Section III  Economic Details  4
- GDP  4
- Trade  6
- Current Account  9
- Federal Budget Deficit  10
- Debt  10
- Savings  11
- Exchange Rate Regime  11
- Interest Rates  12
- Foreign Reserves  13
- Foreign Direct Investment  14
- Stock Market  15
- Housing Market  16
- Labor  17

## Section IV  Country Forecast and Investment Potential  18

## Section V  Summary  23

Notes  25

References  30
Investment in Brazil – An Economic Analysis

I - Introduction

The hypothetical Blue Suede Shoe Company sells commodity footwear to major retail companies in the US. The company currently manufactures all of its products at factories in China and India. The company has an ownership stake in each of the factories that produces its products.

The Blue Suede Shoe Company has made a strategic decision to enter the fashion shoe business. The company wishes to own and operate an offshore factory to produce the product needed for this market segment. Fashion footwear is a higher value-added product than commodity footwear, and therefore, has a higher profit potential.

The company is interested in the investment potential of the country chosen, its macroeconomic stability, how the worldwide financial crisis of 2008 has affected it, and factors that are relevant to the fashion footwear industry.

The recommendation of this paper is that the Blue Suede Shoe Company should locate its production facility in Brazil in Rio Grande do Sol, Brazil’s southernmost state. The balance of this paper will focus on Brazil and provide the rational for this decision. It is organized as follows:

Section II will discuss some interesting economic and historical details that are unique to Brazil. Facts mentioned in this section will be fully discussed and documented in Sections III and IV.

Section III will document the major macroeconomic factors and trends in Brazil. Their relevance to the investment decision will be more fully discussed in Section IV.

Section IV will discuss all of the important macroeconomic factors that will affect the investment decision. It will discuss the implications of exchange rate movements between the US dollar and the Brazilian Real, Brazil’s comparative advantage in the fashion footwear segment, the relative ease of doing business in Brazil, and issues that could cause concern for entering the Brazilian market.

Section V will provide a summary of the key points that led to this recommendation.
Investment in Brazil – An Economic Analysis
II – Economic and Historical Background

Brazil is one of the BRIC countries an acronym for Brazil, Russia, India and China. These are all developing economies that have been experiencing emergence and prominence on the world market. In a 2003 paper, Dominic Wilson and Roopa Purushothaman of Goldman Sachs proposed that by 2050 the BRIC economies combined could be larger than the G6 economies in US dollar terms. They predict that 2/3 of this increase will come from real GDP growth while the balance will come from currency appreciation against the dollar. These predictions are based on the assumption that these countries will pursue policies and develop institutions that are supportive of growth.

Today Brazil is the 10th largest economy in the world. Its 2008 GDP was US$1.57 trillion. Exports account for about 12.5% of GDP. Therefore, the domestic market, with a population of 192 million, is approximately US$1.37 billion. Currently PPP per-capita GDP is US$9,700. Real GDP growth for 2008 was 4.0%. While GDP is expected to contract in 2009, it is not expected to contract as much as some of the developed economies.

Brazil’s stock market is about 40% below its May 2008 high. While this has been a large correction, the market is up substantially from its 2002 low. Brazil’s banks have not suffered from the bad-debt crisis that has hit the US and other economies, and inflation remains in check.

President Luiz Inacio Lula da Silva assumed office in 2002. He was re-elected in 2006. Due to Brazil’s term limits, President Lula’s term in office will come to an end in 2010. He is a very popular president, and his administration has presided over a period of prosperity for Brazil.

The macroeconomics of the Brazilian economy has not always been as stable as it is today. Before 1994, the Brazilian economy was marked by hyperinflation. Cumulative inflation for the 1980s was 39,043,765%. For 1990, inflation was 1,477%. By the end of 1993, inflation had reached 2,000\%\(^3\). Contributing factors were fiscal deficits, printing money to pay for debt and a problematic tax system\(^3\).

“In 1994 Brazil finally initiated an economic stabilization plan that showed appreciation for the linkage between spending, money creation, and inflation. This Real Plan—named after the new currency, whose exchange rate system would be key to inflation-fighting efforts—temporarily involved indexation. However, the indexation was tied, through the exchange rate, to the number of dollars required to purchase a product rather than to measures of inflation and the currency.”\(^4\)

The Real was introduced in 1994 with a crawling peg to the US Dollar. It was allowed to fluctuate within a band from 1995 to 1999. However, even with these fluctuations the Real was overvalued. By 1998 economists were calling for a devaluation of Brazil’s currency. Brazil’s foreign reserves had fallen to US$30 - US$40 billion from a previous level of US$70 billion. Daily outflows of reserves were US$350 - US$400 million\(^5\).
In early 1999 the crisis became acute when the governor of the Brazilian state of Minas Gerais suspended the state’s debt payment to the central government for 3 months. Six other Brazilian governors expressed an interest in renegotiating their debt. At this time investors, already concerned about Brazil’s ability to pay its debts without printing money, began to rapidly pull money out of the country. The announcement of an increase in the exchange rate band to allow for a 9% devaluation did not stem the outward flow of money which reached US$1 billion daily. In January 1999 the Real was allowed to float freely. It quickly devalued from R$1.20 per US$1 to R$2.11 per US$1, a devaluation of approximately 43%.

