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China-Brazil – Navigating the partnership

- **The Latam-Brazil trade corridor is among the fastest growing in the world**
- **However, obstacles abound, ranging from logistical challenges to navigating tax codes**
- **The relationship is being built on much more than simple resource supply**

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Growing trade and financial linkages

While the world focuses on event risks in Europe and the disappointing growth performance of the US, there is also a remarkably positive growth story involving China and Brazil. It links into the global super-cycle which we first outlined in a comprehensive piece in November 2010 (see **The Super-Cycle Report, 14 November 2010**). Growth in the economic and financial linkages between China and Brazil over the past five years has been impressive. Asia-Latam is one of the world's fastest growing trade corridors, with China-Brazil trade at its core.

China is Brazil's top export destination, receiving more than 17% of exports in January-July of 2011. This is up from 15% in 2010 and a mere 4% in 2002. Brazil continues to benefit from the favourable terms of trade thanks to Chinese demand for Brazilian commodities, ranging from iron ore to sugar to soybeans. One less well documented feature is the success of joint ventures between Chinese and Brazilian companies aimed at tapping into Brazil's growing domestic demand. There are questions, however, about the Brazil-China relationship.

We explore some of the major challenges for firms involved in China-Brazil commerce, including logistical, infrastructure, linguistic, cultural, and tax issues. We also outline the opportunities yet to be exploited within this deepening trade corridor. Over the past weeks, we have discussed these issues with a number of corporates focused on China-Brazil trade; some of the major points are highlighted in this piece.

Our discussions with a selection of stakeholders in this relationship reveal some of the challenges as well as opportunities associated with these new linkages, including some of the obstacles Chinese corporations investing in Brazil, and Brazilian firms that export to China, face.

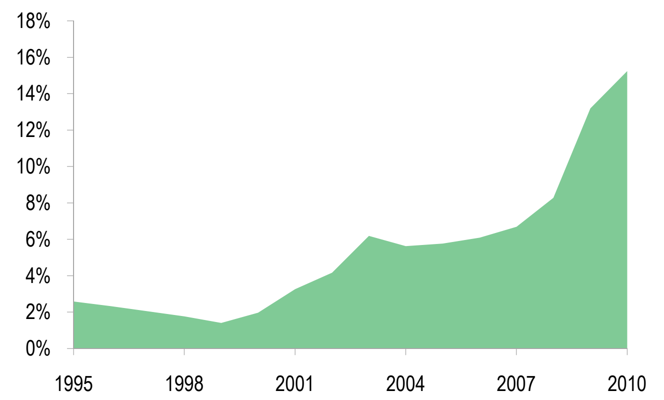
Chart 1: The strength of the relationship is impressive

China's exports to Brazil (USD bn)

Sources: UNCTAD, Standard Chartered Research

Chart 2: Demand from China has been relentless

Exports to China, % of Brazil's total exports



Sources: UNCTAD, Standard Chartered Research

Brazil offers a rapidly growing market for Chinese manufacturers

The infrastructure void is a major challenge

Infrastructure issues in Brazil are the country's greatest obstacle to longer term economic growth. Brazilian television routinely shows extensive traffic jams, as trucks struggle to deliver goods from the interior of the country to ports on the coasts. As the World Cup (2014) and the Olympics (2016) approach, the worry is that the government may be too distracted with these high-profile events to deal with such bottlenecks.

Size, rising demand and stability make Brazil a desirable market

The Chinese firms we spoke with all agree that the domestic market in Brazil holds substantial potential. With nearly 200mn citizens, a BRL 4trn economy (USD 2.4trn) and a rapidly expanding middle class, the Brazilian consumer is a growing force that Chinese firms are increasingly focused on.

While many Brazilians are pessimistic about domestic politics, Brazil offers a comparatively stable backdrop vs. some other emerging markets. Brazil is a democratic country which has experienced peaceful transitions of power over the last decade.

