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Brazil's Trade Liberalization and Growth: Has it Failed?

Mauricio Mesquita Moreira

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Occasional Paper 24

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BRAZIL'S TRADE LIBERALIZATION AND GROWTH: HAS IT FAILED?

Mauricio Mesquita Moreira [*]

Unfulfilled expectations about economic growth in Brazil has led many observers to question the ability of the new, open trade regime to put the economy back on a path of sustainable growth. Whereas the country's growth record has been really poor, the evidence suggests that the underlying causes had nothing to do with trade. Quite the contrary. This paper shows that trade liberalization has given an important contribution to two of the main drivers of growth: productivity and investment in physical capital. It argues that these gains were not turned into growth due to an unfavorable macro and institutional environment. It also claims that Brazil could have enjoyed more gains from trade, had it pursued a more aggressive trade policy at home and abroad. The paper concludes by outlining the main issues of a pro-growth, trade policy agenda for the country.

I. INTRODUCTION

It has been more than a decade since the first imported (Russian) cars reached Brazilian shores and yet the population might be wondering where did all that promised growth go. In fact, when one look at Brazil's disappointing performance in the last decade, a failed "experiment" might be the first thing that comes to mind. A tempting conclusion would be: Brazil was in dire straits with the old, inward oriented, regime, but opening up made things even worse. Is that really the case? As with other matters in economics, here too there is more to it than meets the eye. By revisiting the literature and by sifting through the empirical evidence available in Brazil and elsewhere, one can make a strong case that, far from being a failure, opening up has improved Brazil's chances of sustainable growth and, therefore, the causes of the recent poor performance should be looked for elsewhere.

This case can be built by looking first at what has happened to growth in other trade liberalizing countries. The evidence suggests that there has been a wide range of responses. Clearly, East Asia has been much more successful in translating trade into growth than Latin America, just to name two of the world regions. But even inside these regions, there have been stark differences in performances. In Latin America, Chile, Costa Rica and Mexico were far more successful than Brazil and Argentina, whereas in East Asia, Korea, Taiwan and China are clearly in a league of their own.

What these differences imply is that the links between trade and growth are more complex than the critics and supporters of trade and integration suggest. This, though, should not come as a surprise. Those versed in economic theory know that the main drivers of economic growth are productivity and investments in physical and human capital. Therefore, the impact of trade on

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growth is at best indirect and is likely to take place through these channels.[1] Moreover, the theory also suggests that: (a) the positive effects can be substantial, but there are also considerable risks; (b) the macroeconomic and institutional environments are key ingredients of the trade and growth nexus. I.e., Trade liberalization does not happen in a macroeconomic and institutional void; and (c) the degree and quality of the integration, both in terms of trade-to-GDP ratios and the level and structure of protection, tend to have a major influence in the end results.

An analysis that takes these issues into account has a better chance to uncover the links between trade and growth and, therefore, can offer a more precise explanation to Brazil's performance since the early 1990s. This paper aims to give a contribution in this direction and is organized in three sections, including this introduction. Section two reviews very briefly the theory and the empirical evidence related to trade and growth, with a focus on the Brazilian case. Section three, assesses the limitations of trade liberalization in Brazil and the implications for growth. The last section summarizes the main findings and proposes a new trade and integration agenda for the country.

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[1] Another possibility is the institutional channel. Rodrik, Subramanian and Trebbi [2002], e.g., found evidence that trade has an indirect positive impact on growth through the quality of institutions. Yet, one has yet to formalize this argument and the task of measuring the "quality" of institutions is fraught with difficulties.

II. THEORY AND EVIDENCE

The productivity channel

The arguments - What is the relationship between trade and growth? In the mid-1980s, an average professor of economics would have said none. The prevailing view in these days was that these were two different and unrelated matters. Growth would be driven by technical progress (seen as a scientific issue, not governed by economics) and by labor and capital accumulation. Trade, in turn, would improve resource allocation, but the real income gains would be limited to the period of the trade liberalization. The bridge between the two subjects would only be built in the late 1980s, when a new generation of theorists began to model technical progress as taking place within the course of economic activity and driven, just as any other activity, by the profit motive (see, e.g., Grossman and Helpman [1991]). This new approach allowed economists to explore trade-growth links based on a series of "stories", most of which have technical progress and, therefore, the impact of trade on productivity as the main channel.

Among theses stories, it is worth mentioning the one that deals with the access to international knowledge.[2] According to this argument, opening up would give local producers access to international knowledge via imported inputs, imitation of foreign competitors and access to knowledgeable buyers (learning-by-exporting), which would, in turn, prop up innovation and productivity. Since productivity is one of the main drivers of growth, the link is established. The supporters of this argument, though, are clear about the risks involved. For instance, the dislocation of increasing returns and technologically intensive sectors by imports is seen as having a negative impact on growth.

Later on this argument was reinforced by microeconomic considerations often referred to as the import discipline and turnover effects. The former is the more intuitive and well known. Import competition would reduce slack in firm management and would increase the firms' incentive to innovate. Yet, if local firms lose market share and face higher average costs, one cannot rule out the opposite effect. The turnover effect, in turn, would promote industry productivity growth without necessarily affecting intra-firm efficiency. This would happen because the simultaneous expansion of imports and exports would force the least efficient firm to contract or exit and the most efficient to expand.

The evidence - There are two types of empirical evidence related to these arguments and effects. The first type is based on macroeconomic data and comes out of a series of econometric studies, which test the correlation between openness and income.[3] Most results point to a positive correlation, but that is not robust to changes in econometric techniques and in openness index. These mixed results are compounded by at least two other limitations. They don't say much about the channels through which openness promotes growth and given that they are mostly cross-sectional studies, they cannot tell once-and -for -all from long-term growth effects.

