New China, old challenges

Change in the growth pattern of the world’s second largest economy has exposed structural problems in Brazil that will have to be addressed if the country is to gain lost traction in the Chinese market.

Solange Monteiro

IN RECENT MONTHS, CHINA has attracted global attention because of the volatility of its stock market and the devaluation of the renminbi. Analysts have observed that heavy-handed government intervention was a blow for China’s status as a market economy, making it harder to transform its currency into an international means of exchange. If the path to a market economy is not as clear as previously thought, China’s economic turmoil is enough to exacerbate the risk of economies like Brazil that are dependent on China.

IBRE researcher Lia Valls has noted that although all its exports account for only 10% of GDP and its exports to China
only 1.7%, Brazil’s dependence on Chinese demand for primary goods has been rising over the years, surpassing demand from Peru and Colombia. Without the high commodity prices caused by Chinese demand, Brazil’s structural problems have been unmasked.

Now, says Livio Ribeiro, also an IBRE researcher, “Despite the importance of Chinese demand for commodities, Brazil needs to rethink its strategic targeting of China on its way to ‘new normal’ growth.” He points out that in China the population living in urban areas exceeds 50%, compared to 20% in the 1980s; and its service sector already dominates the economy, accounting for 48.2% of GDP in 2014 compared to 42.6% for primary industry. China’s development has been accompanied by a significant increase in income, heralding new consumption patterns. “Last year, household consumption was already showing signs of recovery—unlike investment,” he says.

In this new setting, Brazil’s challenges multiply. “The new China is less dependent on production and export of traditional industrial products and geared to more elaborated products, which require equally sophisticated services. China is developing segments with higher value-added and will be seeking partners that point in the same direction,” says Jorge Arbache, professor of economics at the Federal University of Brasilia (UNB).

The Chinese economy will not be totally transformed, however. Shortages of water and arable land will keep the country dependent on food imports. The U.S. Department of Agriculture
Although in traded values, cellulose brought in only a tenth of the revenues from the top two exports to China, iron ore and soybeans, the recent impetus to the sector has fueled the plans of large producers to expand and attracted new producers like Eldorado Brazil.

estimates that imports of soybeans to China will grow 40.8% by 2024. In contrast, banks estimate that the country’s imports of iron ore will go up only 1.2% annually between 2015 and 2019. “Prices are not as high as in the past, the demand will not grow as much, but new opportunities will appear,” says Roberto Castello Branco, researcher at FGV Growth and Development. But the Chinese transition, with likely periods of instability, will require that Brazil address the structural problems that limit exports of new products to boost trade with China.

Export opportunities
One sector that has benefited from the changes in China is cellulose, thanks to China’s burgeoning demand for personal hygiene products. The Brazil-China Business Council points out that between 2008 and 2012, China’s demand for pulp imports grew 75%. The Brazilian Lumber Industry found that, from January through August 2015, Brazilian pulp exports to China grew 9.6% compared to the same period in 2014. A National Confederation of Industries survey found that real revenues for cellulose rose 7.7% in January-August, even as manufacturing revenues declined by 6.6%.

Although in traded values, cellulose brought in only a tenth of the revenues from the top two exports to China, iron ore and soybeans, the recent impetus to the sector has fueled the plans of large producers to expand and attracted new producers like Eldorado Brazil. Founded in 2012 in Mato Grosso do Sul, that company has focused on exports, which represent 90% of its sales, of which 39% to Asia, especially China. Luis Felli, director of commercial operations for Eldorado Brasil Celulose S.A., says, “We think opportunities will continue to grow as China’s urbanization has increased demand for both tissue products — toilet paper, disposable towels, napkins—and packaging.” In 2018 Eldorado will bring on line another 2 million metric tons of production a year, compared to the current 1.7 million. “We expect to export to China between 40% and 50% of additional production,” Felli notes. The total investment is R$8 billion, financed with equity and credit lines from equipment suppliers and the National Development Bank (BNDES). He points out
that among other favorable factors, Brazil has “the shortest production cycle of eucalyptus trees in the world, six to seven years.” But once again, the great challenge in trying to compete is outside the plant. Felli says, “With our production concentrated in the Brazilian savanna, we are far away from the consumer market. We need better transport to ports.”

Another promising segment already reaping the fruits of China’s transformation is the meat industry. In April this year, a new agreement ended the Chinese embargo on Brazilian beef that began in late 2012 because of an outbreak of mad cow disease. By mid-June eight slaughterhouses were again exporting to China. “Since then, we have exported about 15,000 metric tons per month, which is the average we expect until the end of the year,” says Fernando Sampaio, director of the Brazilian Association of Meat Exporters.

