Consumer Leather Goods – Fashion Footwear
Brazil and Italy

Ed Vallorani
7/16/2010
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Consumer Leather Goods – Fashion Footwear
Brazil and Italy
I - Introduction

This paper will examine the positives and negatives associated with investing in a facility to manufacture fashion footwear in either Brazil or Italy. The main purpose will be to export this production back to the United States and to sell this product into the host market.

To accomplish this, an exploration of country backgrounds will produce a high-level view of economic and political realities in these two countries today, and how these realities have developed over the past few decades. Cultural awareness is one of the most important elements when deciding to do business in another country. It can be the difference between success and failure. Understanding the cultural norms in Brazil and Italy is critical for any planned investment.

The macroeconomic factors in each country will be explored including an examination of each currency and future prospects for rate movement. Other issues considered will be the current political situation and likely changes in the near future, the banking and financial situation, and regulations that affect the ease of doing business in each country.

The similarities and differences of the fashion footwear industry in each country will be examined. This will include the factors that would affect the industry such as: availability of raw materials, expertise in the industry, industry clusters, domestic markets and the labor situation.

This paper is organized as follows:

Section II  Discusses some interesting economic and historical details that are unique to Brazil and Italy.

Section III  Looks at the cultural norms in each country.
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Section IV  Documents the major macroeconomic factors and trends in Brazil and Italy. Their relevance to the investment decision will be more fully discussed in later sections.

Section V  Discusses the effect that the European Union and the Euro Zone has on the economy of Italy.

Section VI  Analyzes the fashion footwear industry and the segments in which each country has a comparative advantage.

Section VII  Provides an analysis of the key factors that need to be considered in the investment decision.

Section VIII  Provides the recommendation for investment along with the rationale for the recommendation.

Section IX  Summarizes the key points of this paper.
Brazil

Brazil is one of the BRIC (Brazil, Russia, India and China) countries. 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.¹

President Luiz Inácio Lula Da Silva assumed office in 2002. He was re-elected in 2006. Because of 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%.² 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 crucial 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 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%.6

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.

**Italy**

Italy emerged from the devastation of World War II and the fascist regime of Benito Mussolini as a new republic in 1946. The first post war Prime Minister, Alcide De Gasperi, fostered industrial growth and agricultural reform. With the help of massive amounts of U.S. aid, Italy achieved rapid industrial expansion, an impressive economic recovery and a sharp increase in the standard of living. During De Gasperi’s over eight years in office, Italy joined the European Coal and Steel Community (ECSC). The ECSC was the first step in forming what is now the 27-member European Union. Italy was one of the six original members of the ECSC.

De Gasperi was the longest serving Prime Minister since the end of World War II. Italian politics are volatile. In the 57 years since De Gasperi left office, there have been 37 Prime Ministers. The average time in office since De Gasperi has been 18 ½ months. Only four other Prime Ministers have served for more than a three-year term. While there has been tremendous turnover in the office of Prime Minister, political stability has been maintained. From 1946 to 1992, 26 of the 28 Prime Ministers were Christian Democrats. During this 47-year period other parties held the office for a little over five years.

The 1960s was a time of prosperity for Italy. The industrial triangle of Milan-Genoa-Turin led the way. Private and state enterprises took advantage of the Marshall Plan. A strong export
sector was developed. During this time Italy was the fastest growing economy in Europe. It rivaled Japan’s growth. Unfortunately, the prosperity was not distributed evenly throughout Italy. While the industrial north prospered, the agricultural south remained impoverished, a situation that remains to this day.

The 1970s were a difficult time for Italy. This period was marked by extreme left wing and extreme right wing terrorist activities. These included bombings, assassinations and kidnappings. A very highly publicized incident was the 1978 kidnapping and murder by the Red Brigade of Aldo Moro, a two-time Prime Minister whose second term ended in 1976. 

While Italy had a free market economy, there was still a lot of government control and state ownership of enterprises. Until the 1980s, this situation did not hinder Italian economic growth. However, during the 1980s, state control became a drag on the economy. Workers at state owned enterprises (SOE) lived beyond their means and relied on taxpayers to pay the bill. Appointments to government jobs and management positions at SOEs became a form of political patronage. Waste was rampant. The social welfare system also put a great burden on the economy, which led to high debt.

The 1980s and early 1990s were a period of widespread corruption in government involving more than the political patronage in job appointments. Large bribes were paid to government officials by construction companies for favorable treatment in the awarding of public works contracts. “Voters, disenchanted with past political paralysis, massive government debt, extensive corruption, and organized crime's considerable influence...demanded political, economic, and ethical reforms.”
Political parties underwent far-reaching reorganizations. The Christian Democrat party, which had held power almost exclusively in the post-war period, could not survive the scandal. It disbanded. In the election of 1994, 72% of the Chamber of Deputies and 68% of the Senate were elected for the first time. At the same time the current Prime Minister, Silvio Burlusconi, was elected to his first of three terms.¹⁴

Burlusconi runs a major commercial and media empire in Italy. He directly controls 50% of the Italian media market and has used the media under his control to aid with his runs for office.¹⁵ He also has “an extensive record of criminal allegations, including mafia collusion, false accounting, tax fraud, corruption and bribery of police officers and judges.”¹⁶

Burlusconi has appeared in criminal court many times. He has used his office to pass legislation that is favorable to his situation. Legislation has included shortening of the statute of limitation and changing the definition of accounting fraud. These changes have resulted in dismissal of pending cases.

As politics was changing so was the economic structure of the country. Privatization of enterprises began in the late 1980s and continued into the 1990s. Other reforms were introduced: cuts to the welfare system, measures to eliminate waste, making the tax system more efficient and tight monetary policies to reduce inflation.¹⁷

As mentioned before, the southern part of Italy has not enjoyed the prosperity of the northern part. To remedy this situation, Italy passed Law 488 to aid investment in impoverished areas. Under this law, companies involved in manufacturing and extraction can apply for grants from the government for capital investment. The amount of the grant is determined by the
type of investment, the specific region of the investment and a yearly auction system for the
grant money. Depending on these and other variables, the grant can be up to 50% of the total
investment.\textsuperscript{18}

A huge change occurred in Italy in 2002 when the national currency, the Lira, was
replaced by the multi-country currency, the Euro. Through the 1990s and into the early 2000s,
the value of the Lira fell consistently from about 1,200 Lira per US$1.00 to approximately 2,200
Lira per US$1.00.\textsuperscript{19} The introduction of the Euro has reversed this trend. The Euro and its
implications for Italy will be discussed later in this paper.
Culture plays an important role when doing business across borders. Understanding, or not understanding, the culture of a country can be the difference between success and failure. The best business plan, the best operations or the best execution cannot compensate for a lack of cultural awareness.