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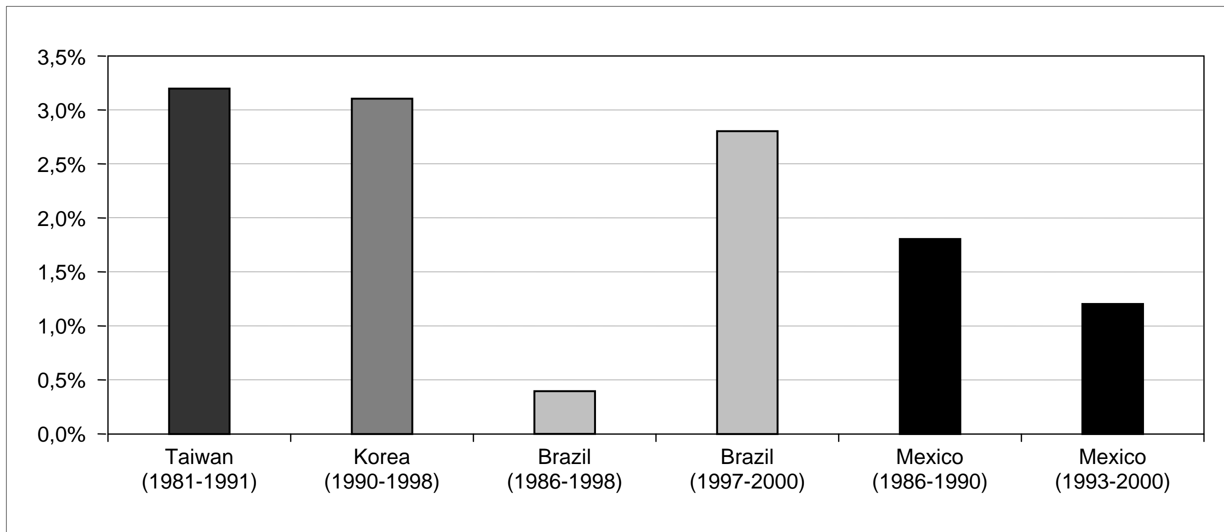
[2] For a more complete review of these stories see, e.g., López-Córdova and Moreira [2003].

[3] See, e.g., Rodriguez and Rodrik [2001] for a critical review. See Wacziarg and Welch [2003] for more recent and robust evidence.

The second type of evidence arises from studies using firm-level data and they manage to overcome some of the limitations of the macro evidence. The focus is on directly measuring the trade effects on the productivity of the manufacturing sector and most results point to positive and robust impacts, coming mainly from import discipline.[4]

Muendler [2002] and López-Córdova and Moreira [2003] (hereafter, LM [2003]) cover the case of Brazil and, therefore, their results are of particular interest. They show that productivity growth resumed during the nineties and that was particularly strong in the second half of the decade. Total factor productivity grew by an annual average rate of 2.7 per cent in 1996-2000, a performance that was better than post NAFTA Mexico's (1.2 percent in 1993-2000, LM [2003]), despite Brazil's limited openness (see below), and close to East Asian standards. Taiwan and Korea, e.g., in their post-liberalization period, had a 3.2 and 3.1 per cent growth, respectively (see Figure 1).

FIGURE 1
POST TRADE LIBERALIZATION TOTAL FACTOR PRODUCTIVITY GROWTH
BRAZIL, MEXICO, KOREA AND TAIWAN



Source: Mexico: 1986-1990, Tybout and Westbrook's [1995] and 1993-2000 LM [2003]. Brazil: 1986-1998, Muendler [2002] and 1997-2000, LM [2003]. Korea: Hahn [2000]. Taiwan: Aw, Chen and Roberts [2001].

Muendler and LM also show that trade liberalization might be behind this performance. For instance, Figure 2 suggest that firms in sectors more exposed to regional and worldwide trade and firms that export goods or import inputs had a better productivity performance than their counterparts. The econometric evidence also points in this direction. Muendler *op. cit*, using data for the 1986-1998 period, argues that a 10-point reduction in tariffs, for instance, would have increased TFP by 2.8 percent. Given that the average tariff in 1987 was 52 per cent, this estimate suggests a powerful import discipline effect. The same author also finds evidence of (not so powerful) positive impacts coming from imported input and turnover effects.

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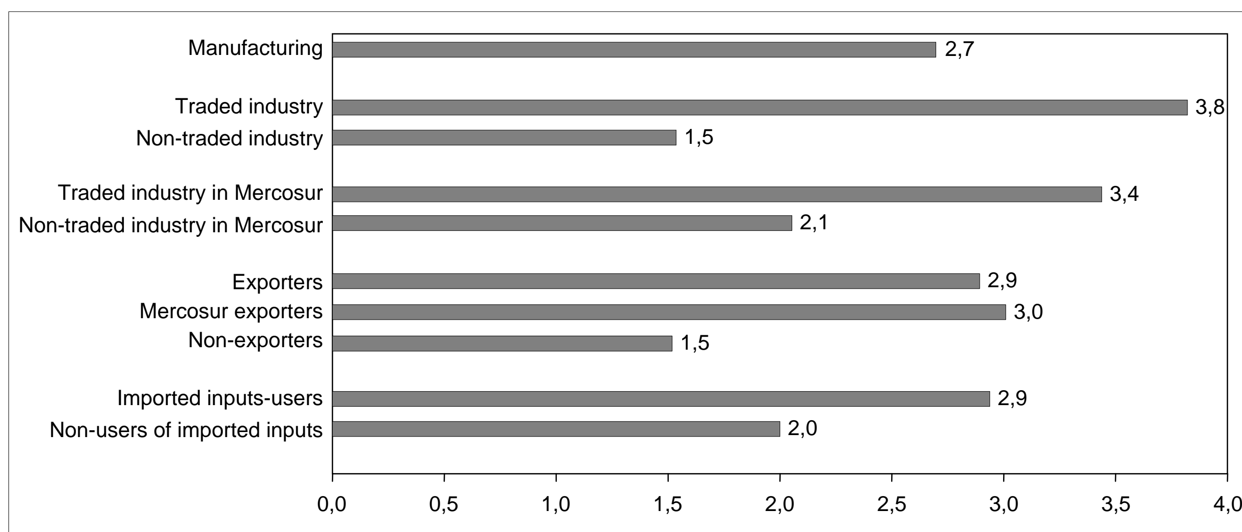
[4] See Tybout [2001] for a review.

In LM [2003], there is also evidence of a strong import discipline effect. Estimates for the 1996-2000 period suggest that a 10 per cent increase in import penetration would have increased TFP by 1 per cent. This, in a context where import penetration jumped by 27 per cent. The impact of a tariff reduction would have been similar. LM's estimates also point to relevant turnover and learning by export effects. With respect to the former, the reallocation of resources among firms of a same industry and among firms of different industries would have explained 72 per cent of the productivity growth in 1996-2000. One possible reading of these results is that, despite the risks, trade liberalization does not seem to have had a negative impact on the more productive firms and sectors. As to learning by exports, the estimates suggest that an one percentage point increase in the propensity to export would have increased firm productivity growth by 0.4 percentage points. A sizeable impact given that the annual average productivity growth in the period was 2.7 per cent.