Brazil is part of MERCOSUR, a regional trade pact between Brazil, Argentina, Paraguay and Uruguay. It started in 1998 with an agreement between Brazil and Argentina to reduce tariffs and quotas between the 2 countries. Paraguay and Uruguay joined in 1990. Membership was extended to Venezuela in 2005, although Venezuela is not fully integrated into the pact. The goal of MERCOSUR was to establish a free trade zone and eventually a common market. Its history has been marked by disputes among its members. MERCOSUR has yet to achieve a well functioning customs union where trade barriers among members are completely eliminated and there is a common external trade policy.

World footwear production is dominated by China and India. They account for approximately 80% of world production, and they are the key players in the commodity footwear segment. Brazil is the 3rd ranked country in world footwear production. Brazil has been strategically repositioning itself toward the fashion footwear business and away from the commodity footwear market where China and India dominate. Brazil has created a comparative advantage for itself in the fashion segment. It has developed clusters in the manufacture of fashion footwear and in the leather industry, which is one of the key raw materials for fashion footwear.
GDP

Since the introduction of the Real Plan in 1994, GDP has risen each year when measured in the local currency\(^1\). This is not the case when measured in US dollars. GDP in US dollars rose from 1994 through 1997. With the exception of 2000, GDP declined over the next few years reaching bottom in 2002. Since 2002, GDP has risen to US$1.57 trillion in 2008 from US$0.5 trillion in 2002.

![GDP Chart](source: Central Bank of Brazil)

Even with the world financial crisis of 2008, Brazil’s real GDP growth in 2008 was 4.0%, down slightly from the 4.5% real growth rate in 2007. In relative terms, 2008 was a strong year being the 4\(^{th}\) highest rise in real GDP of any year since 1994. However, GDP growth in the 4\(^{th}\) quarter of 2008 slowed dramatically to only 1.69% over the 4\(^{th}\) Quarter of 2007. Brazil will not totally escape the world economic slowdown. Real GDP is expected to contract by 1.5% in 2009 before recovering to a growth of 2.7% in 2010\(^2\).

![Real GDP Growth Chart](source: Central Bank of Brazil)
The pattern of per-capita GDP is similar to the pattern of nominal GDP growth.

Purchasing Price Parity (PPP) adjusted per-capita GDP has shown an interesting trend. The gap between GDP measured in US dollars and PPP dollars has been shrinking since 2002, indicating that the wages earned in Brazil do not have a significantly higher purchasing power than those earned in the US. In 2008, Brazil’s per-capita GDP was US$8,300. In Brazil that US$8,300 had the purchasing power of US$9,700 in the US, a 17% differential. In 2002 the differential was 158%\(^3\).
Investment in Brazil – An Economic Analysis
III – Economic Details

TRADE

Brazil’s exports reached US$197.7 billion in 2008. With the exception of a few years in the 80s and 90s, the country has shown steady growth in exports since 1962 when Brazil’s exports were only US$1.2 billion.

In 2008, exports were 12.58% of GDP. This rose from 6.69% of GDP in 1990. Again, the rise in the importance of exports as a percent of GDP has seen its ups and downs. It peaked in 1992 at 9.01%. This peak was followed by decreasing levels, reaching a low of 5.68% in 1996. Exports as a percent of GDP jumped in 1999, reaching a peak of 14.31% in 2004. Since then exports have leveled out at approximately 12.5% of GDP.

Brazil’s trade balance in 2008 was a positive US$24.8 billion. As shown above, exports continued to increase in 2008 over 2007 level, by 23.2%. The same is not true for the trade balance which decreased by 38%. This is due to a drastic increase in imports to US$173.1 billion in 2008 from US$120.6 billion in 2007, a 43.5% increase. Over the last decade, the trade balance has not been excessive in either direction ranging from a negative US$6.6 billion in 1999 to a positive US$46.5 billion in 2006.

Source: OECD Factbook 2008: Economic, Environmental and Social Statistics / Central Bank of Brazil
Brazil truly has a global trading partner structure. Its top 4 trading partners in 2007, the US, Argentina, China and Germany are located on 4 different continents. These 4 partners account for 38.5% of Brazil’s trade\textsuperscript{10}. The top 14 trading partners represent 62.7% of Brazil’s trade. (See Table 1, page 8)

With these 14 trading partners, Brazil had a US$16.9 billion surplus. Brazil ran a surplus with 9 of these countries and a deficit with 5 of them. Since Brazil’s total surplus was US$40.0 billion in 2007, Brazil had a trade surplus of US$23.1 billion with the balance of its trading partners. (See Table 2, page 8)

The effects of the worldwide economic slowdown and the collapse in commodity prices were apparent in Brazil’s export and import activity during the 4\textsuperscript{th} quarter of 2008. While exports for the entire year grew at 23.2%, exports in the 4\textsuperscript{th} quarter grew by only 6.88%. Imports followed a similar pattern. Imports increased by 40.1% in 2008. Import growth in the 4\textsuperscript{th} quarter slowed to 19.9%. The full effect of the economic slowdown is evident in the 1\textsuperscript{st} quarter of 2009. Export fell by 19.4%, while imports in the 1\textsuperscript{st} quarter of 2009 shrank by 21.6\textsuperscript{11}.