Geert Hofstede’s 1980 book, *Culture's Consequences*, contains conclusions drawn from a survey that he conducted using IBM employees from around the globe. In this work Hofstede identifies four major components to culture that differ in different countries. While other studies have followed, Hofstede’s work is still recognized as valid around the world for understanding cultural differences at a broad level. Hofstede’s original four dimensions are:

**Power Distance Index (PDI)**

This dimension measures the extent to which an unequal distribution of power is accepted by the most and the least powerful members of a society. A high score on this dimension indicates that all members of the society accept an unequal distribution of power and prestige. Societies where hierarchy is important tend to have a high power distance number. A low score on this dimension indicates that inequality in power distribution is not readily accepted, and there will probably be more interaction between people at differing power levels.
Individualism (IDV)

This dimension measures the extent to which a society values individual accomplishment over group accomplishment. A high score on this dimension indicates that a society values individual achievement. Groups tend to be loose affiliations, and membership can change easily. A low score indicates a collectivist society where the achievement of the group is emphasized over the achievement of any one individual. Group affiliations are strong for both family affiliations and work-group affiliations. It is not easy for an outsider to break into or to be trusted by the group.

Masculinity (MAS)

This dimension measures the extent to which the society tends to be assertive. A high score on this dimension indicates that the society tends to be assertive and competitive. A low score indicates that the society tends to be more modest and caring.

Uncertainty Avoidance Index (UAI)

This dimension measures the extent to which members of a society tolerate uncertainty and ambiguity. A high score for this dimension indicates that members of a society are uncomfortable in unstructured situations, those that are novel, unknown, surprising, or different from the usual. Philosophically and religiously there is a belief in a universal “Truth.” In these societies, laws and rules are used to create structure.
A low score for this dimension indicates that the members of society are tolerant of new and unstructured situations. They are more willing to listen to and accept views that differ from their own. Philosophically and religiously they are more relativistic. Right and wrong will depend more on the situation than a universal “Truth.” These societies like to have as few rules as possible.

After the initial study, Hofstede added a 5th dimension, Long-Term Orientation. Data for this dimension is limited. The survey was distributed to students in only 23 countries.

**Long-Term Orientation (LTO)**

A high score for this dimension indicates that the society values persistence and results that can be achieved over a long-term. Relationships are ordered by status and are initiated with the idea that they will last over time. Being thrifty is also highly valued. A low score for this dimension indicated that the society is interested in quick results. Status is not important in relationships. These relationships can begin and end quickly as circumstances dictate. A higher value tends to be put on spending and not on saving or being thrifty.
The chart above compares Hofstede’s cultural dimensions of Brazil and Italy to those of the Unites States. These comparisons are important to understand negotiating, managing, working with or marketing to people from other cultures. Looking across all of the dimensions, it becomes evident that culturally the Unites States is more similar to Italy than it is to Brazil.

For the Power Distance dimension, both the Unites States and Italy rank in the lower half of the countries surveyed. People in these countries will not readily accept unequal distribution of power, and interactions between people at different power levels will be more common. Brazil ranks in the top third of countries surveyed. Their society has a much more hierarchical structure. Upon entering a room, it will be important to greet the highest ranking member first before greetings are extended to everyone else in the room. Subordinates will tend to defer to superiors. Decision making will be reserved for the leader.

The United States is the most individualistic country in the survey, followed very closely by Australia and the United Kingdom. Italy is not far behind. In these countries, individual achievement is highly recognized and rewarded. The individual is more important than the group. One important thing to remember about Italy is that extended familial relationships are very important, much more so than in the Unites States.
Brazil ranks in the lower half of the countries surveyed indicating that they are a more collectivist society. Achievements of the group will be more important than achievements of the individual. Relationships within groups are also very important. Hiring and promotions may be based more on relationships, especially family relationships, than on merit. As with most South American cultures, a person may miss work because of a pressing family issue. This same issue may be viewed by a person in the United States as relatively unimportant and not a reason to miss work.

For the Masculinity dimension, Italy ranks a little higher than the United States indicating that Italians will tend to be more assertive and competitive than Americans. Brazil ranks much lower on this dimension indicating they will not be nearly as assertive as Italians or Americans.

Italy and Brazil are almost identical for the Uncertainty Avoidance Index. They rank in the middle of the group of countries surveyed. The United States ranks in the bottom 20% for this dimension. Americans will tend to be more comfortable in new or unusual circumstance than their counterparts in Brazil or Italy. For an American in either of these countries, (s)he will have to be more patient when asking Brazilians or Italians to embrace new ideas or to deviate from the norm.

The United States has one of the lowest ranks for the Long-Term Orientation dimension. Asking “what have you done for me lately” or focusing on the next quarter’s results without worrying about longer-term consequences is standard operating procedure in the United States. Brazil is ranked in the upper third for this dimension. Brazilians will tend to take a
longer-term view for business results and relationships. This is another area in which an
American doing business in Brazil will have to adapt. Italy was not ranked on this dimension.
Edward T. Hall also identified a couple of different cultural dimensions in his 1976 book
*Beyond Culture*. One dimension he identified was high-context versus low-context cultures. A
low-context culture tends to be very direct. Verbal communication is very explicit. All of the
necessary information is contained in the verbal communication. This type of culture tends to
get down to business quickly. In a high-context culture, verbal communication is not explicit.
The meaning of what is being communicated cannot be completely understood from the words
alone. Non-verbal communication may be just as important, if not more important, than verbal
communication. The context of the communication is also highly significant.

The United States is a very low-context culture. Verbal communication tends to convey
the total meaning of the message being delivered. Italy ranks in the middle. Its communication
style will not be as direct as the United States. Additional meaning will be conveyed by non-
verbal means. Brazil is a high-context culture. Much of the meaning of a communication can be
expected to come through non-verbal means. To be effective, an American will have to
appreciate and understand these differences in communication style.

The other dimension that Hall identified was monochronic time (M-time) vs. polychronic
time (P-time). M-time cultures emphasize adherence to schedules and agendas, promptness,
and focus on doing one thing at a time. Time is viewed as linear. It is important to complete a
task before moving on to the next task. M-time tends to be found in low-context cultures. In P-
time cultures, adherence to schedules and agendas is not important. People will tend to be late
for meetings or appointments, and this is accepted. Many things may be occurring at the same
time. Time is viewed as fluid. P-time tends to be found in high-context cultures.

The United States operates on M-time. It emphasizes schedules, agendas, promptness
and completing a task before moving on to the next. Brazil and Italy are both P-time cultures.
People will not adhere to schedules and agendas in the same way as people in M-time cultures.
There may also be many things happening at the same time. For an American doing business in
these countries, it can be very frustrating. Most Americans view time as money. Wasting time is
like wasting money. P-time cultures do not view time in this way. Since time is fluid, they are
not wasting it when they don’t adhere to a set schedule. Americans doing business in these
countries will have to adapt to a radically different way of perceiving time if they are to be
successful. This can also lead to a conflict between the realities in a country and the
expectations of the home office.
This section analyzes the macro-economic factors that are relevant to doing business in Brazil and Italy. It relies on trend analysis of historical data. Where available, the historic data goes back to 1994. As discussed previously, 1994 marked the introduction of the “Real Plan” in Brazil. This plan introduced a new currency and ended the hyperinflation of the 1980s and early 1990s. Information before that time would not be useful for comparison purposes.

Through studying the historical trends, a picture of each economy arises. It is valuable for understanding how each country got to where it is today. It is also the basis upon which future projections can be made. These projections will be important to the decision making process, which will be covered later in this paper.