FIGURE 2
AVERAGE TFP GROWTH BY FIRM AND INDUSTRY
BRAZIL, 1996-2000
(Percentages)



Source: López-Córdova and Moreira [2003].

The investment channel

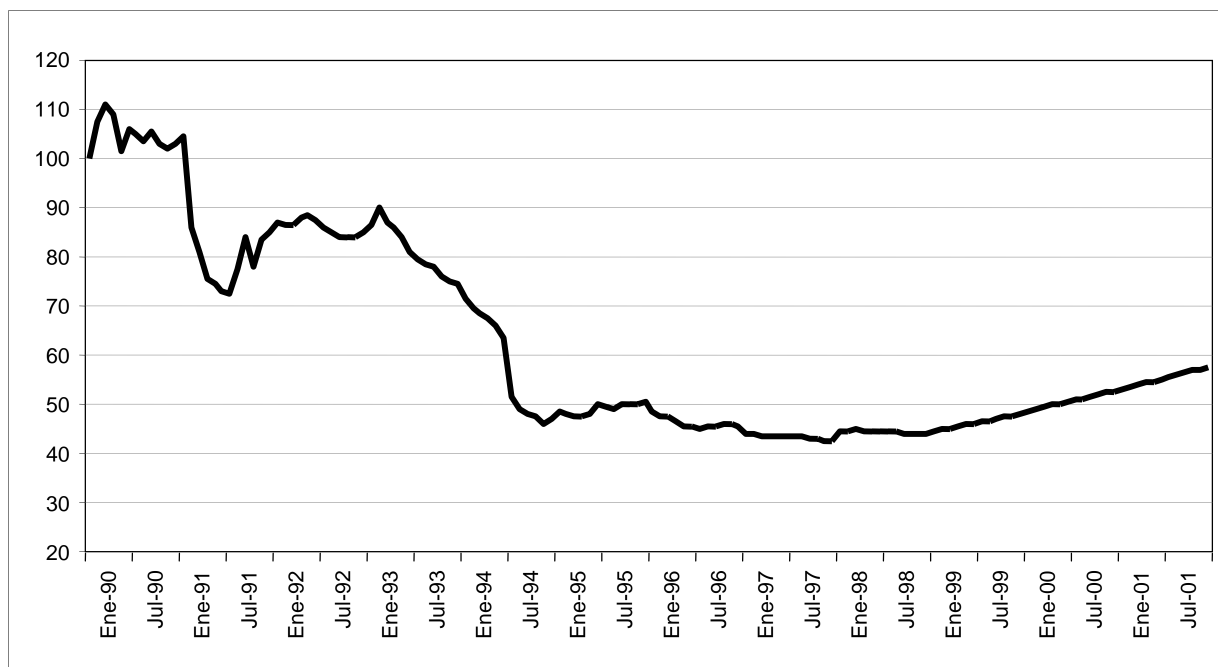
The figures discussed above speak of a sizable contribution of trade liberalization to the revival of one of the main drivers of economic growth. This contribution took place in a context where productivity growth in the manufacturing sector reached East Asian levels. Given Brazil's human capital constraints, it is very unlikely that the country could have put on a better performance. The burning question then is why this productivity performance did not translate into higher growth rates for the industry and for the economy as a whole. The answer seems to lie in the behavior of the two other drivers of growth: investment in human and physical capital.

In contrast to the productivity channel, economic theory does not have much to say about the links between trade and investment. The few and relevant arguments are on the impact on physical

capital. Despite the recent emphasis on productivity, most economists would agree that high investment rates in equipment and machinery play a key role in sustaining high rates of growth. De Long and Summers [1991], for instance, shows that there is a strong and negative correlation between growth and the relative price of capital goods, and a strong and positive correlation between growth and investment in capital goods. Such type of evidence suggests that there is a link between trade and growth other than productivity. Since machinery and equipment are tradable goods, trade liberalization would lower its relative price, reducing the cost of investment and boosting growth.

There is evidence that this type of effect was particularly relevant for the case of Brazil. The relative price of capital goods, measured by the wholesale (IPA) and general price index (IGP), fell by 47 per cent in the first decade of the liberalization (1990-2001, Figure 3). Figure 4 suggests that this drop might have been related to trade. The small number of observations does not leave room for strong conclusions, but it gives hints of clear negative correlation between import penetration and the relative price of capital goods. Exercises involving all the components of aggregate investment point to more modest gains. For, instance, Abreu [2003] estimates that the relative price of investment (construction and capital goods) fell by only 3 per cent in 1990-1999. This discrepancy seems to be related to the performance of the construction industry, which produces non-tradable goods, and which typically accounts for two thirds of the total investment. In fact, the industry's relative price, using its cost index as a proxy, seems to have oscillated around the 1980s average. If there was any trend at all, it was positive (Figure 5).