Major exports are listed in Table 3 on page 8. Footwear and leather products are part of the Manufactured Goods segment that ranks 3\textsuperscript{rd} in importance.
Table 1

<table>
<thead>
<tr>
<th>2007 Rank</th>
<th>Country</th>
<th>2007 Exports</th>
<th>2007 Imports</th>
<th>2007 Total Trade</th>
<th>% to Brazil</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>United States</td>
<td>25,335.5</td>
<td>18,889.8</td>
<td>44,225.3</td>
<td>15.7%</td>
</tr>
<tr>
<td>2</td>
<td>Argentina</td>
<td>14,416.9</td>
<td>10,410.0</td>
<td>24,826.9</td>
<td>8.8%</td>
</tr>
<tr>
<td>3</td>
<td>China</td>
<td>10,748.8</td>
<td>12,617.8</td>
<td>23,366.6</td>
<td>8.3%</td>
</tr>
<tr>
<td>4</td>
<td>Germany</td>
<td>7,211.3</td>
<td>8,674.5</td>
<td>15,885.8</td>
<td>5.6%</td>
</tr>
<tr>
<td>5</td>
<td>Japan</td>
<td>4,321.3</td>
<td>4,609.6</td>
<td>8,930.9</td>
<td>3.2%</td>
</tr>
<tr>
<td>6</td>
<td>Netherlands*</td>
<td>8,840.9</td>
<td></td>
<td>8,840.9</td>
<td>3.1%</td>
</tr>
<tr>
<td>7</td>
<td>Italy</td>
<td>4,463.6</td>
<td>3,347.2</td>
<td>7,810.8</td>
<td>2.8%</td>
</tr>
<tr>
<td>8</td>
<td>Chile</td>
<td>4,264.4</td>
<td>3,482.7</td>
<td>7,747.1</td>
<td>2.8%</td>
</tr>
<tr>
<td>9</td>
<td>France-Monaco</td>
<td>3,536.0</td>
<td>3,531.6</td>
<td>7,067.6</td>
<td>2.5%</td>
</tr>
<tr>
<td>10</td>
<td>Mexico</td>
<td>4,260.4</td>
<td>1,979.1</td>
<td>6,239.5</td>
<td>2.2%</td>
</tr>
<tr>
<td>11</td>
<td>Russian Federation</td>
<td>3,741.3</td>
<td>1,709.4</td>
<td>5,450.7</td>
<td>1.9%</td>
</tr>
<tr>
<td>12</td>
<td>Korea, Republic of</td>
<td>2,046.6</td>
<td>3,391.1</td>
<td>5,437.7</td>
<td>1.9%</td>
</tr>
<tr>
<td>13</td>
<td>Spain</td>
<td>3,476.3</td>
<td>1,843.3</td>
<td>5,319.6</td>
<td>1.9%</td>
</tr>
<tr>
<td>14</td>
<td>Nigeria*</td>
<td>5,273.2</td>
<td></td>
<td>5,273.2</td>
<td>1.9%</td>
</tr>
<tr>
<td>Sub-Total</td>
<td></td>
<td>96,663.3</td>
<td>79,759.3</td>
<td>176,422.6</td>
<td>62.7%</td>
</tr>
</tbody>
</table>

Brazil Total 160,648.9 120,620.9 281,269.8

Source: UN Comtrade – Country Pages

* No import data available for The Netherlands. No export data available for Nigeria.

Table 2

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
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<td>2,281.3</td>
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<tr>
<td>5</td>
<td>Russian Federation</td>
<td>3,741.3</td>
<td>1,709.4</td>
<td>2,031.9</td>
</tr>
<tr>
<td>6</td>
<td>Spain</td>
<td>3,476.3</td>
<td>1,843.3</td>
<td>1,633.0</td>
</tr>
<tr>
<td>7</td>
<td>Italy</td>
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<td>3,347.2</td>
<td>1,116.4</td>
</tr>
<tr>
<td>8</td>
<td>Chile</td>
<td>4,264.4</td>
<td>3,482.7</td>
<td>781.7</td>
</tr>
<tr>
<td>9</td>
<td>France-Monaco</td>
<td>3,536.0</td>
<td>3,531.6</td>
<td>4.4</td>
</tr>
<tr>
<td>10</td>
<td>Japan</td>
<td>4,321.3</td>
<td>4,609.6</td>
<td>(288.3)</td>
</tr>
<tr>
<td>11</td>
<td>Korea, Republic of</td>
<td>2,046.6</td>
<td>3,391.1</td>
<td>(1,344.5)</td>
</tr>
<tr>
<td>12</td>
<td>Germany</td>
<td>7,211.3</td>
<td>8,674.5</td>
<td>(1,463.2)</td>
</tr>
<tr>
<td>13</td>
<td>China</td>
<td>10,748.8</td>
<td>12,617.8</td>
<td>(1,869.0)</td>
</tr>
<tr>
<td>14</td>
<td>Nigeria*</td>
<td>5,273.2</td>
<td></td>
<td>(5,273.2)</td>
</tr>
<tr>
<td>Sub-Total</td>
<td></td>
<td>96,663.3</td>
<td>79,759.3</td>
<td>16,904.0</td>
</tr>
</tbody>
</table>

Brazil Total 160,648.9 120,620.9 40,028.0

Source: UN Comtrade – Country Pages

* No import data available for The Netherlands. No export data available for Nigeria.