GDP

For 2009, Italy and Brazil have grown to be the 7th and 8th largest economies in the world at US$2.12 trillion and US$1.57 trillion, respectively.¹ From 1994, Brazil has outpaced Italy in total growth, gaining 290%² to Italy’s 201%³. In addition, Italy is part of the European Union. This common market of 27 European countries had a total 2009 GDP of US$16.4 trillion. As a market, only the United States is close to the size of the EU with a 2009 GDP of US$14.3 trillion.
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IV – Macro-Economic Indicators

trillion. The US is by far the world’s largest single country market. Japan, the #2 single country market had a 2009 GDP of US$5.1 trillion, with China close behind at #3 with a GDP of US$4.9 trillion in 2009. The unique factors that affect Italy as part of the European Union and the Euro Zone will be discussed in the next section.

The world financial crisis of 2008 had a negative effect on most of the country GDPs around the globe. Brazil was one of the countries that only suffered modestly from the downturn. Brazil’s real GDP growth in 2008 was 4.0%, down slightly from the 4.5% real growth rate in 2007. For 2009 Brazil’s real GDP growth rate did turn negative; however, it was only down by 0.2%.

With the exception of the 1998 to 2001 time frame, Italy has had a slower GDP growth rate than Brazil. This is not unexpected since Brazil’s economy is developing and Italy’s economy is mature. Italy suffered more than Brazil from the 2008 financial crisis. Italy’s GDP dropped by 1% in 2008 compared with Brazil’s 4.0% gain. For 2009 Italy’s GDP dropped by 5% compared to Brazil’s 0.2% drop.
According to the World Economic Outlook published in April 2010 by the IMF, both countries should return to growth in 2010: however, there will be a significant difference in the level of growth. While Brazil is predicted to grow by over 5.5%, Italy’s economy is predicted to expand by less than 1%. From 2011 through 2015 Brazil’s economy is predicted to grow at approximately 4.0% while Italy’s economy is predicted to grow at a much more modest 1% to 1.5%.

Italy and Brazil may be ranked 7th and 8th in total GDP for 2009: however, the two countries have significantly different sizes of population. Brazil is ranked 5th in the world with a population of almost 200 million people. Italy is ranked 23rd with just over 58 million people. Therefore, there is a huge disparity in GDP per capita. Italy’s GDP per capita at approximately
30,000 was three times greater than Brazil’s in 2009. This differential has narrowed only slightly since 1994 when Italy’s per capita GDP was 3.4 times that of Brazil.

TRADE

Exports for these two countries peaked in 2008. In that year, Brazil’s exports reached almost US$200 million, while Italy’s exports were nearly US$550 million. The world economic crisis of 2008 had a significant negative impact on global trade. While exports from both countries decreased, Italy was hurt worse than Brazil. Italy’s 2009 exports dropped by 33% from 2008 levels, while Brazil’s slid by 20% from 2008.

Italy has been a much more export driven economy than Brazil. Italy’s exports have averaged 21% of GDP since 2000 while Brazil’s exports have averaged 12% of GDP. For 2009,
both countries slipped off their average for the decade with Italy slipping to 17% and Brazil sliding to 10%.

The trade balance for Italy and Brazil are almost mirror images of each other. From 1994 to 2002, Italy had a more positive trade balance than Brazil. After 2002, two countries traded positions. It is interesting to note that while exports decreased significantly in 2009 for these countries, the 2009 trade balance for each country did not suffer. For Brazil, the trade surplus improved by less than US$0.5 billion to US$25.3 billion. Italy saw a dramatic US$21.7 billion improvement from a negative US$11.4 billion to a positive US$10.3 billion. This indicates a sharp drop in imports for both countries.

As expected, the trade balance for both Italy and Brazil as a percent to GDP follows the same pattern as the nominal trade balance.
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IV – Macro-Economic Indicators

<table>
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<tr>
<th>2008 Italy Exports</th>
<th>US$ (Millions)</th>
<th>2008 Brazil Exports</th>
<th>US$ (Millions)</th>
</tr>
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<tbody>
<tr>
<td>World</td>
<td>537,075.5</td>
<td>World</td>
<td>197,924.4</td>
</tr>
<tr>
<td>Germany</td>
<td>68,147.9</td>
<td>USA</td>
<td>27,734.7</td>
</tr>
<tr>
<td>France</td>
<td>59,742.7</td>
<td>Argentina</td>
<td>17,605.6</td>
</tr>
<tr>
<td>Spain</td>
<td>34,815.1</td>
<td>China</td>
<td>16,403.0</td>
</tr>
<tr>
<td>USA</td>
<td>33,671.9</td>
<td>Netherlands</td>
<td>10,482.6</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>28,048.3</td>
<td>Germany</td>
<td>8,850.8</td>
</tr>
<tr>
<td>Switzerland</td>
<td>21,287.7</td>
<td>Japan</td>
<td>6,114.5</td>
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<tr>
<td>Russian Federation</td>
<td>15,333.8</td>
<td>Venezuela</td>
<td>5,150.2</td>
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<tr>
<td>Belgium</td>
<td>14,149.4</td>
<td>Chile</td>
<td>4,791.7</td>
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<tr>
<td>Poland</td>
<td>13,944.9</td>
<td>Italy</td>
<td>4,765.0</td>
</tr>
<tr>
<td>Austria</td>
<td>12,512.7</td>
<td>Russian Federation</td>
<td>4,653.0</td>
</tr>
<tr>
<td>Top 10 Total</td>
<td>301,654.4</td>
<td>Top 10 Total</td>
<td>106,551.1</td>
</tr>
<tr>
<td>% to Total</td>
<td>56.2%</td>
<td>% to Total</td>
<td>53.8%</td>
</tr>
</tbody>
</table>

Source: UN Comtrade

Brazil truly has a global trading partner structure for its exports. For 2008, the top 10 export countries accounted for 53.8% of all of its exports. Brazil’s export partners were located on four continents, North and South America, Asia and Europe. The United States was Brazil’s largest export market and accounted for 14% of Brazil’s total exports.20

A review of Italy’s top 10 export countries does not show the diversity of trading partners that Brazil has. The top 10 countries account for 56.2% of Italy’s 2008 exports. Of the top 10, only the United States is not a European country. The United States is Italy’s 4th largest export market and represents 6.3% of Italy’s total exports.21
As with the trade balance, Italy and Brazil are heading in different directions with their federal budget deficits. Since 2003, Brazil had steadily improved its deficit from 4.8% of GDP to about 1.2% of GDP. Until 2004, Brazil had a larger budget deficit than Italy, but since 2008, Italy has had the larger deficit.