Gree Brazil

Our first example is Gree Brazil, a listed Chinese air conditioner (AC) manufacturer. For Gree, the hot weather characteristic of a mostly tropical nation and a large population signify huge demand. Gree also notes that domestic consumption is one of the major drivers of Brazil's economy, providing purchasing power for its products. They expect the World Cup and Olympic games to boost demand for AC systems.

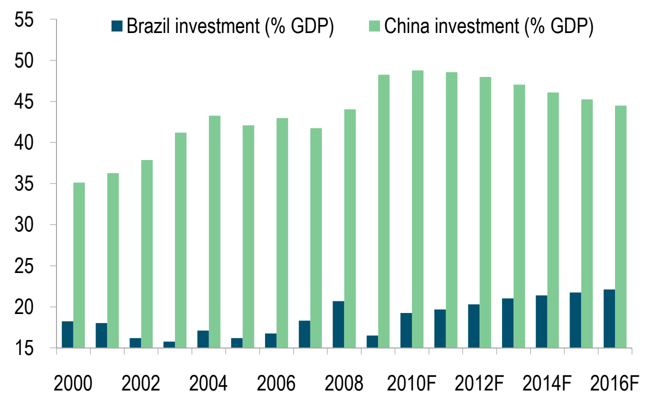
Gree has a plant In Manaus, Brazil to service the large domestic market. However, owing to transportation costs, it is actually more expensive to export from the Brazilian plant than from China to other Latam countries. Consequently, Gree exports to non-Brazil Latin America primarily from China, despite the distance.

CR Zhongshen do Brasil

Another success story, CR Zhongshen do Brasil (CRZ) is a joint venture funded equally by Zongshen Group (China) and Brazil Claudio Rosa group in 2008. It produces electric vehicles, and lists Brazil as a target market because of its large population and the potential of its domestic market. CRZ notes that regional diversity within Brazil creates opportunities for CRZ products at various price points.

Chart 3: Investment in China towers over Brazil's

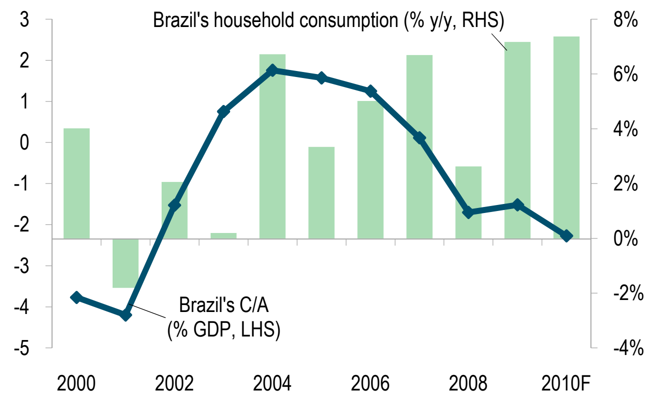
Brazil, China investment (% GDP)



Sources: IMF, Standard Chartered Research

Chart 4: Brazil's household consumption remains robust

Brazil, C/A balance (% GDP),household consumption y/y



Sources: IMF, Standard Chartered Research

It would be a misconception to suggest that the Brazilian domestic market is uniform: the tropical Amazon basin has little in common with the temperate southern regions of the country, for example.

Culture matters

The complicated tax code in Brazil trumps the issues of language, distance and culture for Chinese firms

Chinese firms operating in Brazil highlight the challenges of integrating the production, sales and management team into the local market place. In essence, cultural differences matter. Gree mentions that in its early years in Brazil, its Chinese-style management and unfamiliarity with local tax laws resulted in fines, labour conflicts, and a product style that did not mesh with local tastes.

These lessons have made Gree take a more flexible and cautious attitude towards the Brazilian market. Language barriers and cultural difference are ongoing issues, as one would expect for any company operating far from home.