FIGURE 3
RELATIVE PRICE OF CAPITAL GOODS
BRAZIL, JANUARY 1990 - DECEMBER 2001

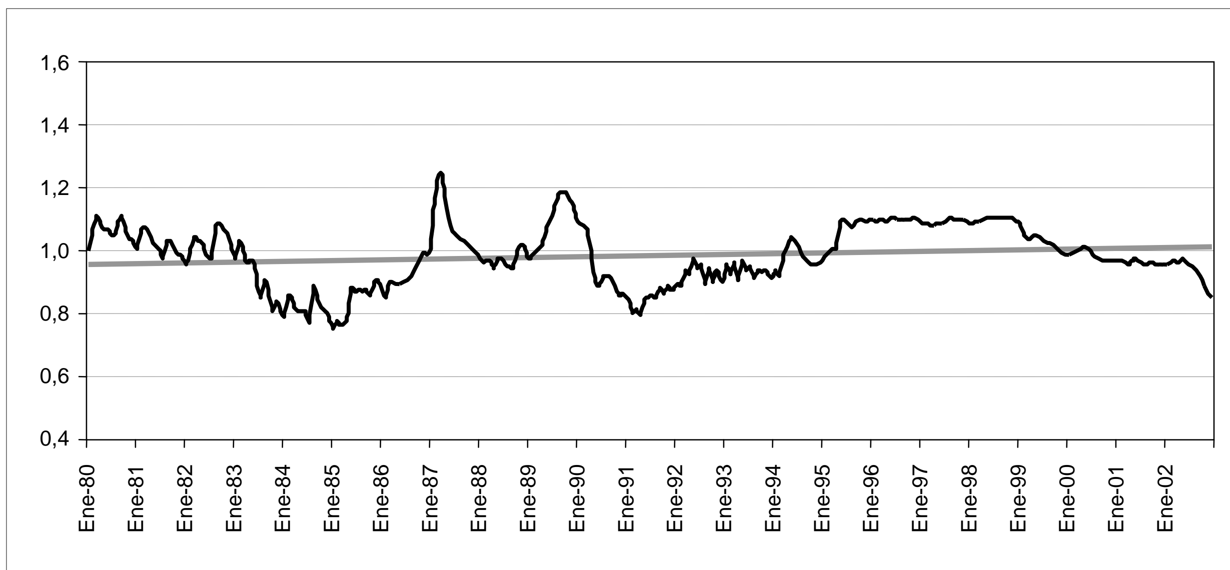


Note: Based on data from the wholesale price index (IPA) and general price index (IGP-OG), Fundação Getúlio Vargas.

FIGURE 4
IMPORT PENETRATION AND THE RELATIVE PRICE OF CAPITAL GOODS
BRAZIL, 1990-2001

Source: Own calculations based on IBGE Annual Industrial Survey and FGV price indices.

FIGURE 5
CONSTRUCTION INDUSTRY'S COST INDEX *
BRAZIL, JANUARY 1980 - OCTOBER 2002 (JANUARY 1980=1)



Note: * INCC-FGV deflated by the IGP-DI. Fundação Getúlio Vargas.

The construction industry performance helps to explain why the dramatic drop in the relative price of capital goods has not led to higher investment ratios. Despite a modest recovery in the second half of the 1990s, Brazil's investment ratio remained below the already depressed levels of the 1980s (IPEADATA). Yet, the construction industry was neither the only nor the more important

factor behind the low investment ratios. The chaotic macroeconomic environment that prevailed for most of the period was most likely the dominant impediment. Variables such as inflation, interest and exchange rates conspired to minimize the positive impacts of trade liberalization on investment. Even after the progresses made with the Real Stabilization Plan in 1994, one could hardly argue that the macroeconomic environment was investment friendly.[5] The exchange rate remained highly appreciated until 1999 and after that became extremely volatile, discouraging investment in tradables. Likewise, interest rates were kept at prohibitive levels, averaging 17.6 percent in real terms in 1995-2001 (IPEADATA). One could also argue that institutional deficiencies such as Brazil's shallow capital markets were also an important factor in undermining the local firms' capacity to invest.[6]

In all, taking the theory as a guide, it is possible to identify the channels through which trade liberalization might have impacted economic growth in Brazil. The evidence suggests that, so far, the effects have been positive and significant, both in terms of productivity and investment. These effects, though, were not translated into higher rates of growth most likely because of the relative price behavior of the non-tradable components of the investment and, perhaps more importantly, because of an unfavorable macroeconomic and institutional environment.

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[5] For details of the macroeconomic environment during the 1990s and of the Real Plan see Pinheiro, Giambiagi and Moreira [2001].

[6] On that see, e.g., Moreira and Puga [2001].

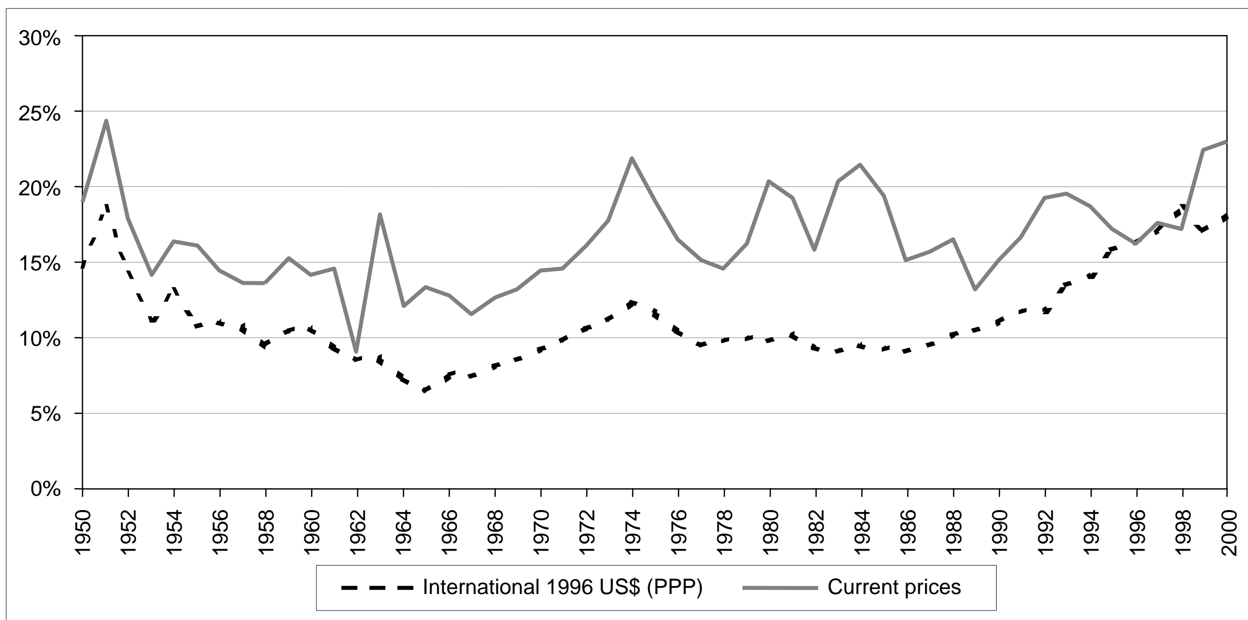
III. LIMITS AND LIMITATIONS OF TRADE LIBERALIZATION IN BRAZIL

Openness

The productivity and investment channels and the environment they have operated do not tell the whole trade-and-growth story in Brazil. Another important chapter has to do with the limits and limitations of its trade liberalization. Is it fair to say that the prevailing structure of protection maximizes the gains from trade or is, at least, a second best? One way of approaching this question is to look at issue of the "natural" openness of the Brazilian economy. How far the country has gone in achieving a degree of openness that would be close to that of free trade?