It is no surprise that the world economic crisis of 2008 caused budget deficits to grow in most countries. Brazil’s deficit grew to 2.2% of GDP in 2009. In 2008, Italy’s budget deficit took a turn for the worse. It fell to 2.5% of GDP from 1.6%. In an attempt to recover from the world-wide recession in 2009, Italy’s deficit worsened dramatically to 5.3% of GDP.
Brazil has made great strides in reducing its total debt with just a slight uptick in 2009 to 46.8%\textsuperscript{26} of GDP from almost 60%\textsuperscript{27} in 2004. Italy’s public debt has remained in the 110% of GDP range since 2004. Along with Greece, Spain and Portugal, Italy could be facing a debt crisis. This crisis is having an effect on the value of the Euro. The Euro Zone and the European Union will be more fully discussed in the next section.

EXCHANGE RATES

Before 1994, the Brazilian Real was pegged to the U.S. dollar. Since 1999, the Real has been allowed to float freely. The value of the Real in early May 2010 is almost identical to the exchange rate in 1999. In the early to mid-2000s the value of the Real depreciated against the dollar as inflation in Brazil increased. As the inflation rate eased, the value of the Real appreciated.\textsuperscript{27}

Before 2002, Italy used the Lira as its national currency. It floated freely against the U.S. dollar. I could not find actual data on the Dollar / Lira exchange rate after 1998. However, when I took my first trip to Italy in early 1998, the exchange rate was about 1,700 Lira per US$1.00.
My last trip to Italy before the Euro changeover was in 2001, and the exchange rate was about 2,200 Lira per US$1.00.

When the Euro was introduced in 2002, the exchange rate was US$0.89 per €1.00. Since that time the Euro has appreciated against the U.S. dollar, reaching its high of US$1.60 per €1.00 in 2008. During the world financial crisis of 2008, investors became very risk adverse and invested in the U.S. dollar. The value of the Euro fell in early 2009 to US$1.25 per €1.00, before rebounding later that year to US$1.51 per €1.00 as investors became less risk adverse. The debt crisis in the Euro zone has caused the Euro to depreciate again to US$1.23 per €1.00 in late June, 2010. Even with this latest drop, the Euro has appreciated by 44% against the U.S. dollar since its inception. It is a reversal of the trend that the Lira experienced before it was replaced by the Euro.28

**INFLATION**

![Inflation Chart](Source: IMF, Living in Italy, CRIEnglish.com)

Italy has done a great job holding inflation in check. Since 1999, Italy’s inflation rate has remained around 2%. With the exception of 2008, Italy has been able to hold its inflation rate...
under the 3% target of the Euro Zone. Inflation peaked in 2008 at 3.5% but fell to 0.8% in 2009.

Brazil’s inflation rate is significantly higher than Italy’s rate. However, when compared to the hyperinflation of 1,500% to 2,000% per year of the 1980s and early 1990s, Brazil’s numbers are impressive. Since 2006 Brazil’s inflation rate has been relatively stable at approximately 4.0%. The exception was 2008, when inflation reached 5.6% before falling again in 2009 to 4.3%.

INTEREST RATES

The Central Bank Overnight Rate in Brazil, while still high at 9.5%, is significantly lower than 1999 when the rate was 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. As of the end of 2008, Brazil’s commercial bank prime lending rate stood at 47.25% and ranked as the 4th highest in the world.
Italy is part of the Euro Zone; therefore, its Central Bank Overnight Rate is controlled by the European Central Bank (ECB). Since the introduction of the Euro in 2002, this rate has been between 2% and 4%. As of late June 2010, this rate stands at 1%. This easy money policy has been initiated by the ECB to stimulate the Euro Zone economies as they struggle to recover from the global recession. Since Italy’s inflation rate is low, this policy should have the desired effect. As would be expected, Italy’s commercial bank prime lending rate is well below that of Brazil. As of the end of 2008, Italy’s rate was 11.34%.  

Through the early part of the 2000s, the market put a much higher risk premium on Brazil’s sovereign debt than it did on Italy’s debt. Brazil’s economy has been developing rapidly, and the market has rewarded this development with a much lower risk premium as the decade progressed. As of early 2010, the gap between the yield on 10-year government bonds between Brazil and Italy has all but disappeared. In late June 2010 the yields for Brazil and Italy stood at 4.80% and 4.06%, respectively.
Brazil’s Real plan made economic conditions much more stable than they had been prior to 1994. From the introduction of the plan, FDI in Brazil has made a steady climb to US$31.9 billion from a base of just USD$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 rose reaching a peak of US$45.1 billion in 2008.\(^{39}\) However, in 2009, FDI in Brazil dropped sharply to US$26 billion.\(^{40}\)

From 1994 through 2005, Italy had a gradual, yet steady, rise in FDI inflows. The introduction of the Euro in 2002 did not have an effect on this general trend. For this 12-year period, FDI in Italy was greater than FDI in Brazil in only two years, 2003 (Brazil’s high inflation year) and 2005. FDI dramatically increased in 2006 and 2007 to approximately US$40 billion for each year.\(^{41}\) This was partly a result of liberalization efforts in the EU with the introduction of the EU Directive on Services in the Internal Market.\(^{42}\) This directive removed the legal and administrative barriers to trade in the services sector, thus creating the same type of single market for services that exists for goods.\(^{43}\)
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IV – Macro-Economic Indicators

There was a significant drop, over 50%, in the level of FDI inflows into Italy in 2008. This was worse than the average 21% drop for developed countries. The troubles with financial institutions and the world liquidity crunch of 2008 contributed to this decrease. In 2008, FDI into developing countries were not yet affected. Brazil achieved an all-time high for FDI in 2008. FDI into Italy in 2009 recovered half of the ground it lost in 2008, and was slightly higher that FDI into Brazil for that year.

LABOR

Wages

When President Lula took office in 2002, he pledged to double the minimum wage in four 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.
Italy has no national minimum wage laws. Minimum wages are controlled by collective labor agreements that are set by sector. Almost 100% of workers in Italy are covered by these collective agreements. Contract workers in Italy earn approximately US$15.00 per hour.

Unemployment

Since 1998, Brazil’s 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 2009 has remained at the lower end of this range. It is also interesting to note that the rise in the minimum wage has not had a negative impact on the unemployment rate.

From 1998 through 2007, Italy’s unemployment rate showed a steady and significant decrease from over 11% to about 6%. The world recession has raised Italy’s unemployment rate to close to 8% in 2009; however, this is below other developed countries, most notably the United States.
Italy is part of the 27-member European Union and the 16-member Euro Zone. The EU is the largest common market in the world with a 2009 GDP of US$16.4 trillion. Goods, services, labor and capital can move freely among the 27 Member States. The only market that is close in size is the United States with a 2009 GDP of US$14.3 trillion. However, that is where the similarity ends.

The United States is a political union. U.S. federal law is consistent throughout its borders. There is one common currency and a common culture throughout the United States. For the most part, the United States market is fairly homogeneous. Products and services that will sell in one part of the country, will sell as well in the other parts of the country. Shopping malls located throughout the United States will be filled with national chain stores selling the same products in each location. Marketing campaigns will tend to be successful or unsuccessful on a national scale.

Where product differentiation exists, many times it is due to the climate. It is impossible to sell snow blowers or to have a snow removal business in Miami. There is just no need for these products in this and other warm weather locations. It would be equally difficult to sell lightweight clothing in Minneapolis in December. Some markets may be more fashion forward and others more conservative. However, these regional variations are a minor part of the U.S. economy.