Table 3

<table>
<thead>
<tr>
<th>Product Category</th>
<th>2007 Value*</th>
<th>% to Brazil</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery &amp; Transport Equipment</td>
<td>37,031.6</td>
<td>23.1%</td>
</tr>
<tr>
<td>Food and Live Animals</td>
<td>31,100.0</td>
<td>19.4%</td>
</tr>
<tr>
<td>Manufactured Goods</td>
<td>27,490.4</td>
<td>17.1%</td>
</tr>
<tr>
<td>Crude Materials Except Food</td>
<td>27,156.6</td>
<td>16.9%</td>
</tr>
<tr>
<td>Petroleum &amp; Related Products</td>
<td>13,296.9</td>
<td>8.3%</td>
</tr>
<tr>
<td>Chemicals &amp; Related Products</td>
<td>10,655.6</td>
<td>6.6%</td>
</tr>
<tr>
<td>Sub-Total</td>
<td>146,731.1</td>
<td>91.3%</td>
</tr>
</tbody>
</table>

Brazil Total 160,648.9

* Millions of US Dollars

Source: UN Comtrade – Country Pages
CURRENT ACCOUNT

From 1998 through 2002, Brazil ran a current account deficit. From 2003 through 2007, Brazil ran a current account surplus. This surplus was driven by the surpluses from the trade balance. The current account reversed itself in 2008, becoming a deficit once more. This is partly due to the drop in the trade balance from 2007 to 2008. The other major component of the current account is net income from investment and wages. In 2008, this subcategory of the current account for Brazil’s was –US$57.3 billion.

While there have been swings in the current account, it has fluctuated within a fairly narrow range when measured as a percent to GDP. The largest deficit was 4.3% in 1999, and the largest surplus was 1.8% in 2004. These types of fluctuations, within a narrow range, would not be a great concern for the economy of the country.
FEDERAL BUDGET DEFICIT

The large fiscal deficits that led to the institution of the Real Plan do not exist today. While Brazil still runs a budget deficit it has been shrinking since 2005. In 2008, the deficit was 1.5% of GDP. This is a significant decrease from the 5.9% of 1999.

Source: Latin-Focus.com, Economist.com

DEBT

The level of public debt as a percent to GDP has been dropping since 2004. In 2008, public debt was 43.9% of GDP down from 58.5% of GDP in 2004.

In addition to the drop in public debt, Brazil has moved from a net foreign debtor to a net foreign creditor. Foreign debt as a percent to GDP was -1.35% in September 2008. At the end of 2005, Brazil’s net foreign debt was 11.45% of GDP.
SAVINGS

Brazil has had a positive savings rate for the period reported by the IMF, averaging approximately 8.5% from 2000 through 2007¹⁸.

EXCHANGE RATE REGIME

Since 1999, the Real has been allowed to float freely. The chart below shows the exchange rate from 1999 to 2008. The rates on the chart are the average exchange rate for the year. Also plotted on this chart is Brazil’s inflation rate for the same time period. There is a strong correlation between inflation and the exchange rate. The exchange rate was at its lowest in 2003 (US$1 = R$3.08; R$1 = UD$0.33) when yearly inflation was at 14.7%, its highest point for this time period. As inflation decreased from 2004 through 2007, the Real appreciated against the dollar. In 2008, inflation saw an uptick, and the Real lost value relative to the dollar¹⁹. Inflation is expected to moderate in 2009. As of April 24, 2009, the exchange rate is US$1 = R$2.19.
The real exchange rate vs. the US dollar follows a pattern similar to the nominal rates listed above. The Central Bank of Brazil presents this data as an index with 1994 = 100. Real effective exchange rates against a basket of currencies also follow a similar pattern.

**INTEREST RATES**

Interest rates in Brazil, while still high at 11.25%, are significantly lower than 1999 when rates were at 32.0%. This type of tight monetary policy has helped to keep Brazil’s inflation in check, although it does make it more difficult for businesses in Brazil to borrow money. The high rates also help attract foreign money. As of April 22, 2009, 3-month government bonds are yielding 10.14%. Because of easing inflation worries, “Economists expect Brazil’s central bank to reduce interest rates for the third time this year when it meets next week. Policy makers may cut the rate to 9.75 percent from the current 11.25 percent, according to the median estimate of analysts polled by Bloomberg.”
Yields on Brazil’s government bonds are significantly higher than yields on US government bonds. The spread on varying maturities from 3 months to 4 years is between 965 and 1070 basis points.