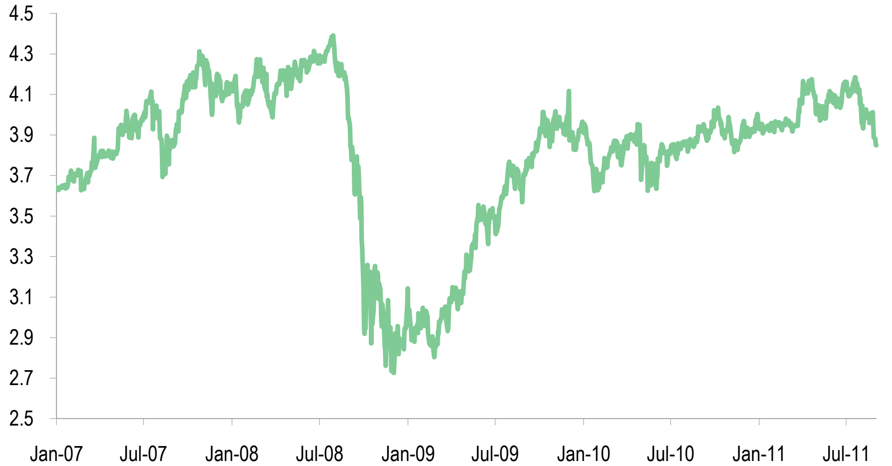
In recent years, Gree has increased the percentage of local staff so as to reduce the language barrier. CRZ also cited the impact of cultural differences on communication. This becomes especially crucial in joint-venture arrangements.

Legal considerations come into play because of the vast differences in the legal systems between China and Brazil. CRZ asserts that there are imperfections in the legal systems in both China and Brazil, and substantial inconsistencies that affect co-operation. Multinationals invest significant time and resources to address legal issues; indeed, Brazil's tax code is considered one of the world's most complex.

Brazil never ranks particularly highly as far as 'ease of doing business', according to various international surveys. Red-tape issues like tax policies are hurdles. For example, Gree pays high import costs when it needs to import high-tech equipment from China. Also, government procurement policies are likely to favour local brands.

Chart 5: Volatile BRL-CNY rate worries Chinese firms

BRL-CNY spot rate



Sources: Bloomberg, Standard Chartered Research

Macroeconomic considerations are important for multinationals

The economic factors that Gree pays most attention to are:

- **Brazil's complicated tax code.** Gree picked Manaus, a city located in a relatively remote Amazon location, to invest in mostly because the local favourable tax policy outweighs the logistical inconveniences. CRZ also identified tax policies as a key issue.
- **Localizing the production process is a good FX risk hedge**.
- **Chinese yuan (CNY) appreciation could push up Chinese import costs**. However, so far, because of BRL appreciation, the opposite has been the case
- **To hedge Brazilian real (BRL) FX risk, Gree's headquarters offers the company loans** with long-term payment options.

Agricultural producers benefit from Chinese demand

We also examined Brazilian agricultural producers. This sector has benefited from the exponential increase in Chinese demand over the years. One soybean producer noted that in 2004, China imported 15mn tons (mt) of soybeans; in 2011, soy imports totalled 57mt in anticipation of a substantial increase in demand in 2012.

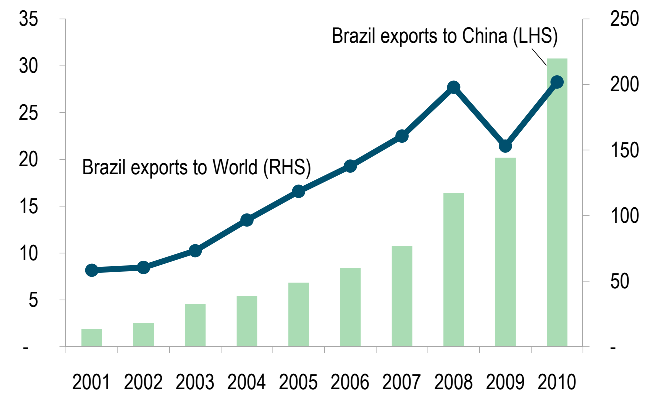
Strong demand from China is expected to continue. As a result, Brazilian firms are committing more resources to R&D, and enhancing technological processes related to farming. Harvests for soybeans in Brazil continue to improve: 58mt tons in 2009, 69mt last year, 75mt this year, partly owing to Brazil's expertise in agricultural sciences.