Another nine slaughterhouses await authorization to sell there, once their plants are certified as complying with Chinese requirements, and more are applying. Official figures put China beef imports at just over 300,000 tons a year but market estimates are that volumes are three times higher. Sampaio emphasizes that China is a market for all cuts and brands—meats used to prepare ready-to-eat dishes, everyday meats sold in supermarkets, and gourmet cuts offered in restaurants and steak houses. It is also possible to achieve higher profit margins in products like muscle beef; as Sampaio explains: “Although these are among the cheapest cuts, Chinese use them often mixed with rice or pasta. It has a huge market in China, where a ton of muscle beef costs US$1,000 more than in Hong Kong.” The challenge now is to build partnerships with Chinese distributors, retailers, and processors.

The Chinese market opened to poultry in 2009 after six years of negotiations. Francisco Turra, president of the Brazilian Animal Protein Association, said, “We sold 18,000 metric tons the first year and 120,000 the second; this
While in sectors like electronics there are already strong Asian regional supply chains, agribusiness supply chains are still primitive. year we expect to sell 360,000 to 400,000.” He explains that the Chinese are accustomed to consuming chicken wings and claws, adding, “We are looking into how we can provide value-added products for these preferences.” he says. Brazil’s BRF SA, one of the world’s biggest chicken exporters, looks to expand further into Asia. Marcos Jank, Vice President of Corporate Affairs and Development of BRF SA, points out that the major challenge in Asia is market access: “In China, the barriers to access are the factory approval process, from phytosanitary agreements to surveillance missions that can take years to complete. In India, the barriers are import tariffs of 30 to 100%. And Indonesia literally prohibits poultry entry. It is very difficult to move to higher value-added food products.” He notes that moving from soybean to meat increases the value of exports by four to ten times. Recently, BRF SA bought a share in Singapore Food Industries, a subsidiary of the largest provider of airport catering services in Asia, which gives the company access to processing facilities, distribution center, and trademark licenses. “With this partnership, we will process Brazilian meat to meet the demand of local markets in addition to airlines,” Jank says.

For Brazilian meat processors, one major factor that affects their business in China is the lack of a policy to speed up the negotiation process. “A few years ago the Chinese said they needed the chicken production of over 40 plants. We managed to get 5 plants approved, but in fact we could have offered 50,” says Turra. Everyone recognizes, however, that Minister of Agriculture Katia Abreu has been working on this. “I followed a recent

Higher Chinese incomes have expanded the regional air transportation market in China for companies like Embraer, which has produced planes in China since 2002.
mission of the minister to Japan where she highlighted the need to add value in agribusiness,” says Jank. “She plans to go to Southeast Asia by the end of the year, with the message of integrating [agribusiness] supply chains.” Jank points out that, while in sectors like electronics there are already strong Asian regional supply chains, agribusiness supply chains are still primitive: “Intra-regional trade in Asia accounts for 60% of total trade because supply chains are integrated. … Addressing these barriers to trade is as important as investment in infrastructure and logistics to promote Brazil’s exports.”

The lack of trade agreements with China is another hurdle, according to Sampaio: “Australia, our strongest competitor, signed a trade agreement with China and therefore has export quotas and preferential import tariffs, [but] the Mercosur has proved ineffective in concluding any agreement…. If we add this disadvantage to logistical problems, bureaucracy, taxes, we see that there is still much to be done to improve the competitiveness of Brazilian products.”

**Doing business in China**

Higher Chinese incomes have expanded the regional air transportation market in China for companies like Embraer, which has produced planes in China since 2002 through a joint venture with state-owned China Aviation Industry Corp. II (AVIC II) and

“Australia, our strongest competitor, signed a trade agreement with China and therefore has export quotas and preferential import tariffs, [but] Mercosur has proved ineffective in concluding any agreement.”

Fernando Sampaio

Even exporting hospital products to 118 countries, the Brazilian company Fanem has not yet gone to China because of non-trade barriers such as expensive export licensing.
Harbin Embraer. In mid-September during the aviation industry exhibition in Beijing, the company released a market overview projecting that in the next 20 years China will need 1,020 commercial jets in the 70–130-seat segment—about 16% of global demand. Currently, Brazil holds an 80% share of the Chinese market for this size aircraft. Embraer plans to be even more active in China because it believes that in the short term it will be the main world aviation market.

In the past three years, China accounted for on average about 8% of Embraer’s annual revenues, which in 2014 were US$6.29 billion.

Sergio Lazzarini, professor at the Institute of Education and Research, points out that Embraer managed to sell airplanes in China only after it associated with a local company to produce there. Before that, the Embraer sales office, set up in 2000, had contracted five sales and obtain 30 firm orders but did not realize any of them because after the Chinese government raised tariffs on imports of small jets from 7.1% to 22.9%, the Chinese buyers cancelled the orders. This incident convinced Embraer to joint venture with AVIC II.

Something similar happened with Brazilian company Fanem, which produces hospital products, such as incubators, that it exports to 118 countries. With relaxation of the one-child-per-family law and the prospect of expansion of health services, Fanem applied for an exporter license for China. In late 2013, it began to register its equipment, but “As we entered the final certification phase, … we learned from our representative that registration fees had been quadrupled, which

“Today the government is cash-strapped, but if BNDES continues financing capital goods Brazil may export its way out of the crisis.”