Figure 6 presents two openness indicators (trade-to-GDP ratios) based on current and international constant prices. In both cases, there is a steep increase after 1990, but not to unprecedented levels. In fact, the "gains" of the 1990s brought the economy back to the level of the early 1950s, a period when the import substitution model was gaining steam. True, the Brazilian economy of the 1990s was considerably larger than that of the 1950s (with a larger non-tradable sector) and size matter for openness. Not only size, but also geographical variables such as distance from the main international markets. Even though these variables do not change across time, technical progress impacts their relevance. For instance, the impact of distance tends to vary according to transport costs. The fact that openness reflects not only the country's commercial policy, but also other economic and geographical variables advises against drawing strong conclusion from Figure 6. But still, a 1990s Brazil that is as open as that of the 1950s raises, at the very least, serious doubts about the extent of its trade liberalization.

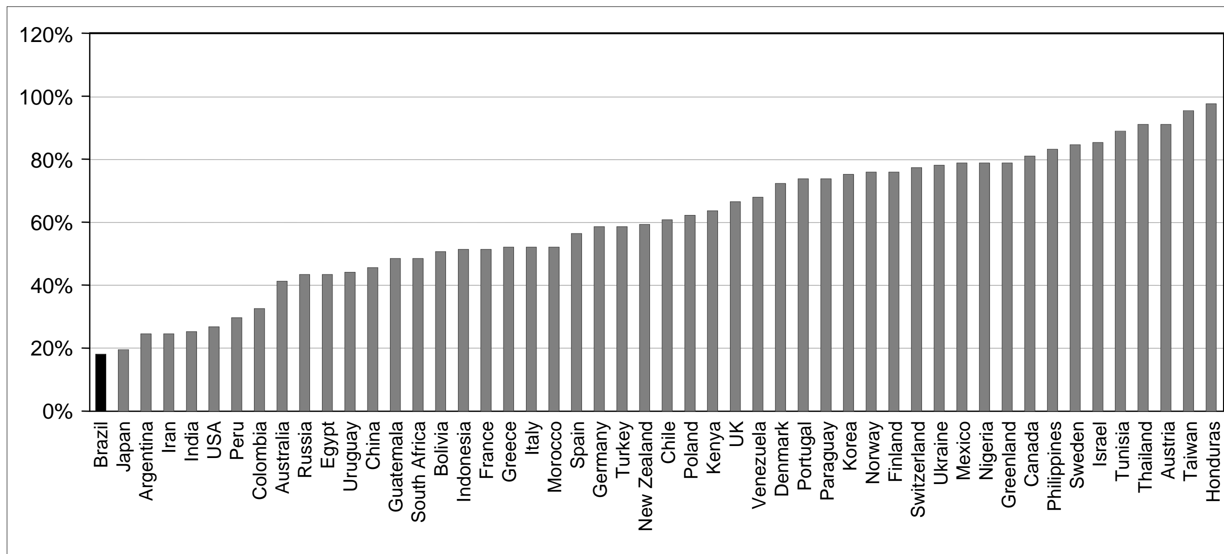
FIGURE 6
BRAZIL'S TRADE-TO-GDP RATIO
1950-2000



Source: Penn World Tables 6.1.

One way of avoiding the ambiguities of the openness indicators is to draw a comparison between Brazil and other countries, taking into account geo-economic differences. Figure 7, for instance, compares trade-to-GDP ratios (international prices) of fifty countries in the late 1990s. As can be seen, Brazil comes out as the most closed economy of the group.[7] Size does not seem to be the answer. The Brazilian economy is as open as economies of much larger size such as those of the United States and Japan. It has also a trade-to-GDP ratio close to that of countries of similar or smaller size, but with either notoriously restrictive (e.g. India or Iran) or similar trade regimes (e.g. Argentina, Brazil's partner in Mercosur).

FIGURE 7
TRADE TO GDP RATIO FOR SELECTED COUNTRIES
(Average 1997-2000, PPP, 1996 International US$)



Source: Penn World Tables 6.1.

To have an even clearer picture, one has to resort to quantitative exercises, which can better isolate trade policy from geo-economic effects. One attempt in this direction was done using Estevadeordal and Robertson's [forthcoming] estimates of bilateral trade among 29 countries (1985-1997). Their model -a gravitational model- assumes, *à la* Newton, that the volume of bilateral trade is an increasing function of the size of the economies involved and a decreasing function of the distance between them. Other variables are also taken into account to capture geopolitical effects such as common borders, language and access to ports. The model, unlike other gravitational exercises, also incorporates Most Favored Nation (MFN) and preferential tariffs, which is crucial to assess the impact of commercial policies in the domestic and external markets.

Using Estevadeordal and Robertson's results, then, it was possible to estimate what would have been Brazil's total trade (adding up all its bilateral trade), given: (a) its economic and geo-economic characteristics; and (b) its commercial policy and those of its trade partners. The aim was to estimate Brazil's "natural "openness. The exercise was based on two scenarios, for both imports and exports. In the first scenario, the key assumption is zero tariffs for all trade within the Americas