China seeks to export some of Brazil's agricultural expertise

China is looking to develop what one Brazilian firm terms "its own origination machine" of agricultural products within China; Brazilian firms have been advising Chinese companies – in China - on agricultural sciences. Boosting the output of China's own farms is another positive effect of the increasing economic relationship with Brazil.

Chart 6: Demand from China is strong even in bad years

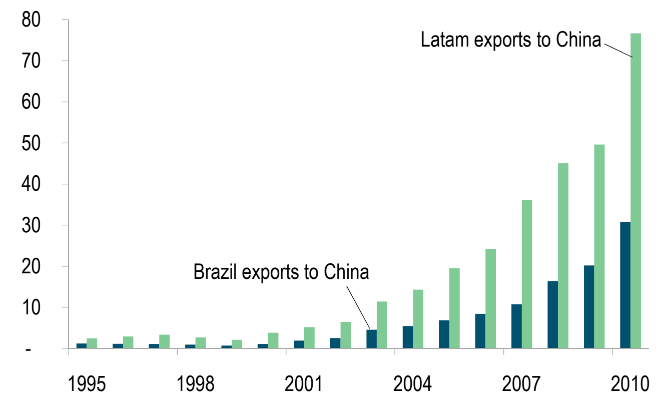
Brazil exports to China and the world (USD bn)



Sources: UNCTAD, Standard Chartered Research

Chart 7: Brazil-China link is the core of Latam-China trade

Brazil, Latam exports to China (USD bn)



Sources: UNCTAD, Standard Chartered Research

Logistical challenges persist

Infrastructure bottlenecks may become an increasing challenge

There is evidence that Chinese trading houses are looking to trade directly with producers. However, this is not easy given the lack of historical linkages, language barriers, time-zone issues, and uncertainty over contract enforcement. Logistics was identified as a key challenge for exporters in the commodities sector. For example, although soybean crushing and warehouse capacity is reasonable, waiting times of up to 30 days at ports are making the private sector more focused on this topic. The private sector sometimes takes matters into its own hands; the construction of a railway by Vale, to transport its iron ore to port, is one such example.

There is an effort at the government-to-government level to reduce transaction costs for agricultural trade. This is mainly happening at the municipal level (combining the collective requirements within each municipality).

Legal nuances thwart China's attempts to buy land in Brazil

Media reports have suggested that China has been an aggressive buyer of land in South America and especially Brazil. However, one agricultural product trader mentioned that while there have been a lot of stories in the local press, not many major land agreements have been effected. This also applies to plans to invest in infrastructure.

New land restrictions for foreigners in Brazil may also be discouraging Chinese attempts to accumulate raw land. The increased land restrictions are a result of new interpretations of existing law, rather than new legislation, resulting in more limited foreign ownership of Brazilian land. China will face the challenge of locking in access to resources for the long term in Brazil, without majority ownership rights.

Solutions to the land ownership issue are already emerging

Already we are seeing solutions to this issue. As long as the Chinese company takes a minority stake it can still have some equity in a venture that enables access to resources over the long term. There are already examples of success stories using this approach.

Also, we note that Brazil expects more of an equity commitment than has been the case elsewhere where Chinese companies have been involved in building up infrastructure. This is difficult for Chinese state-owned companies. This extra complication may be restraining growth in this area. Eventually, we expect some compromise, but it is hard to know how soon.

Over the longer term, these challenges to bigger FDI inflows may be overcome. However it is hard to see this happening in time to help with the construction needs for the 2014 World Cup and 2016 Olympic Games.

Disclosures Appendix

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