<table>
<thead>
<tr>
<th>Maturity</th>
<th>US</th>
<th>Brazil</th>
<th>Spread</th>
</tr>
</thead>
<tbody>
<tr>
<td>3-Month</td>
<td>0.10%</td>
<td>10.40%</td>
<td>10.30</td>
</tr>
<tr>
<td>6-Month</td>
<td>0.29%</td>
<td>10.06%</td>
<td>9.77</td>
</tr>
<tr>
<td>1-Year</td>
<td>0.47%</td>
<td>10.12%</td>
<td>9.65</td>
</tr>
<tr>
<td>2-Year</td>
<td>0.96%</td>
<td>10.64%</td>
<td>9.68</td>
</tr>
<tr>
<td>3-Year</td>
<td>1.36%</td>
<td>11.52%</td>
<td>10.16</td>
</tr>
<tr>
<td>5-Year</td>
<td>1.94%</td>
<td>12.64%</td>
<td>10.70</td>
</tr>
</tbody>
</table>

Source: Bloomberg.com

FOREIGN RESERVES

Foreign reserves remained relatively flat from 1998 through 2005. They began to increase in 2006, jumping 60% from 2005 levels. In 2007, there was another dramatic increase, rising an additional 110% from 2006 levels. Since 2007, they have again been relatively flat, although, at a much higher level than the 1998 – 2005 period. From December 2008 until March 2009 reserves decreased a modest 1.8%.
FOREIGN DIRECT INVESTMENT

The Real plan made economic conditions much more stable than they had been prior to 1994. With the introduction of the plan until 1998, FDI in Brazil made a steady climb to US$31.9 billion in 1998 from a base of just US$1.3 billion in 1993. From 1998 through 2000, FDI remained strong, however, as inflation began to increase FDI dropped. As noted above, 2003 was the high point for Brazil’s inflation rate over the last decade. It was also the low point for FDI at US$10.1 billion. As inflation has fallen since 2003, FDI was on the rise again reaching a peak of US$45.1 billion in 2008. 75% of this total, US$30.0 billion was in equity capital. The balance was intercompany loans.

Brazil’s direct investment abroad was not significant until 2004. Investment abroad peaked in 2006 at US$28.2 billion.
FDI, with a net position of US$24.6 billion, was the largest component of Brazil’s US$33.0 billion capital and financial account in 2008. Net other investments, which include trade credits, loans, currency and deposits, other assets and liabilities and exceptional financing, was US$6.5 billion and accounted for the majority of the balance of the account\(^{29}\).

Net portfolio investments were a relatively small US$1.1 billion. Of this amount, net liabilities were negative US$0.8 billion which consisted of equity securities of negative US$7.6 billion and debt securities of US$6.8 billion\(^{30}\).

**STOCK MARKET**

From April 1999 through March 2003 the Brazil Bovespa stock index remained relatively flat. It started this period at R$10,798 and ended at R$10,306 with a low of R$8,371 in October 2002. From October 2002 to its peak in May 2008, the Bovespa rose an amazing 724% to R$69,018, a 45.9% annual return over this time period. The next 5 months brought a 57.4% drop in the index to its low of R$29,435 in October 2008. Since October 2008, the index has rebounded to R$41,976 on April 16, 2009, a 42.6% increase from the October low\(^{31}\).

The Bovespa index is now 39.2% below its October 2008 peak. However, the market today stands 401.4% above the October 2002 level. A person who invested in a Bovespa index fund in October 2002 and stayed with the investment until mid-April would have been rewarded with 28.2% annual return.
HOUSING MARKET

Brazil has been experiencing a housing boom. The housing market in Brazil has held up much better than the market in the US. Through September of 2008, housing sales for the year were up 25%32. This boom was fueled by:

- A significant drop in interest rates to 11% from the 2002 level of 40%33.
- Reforms in the mortgage financing market. Banks now own the homes until the loan is paid off. Prior to the reforms, the banks did not have recourse against delinquent home owners making them unwilling to lend34.
- A US$236 billion housing and infrastructure investment announced by President Lula in 200235.
- An estimate by Standard & Poor’s analyst Eduardo Chehab that Brazil was suffering from an 8-million-unit housing deficit36.

Brazil’s housing market was not immune from the world economic downturn. A falling equity market, along with rising unemployment at the end of 2008, led to a fall in demand for housing37. President Lula is again stepping in to boost the housing market, injecting US$15.1 billion into the industry to build homes for low income families38.

Brazil’s housing boom since 2002 has been fueled by fundamental reforms in the housing market and not by speculative buying. Because of this, and the continued pent-up demand for housing, this market should recover quickly when the economy starts to recover.
LABOR

Wages

When President Lula took office in 2002, he pledged to double the minimum wage in 4 years. Since that time, he has pledged to keep the minimum wage rising faster than inflation. In Brazil the minimum wage is adjusted once a year. The rise in wages is good for the people of Brazil to the extent that it puts more money in their pockets. However, without a corresponding increase in productivity, it only tends to put additional inflationary pressures on the economy.

Unemployment

Since 1998, unemployment has been in the range of approximately 8% to 10%. It is interesting to note that even with the global slowdown, Brazil’s unemployment rate for 2008 and the first 2 months of 2009 are at the low end of this range, although it has been rising since the end of 2008. It is also interesting to note that the rise in the minimum wage has not had a negative impact on the unemployment rate39.