Ruben Bisi

The Chinese factory of Brazilian company Marcopolo produces luxury buses only for export. Marcopolo does not produce for China's market because regulations require too high a minimum investment of €220 million.
suspended the process,” said José Flosi, Fanem general manager of exports.

With the depreciation of the renminbi, which raised the cost of imported raw materials, and rising wages, the competitiveness of Chinese products has been reduced, making room for foreign competition. According to Brazil’s Marcopolo S.A., which manufactures bus chassis, from January to August this year Chinese salaries went up on average by 10%, says Ruben Bisi, Marcopolo international operations director. Although higher salaries make the company’s operations in its Changzhou factory more expensive, it improves Marcopolo’s competitiveness in relation to Chinese products in the world market. Bisi says that for many years China would sell products similar to Marcopolo’s at prices 30% lower in South America and 35% lower in the Middle East. Now,

“We stumble in the absence of a long-term vision and strategy for Brazil’s inclusion in the world economy.”

Jorge Arbache

Marcopolo is becoming more competitive in these markets, exporting products directly from Brazil. “From January to August this year, China sold 7,000 buses in South America [excluding Brazil] compared to 22,000 in the same period last year,” he notes.

Marcopolo has factories in eight countries. In general, the company exports chassis in PKD (partial knock-down) format to be assembled close to the destination. However, the Chinese factory, which produces about 300 luxury

Source: USDA.
buses a year, is dedicated to export—the local market is still closed to Marcopolo. “We do not want to partner with local companies because companies that have partnered there have had problems with management and sharing technology” Bisi says. “But the biggest obstacle to setting up operations in China is the minimum investment required by law of about €220 million. That makes no sense if I can set up a factory with €40 million,” he says. Chinese authorities are saying that the law should change, as the Chinese automotive industry develops its technology, enters world markets, and does not need protection from foreign competition.

Bisi pointed out that to have access to markets a company needs credit lines: “We need the National Development Bank [BNDES] to continue to support exporters. Today the government is cash-strapped, but if BNDES continues financing capital goods Brazil may export its way out of the crisis.” He points out that Scandinavian competitors such as Volvo and Scania are ahead because they can get financing at lower cost.

**Improving competitiveness**

Companies that have tested the Chinese market confirm that Brazil will have to address old problems if its companies are to compete successfully. “We stumble in the absence of a long-term vision and strategy for Brazil’s inclusion in the world economy,” says UNB’s Arbache.

To improve competitiveness, Brazilian companies should invest in adding value to

---

**China's iron ore imports are expected to growth moderately in coming years as the share of primary industry in GDP is reduced.**

(Millions of metric tons)

Projections are the average of banks (Macquarie, Citi, BTGPactual, UBS, Morgan Stanley, Clarkson) and CRU. Source: China Customs.
their products, starting with commodities—something that had a low priority when prices were high. Former Minister of Agriculture Roberto Rodrigues, coordinator of the FGV Agribusiness Center, suggests, for example, negotiating export contracts that gradually raise the proportion of processed soybean meal and reduce that of soybean grain.

Roberto Castello Branco, former director of mining company Vale and now a researcher at FGV Growth and Development, argues that Brazil needs to negotiate better trade advantages: “It’s a long-standing habit of our diplomats to not focus on commercial factors. We must change this.” When in 2006, China threatened to cap the prices that steelmakers would pay for imported iron ore, defending freedom of trade was Australia, the second largest iron ore exporter. Brazil did nothing.

Castello Branco also argues that long-standing structural factors that affect the competitiveness of Brazilian exports need to be addressed. In addition to a clear export strategy, Brazil also needs a competitive exchange rate and policies to reduce the Brazil costs. Even so, Arbache believes Brazil will have great difficulty in adding more value to its exports to China: “We have built up a production system that to make money did not depend on innovation, better worker skills, sophistication, … and interaction with world markets; meanwhile, the Chinese adopted insightful policies to attract foreign capital, and learned from American, Japanese and European companies, until they became independent,” he says.

Arbache thinks that Brazil has a useful opportunity to take advantage of the new wave of Chinese foreign investment, noting that since the first wave, focused on commodities, and the second, on consumer goods, China is now aggressively investing abroad to diversify use of its international reserves, which are heavily in U.S. government bonds. However, Castello Branco points out that to take advantage of China’s investment appetite, conditions in Brazil have to be attractive. He notes that the US$53 billion in cooperation agreements announced during the visit of Chinese Prime Minister Li Keqiang to Brazil last May will require more than good intentions to materialize. Brazil has serious deficiencies in infrastructure, and Chinese contractors have significant experience in executing hydroelectric projects, roads, railways, and ports. Their experience could help make Brazilian exports more competitive.