COMMODITIES

Iron ore adds more gloominess to Brazil's outlook on the back of China woes

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China slows, Iron prices fall, and Brazil takes the hit

China's slowdown puts downward pressure on prices, impacting iron ore exporters

Iron ore spot prices continue their 2 year descent, plummeting by -48.8% y/y to 64.2 USD/dry MT in January, compared to 125.4 USD/dry MT in the same period last year. The fall in prices can be traced back to excess supply from mining projects that were already in the pipeline as well as weak global demand. In particular, China's slowing growth is putting significant downward pressure on prices (Figure 1).

China is the world's largest consumer of iron ore, importing over 930 million tons in 2014. The country's largely investment-led growth model through much of the last decade helped to fuel a global commodity super cycle, propping up iron ore prices and benefiting commodity exporters. Brazil, one of the largest producers of iron ore in the world, is a clear example.

Increased dependency on China leaves Brazil more vulnerable to shifts in demand

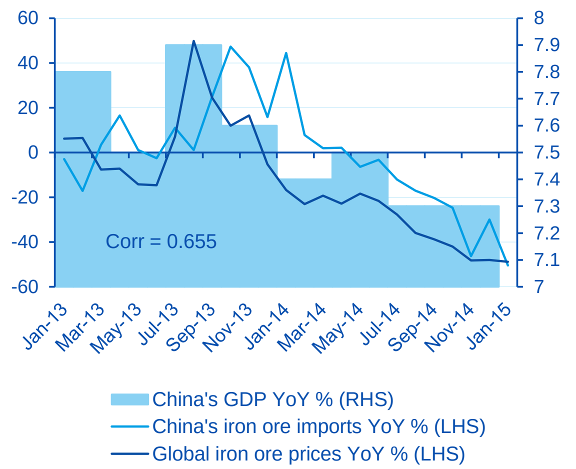
Brazil exported 170 million tons of iron ore to China in 2013, compared to 60 million tons in 2005. According to our Commodity Concentration Index (see our previous Economic Watch), this would imply that Brazilian iron ore exports' dependency on Chinese demand increased by 48% between 2005 and 2013. Other iron exporters in the region also saw their dependency increase during the same period, including Chile (+37%) and Mexico (+113%).

Naturally, these countries are feeling the hit, as China's appetite for commodities dwindles dragging down prices. A slowdown of China's economy will affect these countries, especially Brazil, in at least three ways: (1) lower external demand for iron ore exports; (2) lower commodity prices, putting downward pressure on iron ore prices by as much as -1.5% in 2015 according to our estimates; and (3) lower household and corporate confidence. The countries with a more pronounced export dependency on industrial metals, like Brazil, Chile and Peru, will feel the impact of China's slowdown more strongly, while agricultural products will see less of a decline. Ongoing and prospective easing measures that stimulate investment (see our latest China Flash) may put some tailwind behind global iron ore prices, but we expect this impact to be rather nuanced.

Iron ore: one more factors behind the ongoing deterioration of the Brazilian economy

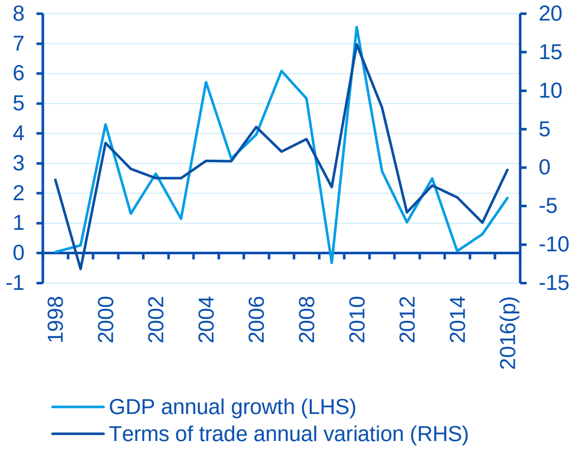
Brazilian iron ore exports to China reached USD12.3bn in 2014, 23% less than in the previous year and 38% less than in 2011, their peak. This decline has contributed to the 7% drop in total exports with respect to 2013 and the 12% drop since 2011. On top of that, the decline in iron ore prices has been playing an important role in worsening Brazil's terms of trade (i.e. the price of the country's exports divided by the price of the country's imports) and therefore on the deceleration of economic activity (see Figure 2). Anyway, this is not the single driver of Brazil's slowdown. The moderation in other commodity markets (oil, soybean, etc.), ongoing tightening of monetary and fiscal policies, crisis in Petrobras, scarcity of water and electricity and the competitiveness problem faced by the manufacturing sector, among other factors, have also prevented the country from growing as fast as in the past. Looking ahead, we expect a further deceleration in Chinese demand to continue to weigh on iron ore markets and to keep economic growth below potential in Brazil (see our 1Q15 Brazil Economic Outlook for more details about our view on the country).

Figure 1
Strong correlation between falling Chinese iron ore imports and falling global prices



Source: Bloomberg, CEIC and BBVA Research

Figure 2
Low iron ore prices, lower terms of trade and therefore lower GDP growth in Brazil



Source: IPEADATA and BBVA Research

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