From 2004 to 2007, the number of people earning paychecks rose modestly to 79.9 million from 73.9 million40.
Investment in Brazil – An Economic Analysis
IV – Country Forecast and Investment Potential

The purpose of this analysis is to decide whether or not The Blue Suede Shoe Company should own and operate a production facility in Brazil for the manufacture of shoes. The company intends to export this production back to the US. There is a good investment potential in Brazil, and Blue Suede Shoe should proceed with this project. To support this decision, it is necessary to analyze the factors that will affect the future value of the assets purchased in Brazil and the future stream of profits from this venture. This will require looking at factors that are specific to Brazil, and the effect of the world-wide economic slowdown on the Brazilian economy. First, the factors that favor investment will be discussed, followed by factors that will cause concern.

Brazil has not escaped the worldwide economic crisis, although it is not as severe as in other countries. Brazil is the 10th largest market as measured by GDP. Real GDP growth for 2008 was 4.0%, down slightly from 2007’s growth rate of 4.5%. The 4th quarter, however, showed a significant slowing of growth to 1.7%. Real GDP is expected to decline in 2009 between 0.3% and 1.5%. This is not as large of a drop as is anticipated in many of Brazil’s major trading partners. It is expected that real GDP growth in Brazil will rebound in 2010 to between 2.7% and 3.8%.

Since 1996, exports have played a more important role in the in the Brazilian economy rising from 5.7% of GDP to a high of 14.3% of GDP in 2004. From 2005 to 2008, exports have remained relatively constant at about 12.5% of GDP. However, the rate of growth of Brazil’s exports slowed significantly in the 4th quarter of 2008 and decreased in the 1st quarter of 2009. In 2009, GDP is expected to contract in 4 of Brazil’s top 5 export markets. Contraction is expected in the US (-3.2%), Argentina (-2.8%), Netherlands (-4%) and Germany (-5.3%). Only China is expected to see GDP grow in 2009; however, the 6% anticipated growth rate is lower than China has been experiencing.

While exports are important to Brazil, their economy is not nearly as export driven as either China or Russia. In 2008, exports for China and Russia were over twice as important to their economies at 34.7% and 27.0% of GDP respectively.

Brazil’s current account balance turned negative in 2008, a modest 1.8% of GDP. This was the first negative year since 2002. The current account since 1998 has seen 5 consecutive years of deficits followed by 5 consecutive years of surpluses. The current account balance is expected to remain in the -2.0% range for the next few years. This level should not have a significant impact on the overall economy as savings are likely to remain strong, and Brazil is making a major investment in infrastructure.

Brazil has been running a budget deficit for a number of years. In 2008, the deficit had been reduced to 1.5% of GDP. Brazil has experienced improvement in its public debt level which has decreased to 43.9% of GDP in 2008 from 58.5% of GDP in 2004. Since 2005, Brazil has moved from a net foreign debtor to a net foreign creditor. Foreign debt as of September 2008 was -1.35% of GDP.
Investment in Brazil – An Economic Analysis

IV – Country Forecast and Investment Potential

Brazil has engaged in stimulus activity to mitigate the effects of the economic slowdown. These include: liquidity boosting measures to help credit markets, relaxing monetary policy, temporary tax cuts, capital infusions into government owned banks and increased spending for public investment. However, even with this government stimulus program, the fiscal deficit is projected to increase in 2009 only modestly to -1.9% of GPD and then drop to -1.1% in 2010.

The credit crisis has not been as severe in Brazil. There is a significant amount of government influence in government-owned banks. For private institutions Brazil maintains an 11% capital requirement. The federal funds rate in Brazil still remains relatively high at 11.25%. While this has pushed up the cost of borrowing in Brazil, it has also kept banks from making the risky loans that have plagued the US market. Another plus for Brazil is the relatively low foreign liabilities. 30% of Brazil’s bank assets are foreign-owned. This compares to 80% for Mexico. Brazil has a comparative advantage for the soundness of its banks, regulation of securities exchanges, strength of investor protection and financial market sophistication.

Brazil’s stock market declined 57% from its peak, but has since recovered 43% from its October 2008 low. It is amazing that, even after this large correction, the market has had a 28% annual return an since 2002.

Investment has been strong in Brazil. FDI rose to an all-time high in 2008. In 2007, the government announced a US$280 billion investment in infrastructure. A similar US$238 billion investment strategy was begun in 2002. Investment in Brazil’s stock market has also been strong. While there has been a real estate boom in Brazil, which slowed significantly in 2008, it was fueled by pent-up demand and fundamental changes in the housing finance market and not by speculations and risky loans.

The Real Plan, which established the Real as Brazil’s currency in 1994, also brought much better control over fiscal policy and inflation. The inflation rate peaked in 2003 at 14.7%, then fell to 3.6% in 2007. As would be expected, the free-floating Brazilian Real depreciated against the US dollar from R$1.81 per US$1 in 2003 to a low of R$3.08 per US$1 in 2003. From 2004 through 2007 the Real appreciated, reaching R$1.95 per US$1 in 2007. In 2008, inflation rose to 5.9%, and the Real again depreciated to R$2.39 per US$1. Inflation is expected to moderate to 4.3% in 2009. As of April 24, 2009, the exchange rate is R$2.19 per US$1.

If the federal budget deficit and inflation remain under control, there should not be much pressure for devaluation of the Real from current levels. If there is pressure for the Real to devalue, Brazil’s significant increase in foreign reserves over the past couple of years will put the country in a good position to defend the exchange rate should it decide to do so.