While the EU is an economic union, it is not a political union. The EU does not have a strong central government. It does issue “Directives” that all Member States must adopt, normally within three years of issuance. However, these “Directives” are not nearly as strong or
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V – The European Union

as far-reaching as U.S. federal legislation. The recent adoption of the Lisbon Treaty by all 27 Member States will strengthen the central government of the EU. It will be interesting to watch as the EU begins to implement the provisions of the Lisbon Treaty and to see the changes that it will cause in the political and economic structure on the EU.

As a common market, products and services can flow freely among the 27 Member States without tariffs or legal restrictions. However, this is where the ease of doing business in the EU ends. Individual Member States have laws that are not covered by EU “Directives.” Culturally, there are vast differences among the Member States. Products that sell in one part of the EU, will not necessarily sell in another part of the EU. If a product segment does have universal appeal across national boundaries, it is reasonable to expect that the marketing message and effort will need to be different in different countries or regions.

Italy’s exports were 24% of GDP in 2008. Its top 10 trading partners were 56.2% of total exports. Among the top 10, exports to EU Member States were 38% of total exports, and exports to Euro Zone Member States were 35% of total exports. Therefore, 2008 exports to other EU member were about 9% of Italy’s GDP. While this is a significant number, it does highlight that cross country trade in the EU is not as easy as cross state trade in the United States.

Currency is not common across the entire European Union. The Euro Zone is comprised of 16 Member States that use the Euro as a common currency. For 2009, the GDP of the Euro Zone was US$12.5 trillion.¹ This was 76% of the total GDP for the entire European Union. Italy can trade within the Euro Zone without having to worry about exchange rate fluctuation.
However, the other 24% of the GDP of the EU is in Member States that still use their own currencies. Exchange rate fluctuation will be a concern with any transactions with non-Euro Zone Member States of the EU.

A common currency has its advantages since it simplifies transactions across borders. It can also be a disadvantage. Monetary policy is set by the European Central Bank for the entire Euro Zone, but fiscal policy is set by each Member State. All Member States have the same targets for budget deficits, inflation and debt levels; however, not all Member States have achieved these targets.

The world financial crisis of 2008 has put a strain on many economies around the globe, and the Euro Zone is no exception. It has affected some Member States worse than others. Greece’s budget deficit and debt levels have proved to be unsustainable. Without the recent intervention and bailout by the IMF and other Euro Zone countries, Greece would have been forced to default of its debt payment. This is the first real test that the Euro has faced in its brief history.

Greece is only about 2% of the GDP of the Euro Zone, yet its debt crisis has had a significant effect on the value of the Euro. This is an interesting situation that occurs with a common currency when there is not a common fiscal policy. Lack of fiscal prudence in one country can have a significant effect on the currency used in other countries. Italy’s currency, the Euro, has devalued because of the situation in Greece. If a country such as Spain, which has a much larger GDP than Greece, should face a similar debt crisis, the value of the Euro would drop again.
Italy has its own debt issues. Total debt is over 100% of GDP. If Italy were to face a debt crisis similar to Greece, the value of its currency would fall; however, the decrease in value would not be as bad as if Italy had its own single currency. The Euro Zone countries will have to determine if it is prudent to continue with a common currency, without a common fiscal policy.
Brazil has a comparative advantage in the manufacture of footwear. It is ranked in the top quintile of the products that Brazil produces.¹ 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 1995.²

Brazil is the 3rd largest producer of footwear in the world behind China and India.³ Approximately 7,500 companies in Brazil produce 775 million pairs per year. About 27% of this production is destined for export with 70% of the exports headed to the United States. As of 2004, the industry employed about 300,000 people. Production is clustered in the southernmost Brazilian state of Rio Grande do Sol but is now starting to expand into other regions.⁴ 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.⁵

The domestic market for footwear in Brazil is strong. In 2009, 630 million pairs were sold, an 8% increase over 2008. The prediction for 2010 is another 10% growth.⁶

Brazil also has a comparative advantage in leather, one of the raw materials used to manufacture footwear. Leather is a by-product of the beef industry. Live animals have a 2004 RCA of 353% and leather has a RCA of 201%.⁷ Meat and leather products are in the 5th (top) and 4th quintiles of Brazil’s products.⁸ Brazil also ranks 3rd among leather goods producers.⁹ Over 300 million hides are processed each year with more than 400 firms that specialize in the dyeing and finishing of leather.¹⁰

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$60.11 By 2013, the €50 - €100 segment of the shoe market is expected to grow to €33.44 billion, an increase from 2009 of 25.5%.12 (At the late June 2010 exchange rate of US$1.23 per €1.00, the stated segment would be US$61.5 to US$123, and total market size would be US$41.1 billion.)

The footwear industry in Brazil dates to the early 1800s13, while the footwear industry in Italy had its beginning 600 years earlier. Italy has a dominant position in the luxury footwear market. This segment is concentrated in three areas, Romagna, the Marches and Veneto. There are 4,500 companies, focused on the luxury market, that employ in excess of 30,000 people.14

Italy’s total footwear industry has been hurt by imports from China and India, but Italy excels in the luxury niche of the market. Italy produces more luxury shoes than any other country15 for prices that begin at €250 a pair.16 (At the current exchange rate of US$1.23 per €1.00, the price would convert to US$308.) By 2013, this segment is expected to reach US$13 billion, a 42.7% increase from 2009.17

A competitive disadvantage for Italy is its high labor costs. To overcome this, footwear manufacturing, especially in the lower price sectors, has become more automated. Automation has been shunned by the luxury segment; however, it is now creeping into this segment in an effort to reduce costs.18

In 2008, Italy exported €13.8 billion of leather and leather products. Of this total, 55% (€7.6 billion) was footwear.19 At 2008’s average exchange rate of US$1.46 per €1.0020, these
totals convert to US$20.2 billion and US$11.1 billion, respectively. In total, Italy accounts for slightly less than 15% of the world’s footwear and leather products.\textsuperscript{21} 

An important component for fashion and luxury shoes is leather. Italy is the world leader in the tanning of leather with 15% of the world’s production.\textsuperscript{22} Italy is recognized as having some of the best tanneries in the world.\textsuperscript{23} “The secret of the Italian tanning industry [is] its quality and the style of the finished leather goods.”\textsuperscript{24} 

Durability, a soft hand and rich colors are some of the characteristics that contribute to Italian leather’s reputation as the best in the world. It is interesting to note that the term, “Italian Leather” refers to leather tanned in Italy. The original hide can come from anywhere in the world. Hides from South America with hot, dry climates are used for lower price point leather products. Hides from North America and Northern Europe, where the climate is cooler, and more care is taken of the cow during its lifetime, are tanned into higher price point leathers. Italian tanneries will tan these two extremes and everything in between.\textsuperscript{25} 

Along with tanned hides, Italy has a dominant position in the machinery needed to tan hides and produce finished goods. 80% of the world’s machinery used to tan hides and 50% of the world’s machinery used to produce footwear and leather goods are produced in Italy.\textsuperscript{26}
In total, the world footwear market is expected to grow to €176 billion (US$216.5 billion) in 2013 from €148 billion (US$205.8 billion) in 2009. Both Brazil and Italy have comparative advantages in the fashion footwear industry and in one of the industry’s key raw materials, leather. However, they occupy different niches in this market. Italy is focused on the very high-end of the fashion footwear market where prices begin at US$300 per pair. Brazil is targeted at a broader segment of the market with prices averaging US$60.