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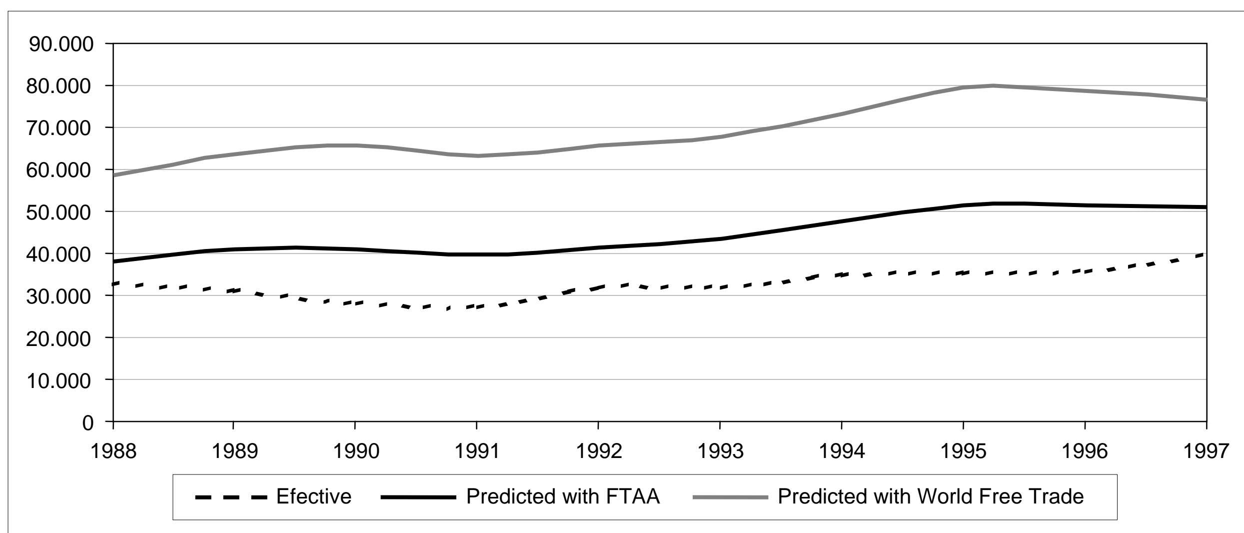
7 This result also stands when current prices are used.

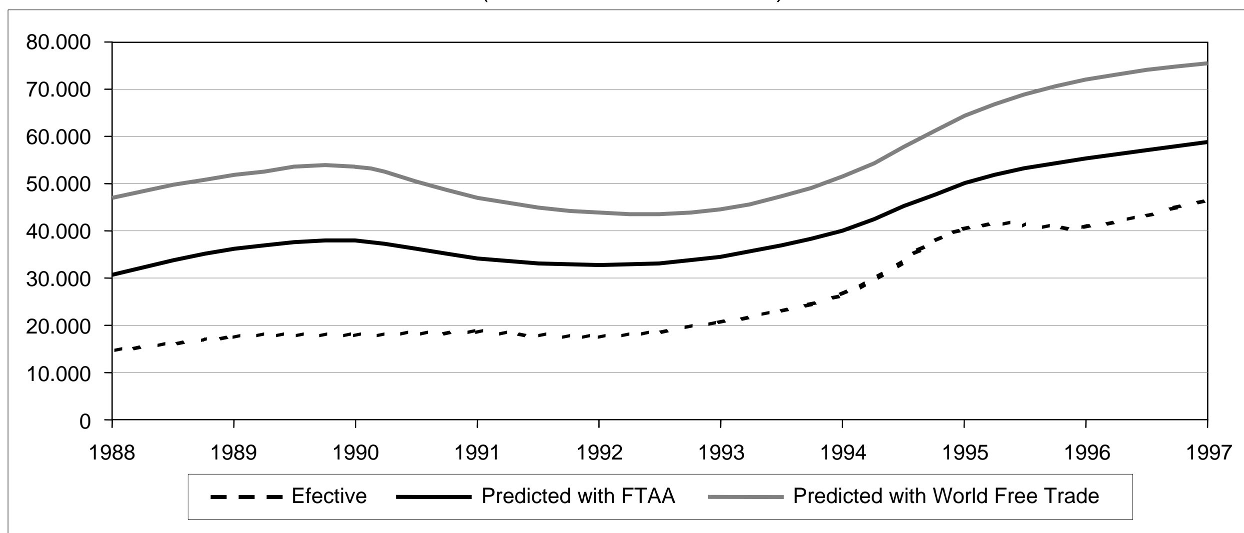
(the Free Trade Area of the Americas) and in the second, zero tariff for all world trade. Figures 8 and 9 show the results and it is clear that the trade policy effect, for both exports and imports, is substantial. The complete tariff removal in the Americas and in the world trade would raise Brazilian exports by 36 and 101 percent, respectively. On the imports side, as expected, the trade policy effect is decreasing in time, reflecting the trade liberalization of the 1990s. Yet, at the end of the period, tariff elimination would still boost imports from the Americas and from the world by 26 and 62 percent, respectively.

FIGURE 8
BRAZIL'S EFFECTIVE AND PREDICTED TOTAL EXPORTS, 1988-1997
(Thousands of 1995 US$)



Source: Own calculations based on Estevadeordal and Robertson's [forthcoming] bilateral trade coeficients.

FIGURE 9
BRAZIL'S EFFECTIVE AND PREDICTED TOTAL IMPORTS, 1998-1997
(Thousands of 1995 US$)



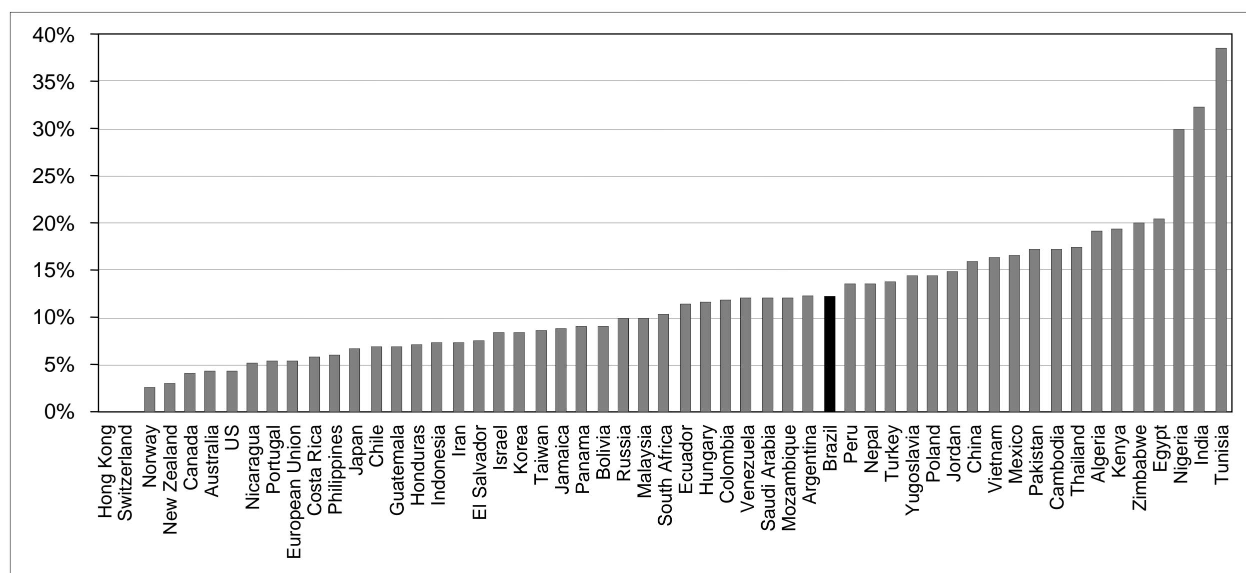
Source: Own calculations based on Estevadeordal and Robertson's [forthcoming] bilateral trade coeficients.