The purpose of the investment in Brazil is to produce products in Brazil and export the finished goods back to the US. A stable exchange rate will make the profits from this activity easier to predict and much less vulnerable to exchange rate fluctuations. If Brazil’s stimulus packages
Investment in Brazil – An Economic Analysis
IV – Country Forecast and Investment Potential

and relaxed monetary policy begin to fuel inflation, the Real could depreciate against the US dollar. This will have a positive effect on profit, because the cost in US dollars of each item will decrease.

If the Real appreciates against the US dollar, this will have a negative effect on profits from this venture. The price of each unit imported will cost more dollars. Over time the exchange rate pass-through to the American consumer has declined significantly\textsuperscript{23}. The competitive nature of the US market, and the need to price to market, means that only a small percentage of this increase will be able to be passed along in the form of higher prices to US consumers.

This factory will produce fashion shoes which will not be as price sensitive as commodity shoes. Fashion differentiation may allow Blue Suede Shoe to have a slightly higher ERPT than the commodity products. However, the US market will not allow for a significantly higher ERPT.

There is one other factor to consider about an appreciating Real. If the Real does appreciate against the US dollar, the dollar value of the assets owned in Brazil will rise. This will offset, to some extent, the negative effect of shrinking profit margins.

Will the Real appreciate or depreciate? In an April 8, 2009 report on country data The Economist predicts that the Real will appreciate by about 5\% between 2009 and 2013\textsuperscript{24}. Factors supporting appreciation of the Real are strong FDI, infrastructure investment, increasing reserves, positive expectations about the economy since it has not suffered as badly as other countries during the current economic crisis and increased efficiency leading to higher productivity. Factors supporting depreciation of the Real are falling interest rates, a current account deficit, although 2008 is the first CA deficit since 2002, the possibility of increased inflation because of liberalized fiscal policy and increased government spending.

Brazil has a comparative advantage in the manufacture of footwear. It is ranked in the top quintile of the products that Brazil produces\textsuperscript{25}. The Inter-American Development Bank in a 2008 paper lists the Balassa Revealed Comparative Advantage (RCA) Index for Brazil’s products. Footwear had a significant increase to 264\% in 2004 from 49\% in 1995\textsuperscript{26}.

Brazil is the 3\textsuperscript{rd} largest producer of footwear in the world behind China and India. The Brazilian footwear industry employs about 300,000 people and produces 700 million pairs per year. Exports are about 26\% of this production\textsuperscript{27}. Production is clustered in the southernmost Brazilian state of Rio Grande do Sul, but is now starting to expand into other regions\textsuperscript{28}. Brazil is the only Latin American country in the top 7 footwear producing countries. The top 7 producers account for approximately 91\% of the world’s footwear production\textsuperscript{29}.

Brazil also has a comparative advantage in leather, one of the raw materials used in shoe manufacture. Leather is a by-product of the beef industry. Live animals have a 2004 RCA of 353\% and leather has a RCA of 201\%\textsuperscript{30}. Meat and leather products are in the 5\textsuperscript{th} (top) and 4\textsuperscript{th}
Investment in Brazil – An Economic Analysis
IV – Country Forecast and Investment Potential

quintiles of Brazil’s products. Brazil also ranks 3rd among leather goods producers. Over 300 million hides are processed each year with more than 400 firms that specialize in the dyeing and finishing of leather.

In 2008, Brazil exported US$5 billion of footwear. The number of pairs exported declined; however, the dollar value of the exports increased by 11%. Brazil’s footwear industry has been strategically repositioning itself toward more fashion products and away from the commodity products that are dominated by China and India. In 2008, the average price of a pair of Brazilian shoes was US$60.

According to the World Economic Forum in their Global Competitiveness Report 2008-2009, Brazil is now in the efficiency driven stage of development. It has the low-cost labor and ample raw materials needed for footwear production. Efficiency will be much more important to this industry than heavy capital investment or tech. licensing.

There is an ample supply of labor in Brazil. Unemployment is currently running at 8.4%. The manufacture of shoes will require mostly unskilled, minimum-wage labor. Since President Lula was elected in 2002, Brazil has seen its minimum wage rise each year to its current level of US$1.63 from its 2003 level of US$0.40. This has been the stated policy for Brazil’s very popular President who has presided over a period of stability and prosperity. President Lula’s term will end in 2010 due to Brazil’s 2-term limit.

It will be important to ensure that the factory uses the most productive manufacturing techniques. General labor productivity in Brazil is about 1/3 of the productivity levels in the US. Productivity improvement will be important if the factory has to sustain continued wage increases. The cost of capital is relatively high in Brazil, but footwear is a labor-intensive product.

Hindrances to increases in productivity include: a large informal sector, the regulatory regime, and Brazil’s infrastructure. The informal market has developed as a way to avoid the costs of regulatory requirements. Brazil has rigid labor laws that make it difficult to lay-off workers. This encourages informal employment which has the added benefit of avoiding high payroll taxes. Overall taxes in Brazil are some of the highest in the world. Regulatory complexity and bureaucracy are also an issue. These same issues are highlighted in The Global Competitiveness Report 2008-2009 which lists the top five most problematic factors for doing business in Brazil as: tax regulation, inadequate supply of infrastructure, tax structure, restrictive labor regulations and inefficient government bureaucracy.