Footwear is a labor intensive product, and Brazil has significantly lower labor costs than Italy. Brazil can compete successfully in the broader fashion segment, where selling prices are between US$60 and US$123. This segment will represent 19% of the world footwear market by 2013. Italy, with its higher labor rates, cannot compete as successfully in this segment. Italy concentrates its product in the very high-end, luxury segment with selling prices starting at US$300. The luxury segment will represent 6% of the world footwear market by 2013 and is the smallest segment of the market.

Some of the high-end manufacturers have begun to look to mechanization as a way to compensate for the high labor costs. However, Italy has a long tradition in footwear, leather goods and fashion design. By positioning itself on the cutting edge of fashion, the Italian luxury footwear industry can compete in the market and justify its higher prices.

Brazil does not have the reputation for leather products and design that Italy has. Without this reputation, it would be hard for Brazil to compete in the luxury market, just as it would be difficult for Italy to compete in the broader fashion shoe market because of its labor costs.
Before making a final decision about which country should be targeted for investment, all of the factors that play a part must be considered. These would consist of economic and political issues, banking and financial issues, cultural issues, and any other institutions that will affect the business environment.

**ECONOMIC ISSUES**

For 2009, Italy and Brazil were ranked 7th and 8th, respectively, in terms of GDP expressed in U.S. dollars. Both countries were hurt by the world economic crisis of the last few years, but Italy suffered much more. In 2009, Italy’s GDP dropped by 5% while Brazil’s GDP contracted by only 0.2%. Brazil is also expected to pull out of the recession much more strongly than Italy with an anticipated 4.0% to 5.5% growth rate through 2015. Italy’s GDP is expected to grow between 1.0% and 1.5% during this same time. This discrepancy is not totally surprising since Brazil is a developing economy and Italy is a mature economy.

While total GDP is similar, Italy is a much wealthier nation with a per capita GDP of US$30,000 compared to Brazil’s US$10,200. Brazil’s population is expected to grow at 1.16% for 2010 while Italy’s population is expected to contract by 0.075%. Extrapolating these trends through 2015, Brazil’s per capita GDP can be expected to grow by 20%, while Italy’s grows by 8%. Even with this difference in growth, Brazil’s per capita GDP will only be at about 37% of Italy’s per capita GDP.

Italy is a more export driven economy than Brazil. The world economic crisis hurt Italy’s exports more than Brazil’s. In 2009, Brazil’s exports dropped by 20% while Italy’s dropped by...
33%. Even with the drop in exports, both countries managed to have a positive trade balance for 2009.

Federal budget deficits have long been an issue for Brazil, but since 2004, Brazil has made great strides in controlling their annual deficits. Since 2004, budget deficits have not exceeded 3% of GDP. Italy’s annual budget deficit from 1999 through 2008, with the exception of 2005, had been under 3% of GDP. As a member of the Euro Zone, 3% is an important number since that is the maximum annual deficit allowed for members. In 2009, Italy did not meet this target. It had a deficit of 5.5%.

Budget deficits are important, but total national debt is also important when assessing future prospects of a country. Before the introduction of the Real Plan by Brazil in 1994, the Brazilian economy was beset by hyperinflation. Since that time, Brazil has improved its macroeconomic condition substantially. In 2004, Brazil’s total debt was at 58.5% of GDP. By 2009, that number had decreased to 46.8%.

Since 2004, Italy’s national debt has remained in the 110% of GDP range. This debt level is not much less than the debt level for Greece. Throughout the first six months of 2010, the Greek debt crisis has significantly hurt the value of the Euro. The fear is that the debt crisis in Greece could spread to other countries in the Euro Zone, such as Portugal, Spain, Ireland and Italy. During the past few weeks fear of a debt crisis in Hungary negatively affected the exchange rate of the Euro. This is especially interesting since Hungry is a member of the European Union, but not a member of the Euro Zone.
Many European countries, including Great Britain and Germany, are passing austerity measures to improve their debt situations. Austria's finance minister Josef Proell states, “This crisis we presently find ourselves in is the largest Europe has ever faced. Irresponsible spending of public funds - living today as if there were no tomorrow - has led in some cases essentially to collapse. We Europeans have no choices left; we have to make significant changes to restructure our economic system.”

Europe is not alone. The United States has its own debt crisis. The projected budget deficit for 2010 is 9.4% of GDP. As of the end of June, the current national debt is US$13 billion. U.S. GDP is projected to be US$14.6 billion, giving the United States a total debt of 89% of GDP.

These numbers can give insight into future exchange rate movements. High debt can mean higher borrowing costs and inflation which will put pressure on a currency to devalue. Greece has seen its borrowing cost skyrocket in 2010, and the Euro has devalued. As the Greek debt crisis has unfolded, the Brazilian Real has also devalued slightly against the U.S. dollar.

The debt situation would not seem to indicate that the Real should devalue. Unfortunately, in the short-term, rates don’t always react as they are expected to react. During the world economic crisis, the U.S. dollar appreciated against most major world currencies. This seems counterintuitive since the crisis started in the United States. However, the United States is by far the world’s largest economy and the U.S. government always pays its debts. Money flowed into the U.S. dollar because investors perceived it to be the safest currency in the world.
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As investor’s appetite for risk increased, money flowed out of the U.S. dollar and into other currencies. The U.S. dollar lost value. The Greek monetary crisis reversed the flow again.

Another future predictor of exchange rates is inflation. Inflation is very low in both Italy and the United States. Both are below 1%. Brazil’s 2009 inflation was 4.3%. While this is higher than the United States and Italy, it is significantly lower than historical norms. The difference in inflation does not seem to be exerting undue pressure on the Real to devalue.

Exchange rate movement is extremely important when considering doing business in another country. If the U.S. dollar increases in value against the local currency, assets in the foreign country will become less valuable and profits repatriated from that country will be also be less when converted to dollars. If product is being produced in the foreign country and exported back to the United States, the cost of the product in terms of U.S. dollars will be less. If the U.S. dollar decreases in value against the local currency, the opposite will happen. Assets and repatriated profits will have more value in terms of U.S. dollars; however, goods shipped back to the United States will cost more.

Given the current macroeconomic situations in the United States, Brazil and Italy, it could be reasonably expected that the Real could rise slightly while the Euro holds steady or devalues slightly. However, another shock to the world economy or continued debt crises in the Euro Zone could cause the U.S. dollar to appreciate as a safe haven. According to John Kicklighter of DailyFX, “it is impossible to ascertain whether or not the USD will be significantly higher or relatively unchanged in 6 months.”8
When considering FDI, a time frame of six months is not long enough. However, current macroeconomics conditions do not point to a drastic change in the value of the Euro or the Real. A prudent currency hedging strategy is necessary with either country. This will be discussed in the next section.