How one should read these results? With a pinch of salt as it is the norm in exercises of this type, which are exposed to measurement and statistical errors. Their message, though, is loud and clear and reaffirm the other evidence examined earlier: Brazil, despite the liberalization of the 1990s, still has a long way to go in opening up its economy and in reaping the gains from trade. This is particular by true for exports, but there is extensive ground to be covered in the import side as well. To put it differently, Brazil's openness to world trade is still well below the level warranted by its geo-economic status. The policy implications are also clear. Brazil has to continue to reform its trade policy and to open markets abroad to enjoy the full static and dynamic benefits of trade. The next section discusses some of the main issues in the trade policy agenda.

Trade policy

What are the main issues of trade policy reform in Brazil? Looking first at imports and leaving aside strategic considerations related to regional and multilateral negotiations, it seems that the country's level and structure of protection is still an important obstacle to higher growth and standard of living. There is no doubt that it went through major improvements during the 1990s, but the average level is still high by OECD standards (Figure 10). True, countries such as China and Mexico, which had impeccable trade performances in the last decade, have higher average tariffs. Yet, in both cases, massive arrangements such as NAFTA and China's special economic zones imply that actual tariffs are much lower than MFN and nominal tariffs.[8]

FIGURE 10
SIMPLE AVERAGE NOMINAL TARIFF FOR SELECTED COUNTRIES, 2001-2002



Source: Trains.

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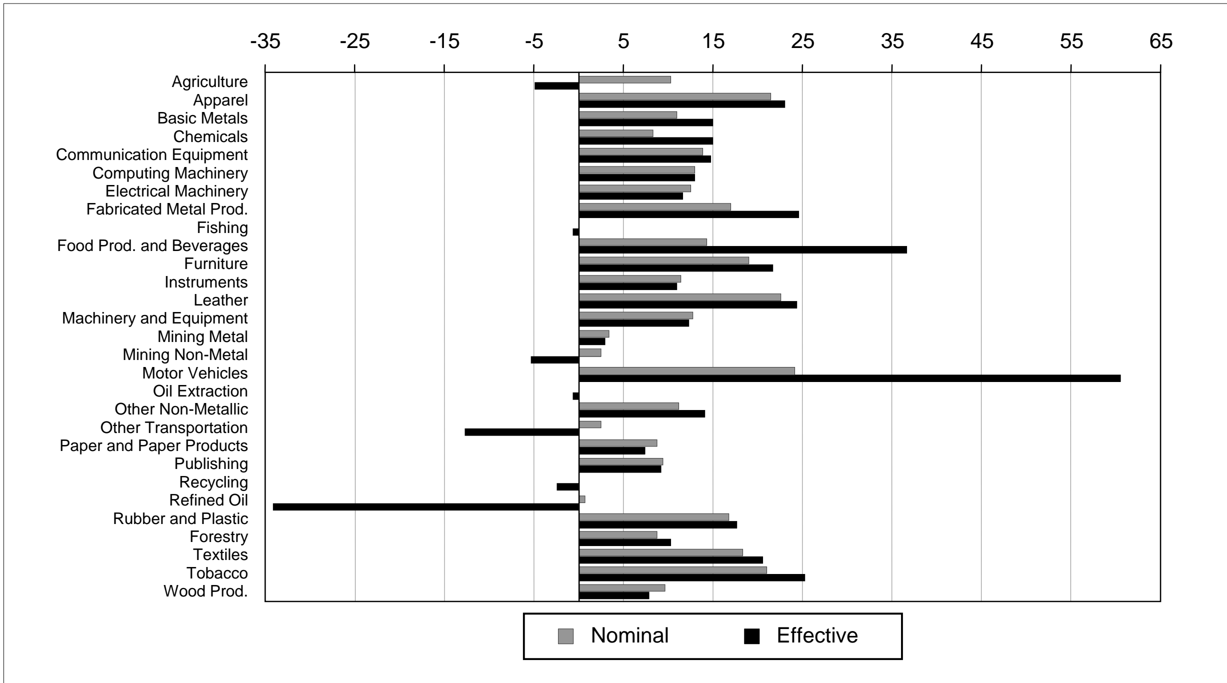
[8] For instance, in the case o Mexico, the average tariff for manufacturing goods (including preferential and MFN tariffs, weighed by imports) in 2000 was 5.1 per cent. See López-Córdova and Moreira [2003].

Protection is not only relatively high but also shows an acute variance, which can hardly be justified on purely economic grounds. Figure 11 shows nominal and effective tariffs for 2002 at the two-digit level of the International Standard Industrial Classification. Nominal tariffs vary from 0 to 35 per cent, an interval high enough to fuel rent seeking and impose severe costs on resource allocation. Yet, the picture from the point of view of Corden-Balassa effective tariffs, which take into account protection for both final products and inputs, is even worse. Rates vary from -34.1 to 60.5 per cent at the two-digit level and, at the four digit level, from -60 to 197 percent! (Not shown in the figure, available upon request). Such figures beg the question: what is the rationale, if any, behind such disparate rates? The answers, though, are difficult to find.