Brazil is also at a competitive disadvantage for favoritism in the decisions of government officials and the transparency of government policy making. Brazil is in the 3rd cluster (out of 4 with 4 being the worst) for bribery. The three forms of bribery, (1) bribery to high-ranking politicians or political parties, (2) bribery to low-level public officials to “speed things up” and
(3) use of personal and familiar relationships on public contracting, are equally prevalent in Brazil\textsuperscript{36}.

Brazil is in the middle of the pack in terms of property rights and protection of intellectual property\textsuperscript{37}. This could pose some concern because of the fashion nature of the footwear business. However, the manufacture of footwear is not a high-tech endeavor.

Brazil places some other hurdles to doing business in their country. Overall the country ranks 125\textsuperscript{th} out of 181 for the ease of doing business. Immediate impacts for our proposal are the 18 required procedures and the 152 days it takes to start a business. It would be beneficial to find an existing building since construction permits require another 18 procedures and 411 days. It will be important to staff the factory properly, or even under-staff slightly at first, since it will cost 37 weeks of salary to fire an employee. Enforcing contracts requires 45 procedures and 616 days. Finally, opening a business in Brazil is a long-term commitment, since it takes 4 years to close a business\textsuperscript{38}.

Even with these drawbacks, Brazil possesses a competitive advantage in business sophistication which includes the quantity and quality of local suppliers, the state of cluster development, production process sophistication and control of international distribution\textsuperscript{39}. 
Brazil offers a good investment opportunity for The Blue Suede Shoe Company. Brazil has a comparative advantage in the production of footwear and some of the raw materials needed for that production such as leather. Clusters have developed for shoe production and leather production. The Brazilian industry has strategically positioned itself into the higher value-added fashion segment of the market. Moving away from the commodity segment takes Brazil’s companies away from direct competition with China and India.

Banks in Brazil have remained stable through the current world financial crisis. High interest rates and high capital requirements for banks have been a drag on the economy in the past. However, these policies have helped Brazil during this crisis. These factors kept Brazil’s banks from making the high risk loans that have plagued other economies.

Inflation is under control, especially when compared with the runaway inflation that Brazil experienced in the 1980s. Government deficits continue in a range from 1% to 2% of GDP. However, Brazil’s debt has decreased significantly over the past few years, and the country has turned into a net foreign creditor from a net foreign debtor just a few years ago. With inflation under control, the exchange rate between the Real and the US Dollar should remain relatively stable. If it does fluctuate, Brazil has substantial foreign reserves to use to defend the Real if it should choose to do so.

While Brazil has been affected by the world economy, it has not experienced as much hardship as some other economies. 4th quarter 2008 GDP slowed dramatically, and GDP is expected to be negative in 2009 with a rebound in 2010. As world economies have slowed, Brazil’s exports have slowed, especially in the 4th quarter of 2008 and the 1st quarter of 2009. The government has instituted stimulus measures to help mitigate the effects of the slowdown. Business sophistication is a competitive advantage for Brazil, and FDI is strong, rising 200% from 2005 to 2008.

Brazil has an ample supply of the low-skilled labor that will be needed to manufacture footwear. Wages are reasonable at about US$1.63 per hour. Brazil has a large domestic market and only about 12.5% of its GDP comes from exports. In future years, The Blue Suede Shoe Company may be able to exploit the Brazilian market should it decide to sell some of its production domestically.

While there is opportunity in Brazil, it is not without its risks. Brazil has neglected its infrastructure over the past 3 decades. It is not in a position to support the Brazilian economy as it exists today. In 2007 Brazil’s government launched a US$280 billion effort to upgrade its infrastructure. This is a good start, but more will be needed.

In addition to infrastructure needs, productivity has been hindered by high taxes, high regulatory requirements and an informal market that has developed to avoid these. Tight requirements make Brazil in the bottom 1/3 of countries for ease of doing business. Enforcing
property rights is also an issue. Government bureaucracy and lack of transparency are other concerns, along with a poor record relating to bribery.

While there are risks associated with doing business in Brazil, the opportunity outweighs these risks. After a slight downturn in 2009, growth should continue in 2010 and beyond. The country is stable politically and economically. The government is addressing the infrastructure issue, and Brazil has a comparative advantage in the fashion footwear segment.

The Blue Suede Shoe Company should invest in a footwear manufacturing facility in Brazil. It is incumbent upon senior management to understand the risks, and to take steps to minimize them, so that full advantage can be taken of the opportunities that Brazil offers.
Section II – Economic and Historical Background


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5. ibid, p. 15

6. ibid, pp. 15-16

Section III – Economic Details


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6. op cit, Central Bank of Brazil; ibid, OECD statistical profiles 2008 – Brazil

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Investment in Brazil – An Economic Analysis

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Investment in Brazil – An Economic Analysis

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35. op cit, Brazil’s Housing Boom Shows Cracks

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Investment in Brazil – An Economic Analysis

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Investment in Brazil – An Economic Analysis

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