**POLITICAL ISSUES**

President Luiz Inácio Lula Da Silva, elected in 2002, campaigned as a populist, left-leaning candidate; however, once in office, his policies have been centrist. He has presided over a period of prosperity and growth for Brazil. A popular policy has been the raising of the minimum wage every year to US$1.77 per hour in 2010 from US$0.40 in 2002. Footwear manufacture is a low-skill, labor-intensive process; therefore, rises in the minimum wage will affect cost structures.

The Brazilian president is elected to a four-year term, and there is a two-term limit. President Lula’s term will end in 2010 because of this limit. The leading candidate to replace Lula as president is Dilma Rousseff, President Lula’s former chief of staff. “Rousseff has pledged to secure economic stability and continue with key reforms, such as to the tax system, which business leaders complain is overly bureaucratic and costly. Neither she nor Serra, a 68-year-old former health minister who is the centrist PSDB party's candidate, are likely to depart much from Lula's recipe of market-friendly policies combined with a strong economic role for the state.”

"9
In 2008 Silvio Berlusconi was elected for the third time as Italy’s prime minister. This term, as his other two, has been beset by scandals, most of which involve Berlusconi himself. However, in regional elections in March 2010, Berlusconi’s right-wing coalition defeated the left-wing opposition. These results indicate that the ongoing scandals are not affecting Berlusconi politically. They seem to be sending a message that the Italian electorate is happy with the manner in which Berlusconi is governing.10

Silvio Berlusconi has three years remaining in his current term. During that time, he hopes to change the Italian constitution through a referendum to give himself more power as a directly elected president. His proposal would also “include changes to the judiciary, which he claims is biased against him, a cut in the number of MPs and senators and direct elections for a head of state with expanded powers.”11

Since the end of World War II, Italy’s politics have been volatile. There have been many prime ministers with short terms. Through his three separate terms, Silvio Berlusconi has served longer than any other Italian prime minister with the exception of Alcide De Gasperi.12 Even with all of his scandals and legal troubles, Berlusconi has staying power, and he may be able to push through some of his constitutional reforms. At this time, it seems that Brazil has a more stable political situation than Italy.

BANKING AND FINANCIAL ISSUES

The credit crisis was not as severe in Brazil as elsewhere in the world. There is a significant amount of government influence in government-owned banks.13 For private
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institutions Brazil maintains an 11% capital requirement.\textsuperscript{14} The federal funds rate in Brazil still remains relatively high at 9.5%. While this has pushed up the cost of borrowing in Brazil (prime commercial lending rates exceed 40%), it has also kept banks from making the risky loans that have plagued the United States and other markets.\textsuperscript{15} 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.\textsuperscript{16} Brazil has a comparative advantage for the soundness of its banks, regulation of securities exchanges, financing through local equity markets and financial market sophistication.\textsuperscript{17}

Italy’s prime commercial lending rate, 11.34%, is much lower than Brazil’s rate. However, footwear manufacture is a labor-intensive process. Brazil’s favorable labor rates will be more important than Italy’s favorable lending rates for this industry. Italy has a comparative advantage in the strength of investor protection.\textsuperscript{18}

CULTURAL ISSUES

An understanding and respect for the local culture is extremely critical to the ability to operate successfully in any foreign country. The cultures of these two countries place much more emphasis on family relationships than is done in the United States. Family and family needs can be more important than the needs of the business.

Both countries are polychronic. Time is viewed as fluid. Schedules and agendas are not as important as in the United States. Being late for meetings or appointments is perfectly
acceptable. In Italy, there is a saying, “quindici minuti.” Literally translated it means 15 minutes; however, it really means, “I will get to it sometime in the future.”

Brazilians and Italians will tend to not be as direct as people in the United States. Non-verbal cues can be just as important as verbal communication. The context of the situation is important and can convey a substantial portion of the intended message. Brazilians tend to be more high-context than Italians.

Brazilians will more readily accept an uneven distribution of authority and a hierarchical structure than Italians or people in the United States. Italy and the United States tend to be very individualistic societies. Personal achievement is valued and respected. Brazil is the opposite. It tends to be a collective society where group achievement is recognized over individual achievement.

Both Brazilians and Italians will want to avoid uncertainty more than people in the United States. It will be important to recognize that these two groups will be less comfortable with change than people from the Unites States. Extra patience will be needed when introducing new concepts that will change the way things are done.

The culture of Italy and Brazil would not be a determining factor in choosing a country for operations. Cultural sensitivity is the key to success. Understand it. Embrace it. Work with the local culture; don’t try to change it.
OTHER INSTITUTIONAL ISSUES

The Global Competitiveness Report 2009 – 2010, published by the World Economic Forum\textsuperscript{19}, ranks both Italy and Brazil almost equally in the Institutions Pillar. Both countries are at a competitive disadvantage in total and in each of the elements that comprise this pillar. Some of the more noteworthy are: property rights, IP protection, diversion of public funds, judicial independence, favoritism in government decisions, burden of regulations, transparency of policy making, organized crime and ethical behavior of firms.

Overall Italy ranks higher than Brazil for infrastructure, health, education, and training. Overall rankings for efficiency enhancers, innovation and sophistication are relatively equal. Financial market sophistication is ranked substantially higher in Brazil than in Italy.

Each year The World Bank publishes Doing Business country profi. It ranks 183 countries based on the ease of doing business in that country. Overall for the 2010 reports, Singapore ranks #1 as the easiest country in which to do business. Italy\textsuperscript{20} and Brazil\textsuperscript{21} rank 78 and 129 respectively. Almost everything is easier to do in Italy than Brazil with the exception of enforcing contracts. Below are comparisons of some of the key factors for each country.

<table>
<thead>
<tr>
<th></th>
<th>Italy</th>
<th>Brazil</th>
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<tbody>
<tr>
<td>Starting a Business</td>
<td>10 Days</td>
<td>120 Days</td>
</tr>
<tr>
<td>Construction Permits</td>
<td>257 Days</td>
<td>411 Days</td>
</tr>
<tr>
<td>Paying Taxes</td>
<td>334 Hours / Year</td>
<td>2,600 Hours / Year</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>68.4%</td>
<td>69.2%</td>
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<tr>
<td>Enforcing Contracts</td>
<td>1,210 Days</td>
<td>616 Days</td>
</tr>
<tr>
<td>Closing a Business</td>
<td>1.8 Years</td>
<td>4.0 Years</td>
</tr>
<tr>
<td>Redundancy Costs</td>
<td>11 Weeks of Salary</td>
<td>46 Weeks of Salary</td>
</tr>
</tbody>
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Source: Doing Business 2010-Italy, Doing Business 2010-Brazil – The World Bank
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The chart below also compares some of the key factors for each country; however, the scale used is an index. Zero is easy and 100 is difficult.

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<thead>
<tr>
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<th>Italy</th>
<th>Brazil</th>
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<tbody>
<tr>
<td>Difficulty of Hiring Workers</td>
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<td>Rigidity of Work Hours</td>
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<td>Difficulty of Redundancy</td>
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<tr>
<td>Rigidity of Employment</td>
<td>38</td>
<td>46</td>
</tr>
</tbody>
</table>

Source: Doing Business 2010-Italy, Doing Business 2010-Brazil – The World Bank

Brazil has the advantage of cheap labor, but it is not easy to do business in this country. Reforms are continuing, especially in the tax regime, but it can be expected that the overall difficulty of doing business in Brazil will not be remedied quickly.
In Italy the luxury shoe industry, a subset of the fashion shoe industry, targets 6% of the world market while the fashion shoe industry in Brazil is targeted to a wider segment that represents 19% of the market. It is the recommendation of this paper that investment be made in Brazil to target the wider fashion shoe market. This investment should take the form of a greenfield project that will produce fashion shoes for the United States as well as the Brazilian market.

Since footwear is a labor intensive industry, Brazil’s low labor costs are attractive. With Brazil’s large population and unemployment rate at 7.5% in May 2010, there is an ample supply of labor. While the constantly rising minimum wage is a concern, it is still significantly lower than Italy’s labor costs. It will take a long time for Brazil’s labor cost structure to reach Italy’s level. Brazil’s rising labor costs would be more of a concern for the commodity shoe market with its lower selling prices and profit margins. The fashion shoe segment will provide differentiation that will allow for higher prices and profit margins.

Brazil also has a large domestic market that is growing faster than Italy’s. With 200 million people, Brazil has the potential to be a very large market, and it is important for a company to position itself to take advantage of that growth. The macroeconomic situation is stable, and there should not be any undue pressure on the Real to devalue.

President Luiz Inácio Lula Da Silva is ending his eight years as president at the end of 2010. His policies have allowed the Brazilian economy to grow and Brazil to prosper. The leading candidate to replace him is his former chief of staff. She has pledged to continue with key reforms and to maintain economic stability. Even her chief rival would not be expected to
deviate much from President Lula’s market-friendly policies. This election should not disrupt Brazil’s current economic and political stability.

With any foreign investment, it is important to mitigate exchange rate risks. One method is to immunize the financial statements. If revenue will be generated in Reals, then expenses should also be in Reals. Production is clustered in the southernmost state of Rio Grande do Sol. Brazil has an ample supply of tanned hides and other components necessary to manufacture fashion footwear.

Brazil is not an easy place to do business, ranking 128 out of 183 countries. Starting a business takes four months and obtaining building permits takes almost 14 months. It would be prudent to look for an existing building that would meet the needs of production instead of building a new factory. If this is not possible, the permit process will need to be built into the project timeline.

Immunizing the balance sheet will be more of a challenge. With commercial prime lending rates in excess of 40%, offsetting assets held in Reals with high-interest debt is not appealing. Brazil does have a competitive advantage in financing through local equity markets and the regulation of securities exchanges. It would seem that equity financing would be preferable to bank financing.

Another option could be a currency swap where one party in the United States needs Reals and another party in Brazil needs U.S. dollars. The party in the United States could borrow money in the United States and swap the dollars for Reals with the party in Brazil. After the swap, the United States party has Reals and the Brazilian party has dollars. Periodic interest
payments are made during the life of the swap, and at the end, the money is swapped back to the original currencies. Other currency hedging, such as options, futures or forwards, will be needed to further mitigate currency risks.2

Experienced local people should be placed in key management positions of the company and the manufacturing facility in Brazil. They will understand the local market for raw materials, the business environment in the country and the locale where the facility is operating. Most importantly, they will be able to understand and relate to the culture of the people working at the facility. The experienced local management will be critical to the success of the plant, and their value should not be underestimated.

Along with the benefits of Brazil, there are drawbacks. A large informal sector, the regulatory regime, and Brazil’s lack of infrastructure hinder productivity. 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.3 These same issues are highlighted in The Global Competitiveness Report 2009-2010 which lists the top six most problematic factors for doing business in Brazil as: tax regulation, tax rates, restrictive labor regulations, inefficient government bureaucracy, access to financing, and an inadequate supply of infrastructure.4

Brazil is also at a competitive disadvantage for favoritism in the decisions of government officials and the transparency of government policy making.5 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.\(^6\)

Brazil does not rank well in terms of property rights and protection of intellectual property.\(^7\) 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.

It will be important to staff the factory properly, or even under-staff slightly at first since it will cost 46 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.\(^8\)

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, control of international distribution and degree of customer orientation.\(^9\)
This paper has examined the positives and negatives associated with investing in a facility to manufacture fashion footwear in either Brazil or Italy. To accomplish this, country backgrounds were explored. This produced a high-level view of economic and political realities in these two countries today, and how they developed over the past few decades. The cultures of each country were explored. Cultural awareness is one of the most important elements when deciding to do business in another country. It can be the difference between success and failure.

The macroeconomic factors in each country were explored. Investing in a country, in which the macroeconomic fundamentals are poor, significantly increases the risk to the investment. Other issues considered were the current political situation and likely changes in the near future, the banking and financial situation, and regulations that affect the ease of doing business in each country.

The fashion footwear industry was explored in each country including the factors that would affect it such as: availability of raw materials, expertise in the industry, industry clusters, domestic markets and the labor situation.

Understanding the niche that each country plays in the fashion footwear industry was a key factor in determining the country in which to invest. Brazil's footwear industry has strategically moved itself from commodity footwear, which is dominated by China and India, to the fashion segment which can command higher price points. Brazil targets the market segment that is approximately 19% of the total footwear market. Italy targets the luxury segment of the
fashion footwear market. Price points for this segment begin at US$300, and this segment is about 6% of the total footwear market.

Footwear is a labor-intensive industry, and labor costs have played a part in determining which segment of the market each of these countries has decided to pursue. Brazil has relatively low-cost labor, but its industry has been affected by low-cost products from China and India. By moving to the fashion segment, Brazil has been able to differentiate itself from these two countries and justify higher prices.

Labor costs in Italy are relatively high. This has forced Italy into the luxury segment. In this segment, Italy can use its comparative advantage in design and quality of leather products to differentiate itself. The high prices that Italy can get for its luxury footwear offset the high labor costs.

Determining in which segment to compete will have a significant impact on the country chosen. This paper proposes that the broader fashion footwear market be chosen. This leads to a decision to invest in Brazil. Once this decision is made, it is important to analyze the other factors to determine if they support this decision.

There are a number of factors that support investment in Brazil. These include:

- A stable macroeconomic and political situation
- A stable currency
- Financial market sophistication
- Availability of equity financing
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- An ample supply of raw materials and low-cost labor
- Industry clusters and expertise
- A large domestic market with rising GDP per capita

Some of the drawbacks include:
- High prime commercial lending rates
- Corruption
- Complicated tax regime
- Lack of infrastructure
- Difficult business regulations

To operate in any foreign country it is important to have a proper currency hedging strategy. It will also be necessary to place experienced local management in key positions. These key managers will be invaluable for navigating the local market and bridging the cultural divide with the remainder of the local workforce.

Even with the drawbacks, Brazil offers ample opportunity. Done properly, fashion shoes can be successfully manufactured in Brazil, exported for sale in the United States and sold in the growing domestic market.
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