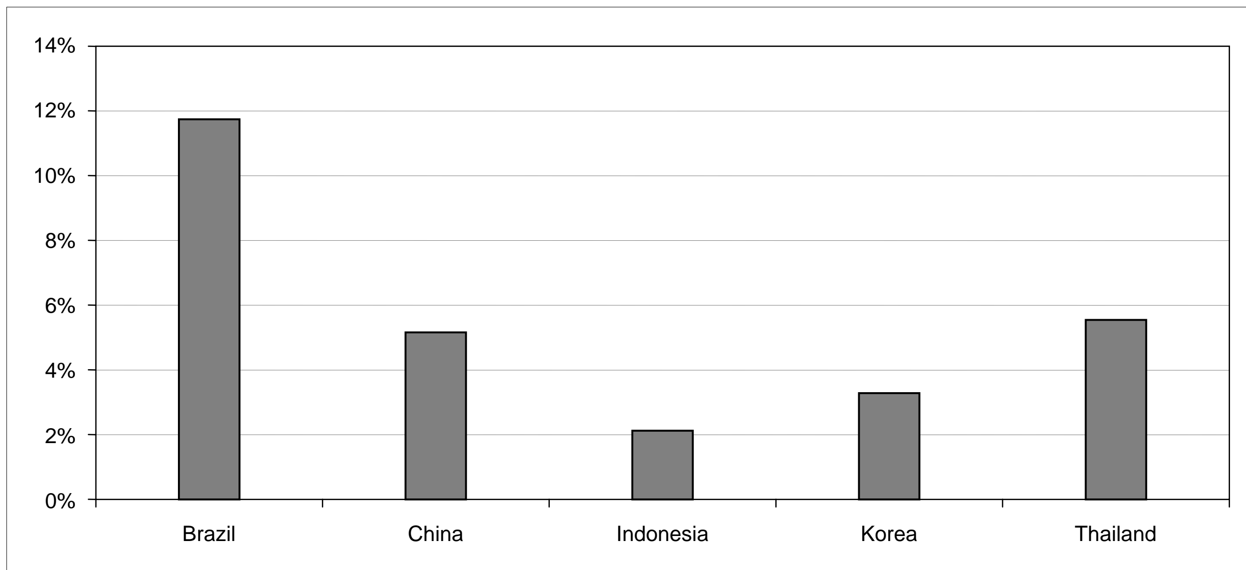
FIGURE 11
NOMINAL AND EFFECTIVE TARIFFS BY INDUSTRY
BRAZIL 2002
(ISIC 2 digits, %)



Note: Effective Rates of Protection based on the Corden's [1974] method. The technical coefficients are based on 1998 national accounts data, Table 1. Nominal Tariffs are from Trains.

The prevailing structure of protection is particularly damaging for growth. Tariffs on capital goods (11.7 percent in 2002), for instance, are still well above those practiced by the fast growth economies of East Asia (Figure 12), clearly punishing investment. True, when measured by actual (tariff revenue divided by imports) rather than nominal tariffs, protection seems to be much lower (6.7 per cent in 2002, Secretaria da Receita Federal). Yet, this reflects the existence of special import regimes, which target those capital goods not produced locally and whose discretionary nature is a fertile ground for red tape and corruption. In other words, they carry a hidden cost, which is not captured by the revenue data.

FIGURE 12
CAPITAL GOODS TARIFFS* FOR SELECTED COUNTRIES, 2001-2002



Note: * Broad Economic Categories (UN), weighted by imports. 2001 tariffs for Thailand and Korea. 2002, for the other countries.
Source: Trains.

On the export side, there are domestic and international agendas. The former has been the subject of a prolific literature (see, e.g., Pinheiro, Markwald and Pereira [2002]) and even though it is always risky to speak of a consensus, few seem to contest the argument that a stable macroeconomic environment and a floating exchange rate regime has been the key missing ingredients in Brazil's export equation. Most analysts also seem to agree that without a strong productivity growth, Brazil has little chance of sustaining an export boom. As mentioned earlier, trade liberalization has given an important contribution in this direction and, therefore, should be seen as an important element of an export promotion strategy.

Beyond macroeconomic environment and productivity, there are also the financial, logistic, institutional and fiscal issues, just to name but a few (see, e.g., *Ibidem*). A detailed analysis of these issues is beyond the scope of this paper, but their importance tends to pale in comparison to the macroeconomic and productivity agenda. Moreover, it is worth mentioning that there were important steps taken in the last decade to confront those issues, particularly in the area of export financing (Sucupira and Moreira [2001]), coordination of government initiatives (the establishment of the foreign trade forum-Câmara do Comércio Exterior) and export promotion (a new agency to promote Brazilian exports-APEX).

The international agenda is more complex and challenging. As suggested by the gravity model, market access should be high in Brazil's trade policy agenda. This issue should be dealt with in the context of an integration strategy, which should not lose sight of important "facts of life". First, Mercosur should remain one of the top priorities in this agenda since it has been playing an important role in speeding up liberalization and in increasing market access for Brazilian exporters. Yet, it is important to acknowledge that Brazil's level and structure of protection, reflected in the bloc's common external tariff, is a major impediment for the long-term survival of the agreement

As it is, and given Brazil's size advantages, the smaller partners are likely to pay a heavy and disruptive price in terms of deindustrialization, fueled by trade diversion and agglomeration economies. This risk is compounded by a structure of fiscal and credit incentives, which is heavily biased towards Brazil (see Moreira forthcoming).

Second, even though, South-South agreements can be an efficient way of moving faster with liberalization and an important source of static and dynamic gains of scale (see, e.g. Devlin and Estevadeordal [2001]), they are not an alternative to a deeper integration with the developed world. The limited size of the market and the similarity of factor endowments impose severe constraints on scale and efficiency gains (Venables [2003]). By contrast, the potential gains of North-South (e.g. FTAA) and multilateral agreements are more promising for involving considerably larger markets and a longer array of comparative advantages. True, the risks of this type of accords are higher, especially of dislocation of knowledge intensive, growth-enhancing sectors. Yet, Brazil's response to trade liberalization in the last decade plays down the likelihood of any catastrophic scenario. Besides, in the specific case of North-South agreements, one cannot overlook the costs of non-participation, whose magnitude can be grasped by the size of the markets involved, and which is likely to be augmented by trade diversion against local producers.

IV. CONCLUSIONS

Brazil's disappointing performance since opening up in the early 1990s has swollen the ranks of skeptics about the links between trade and growth. Yet, they might be jumping to wrong conclusions. Theory and evidence suggest that trade can boost growth mainly through higher productivity and investment, but not under any circumstances. The translation of trade gains into growth seems to be highly dependent on a favorable macroeconomic and institutional environment. Brazil has stumbled on both counts. The evidence suggests that macroeconomic and institutional hurdles have diluted the impact on growth of substantial trade-related productivity and investment gains.

It is also possible to argue that these gains could have been even more impressive if it were not for the limits and limitations of Brazil's trade liberalization. The level and variance of the prevailing structure of protection, alongside a restricted access to the world's major markets point to a trade policy agenda whose main objectives would be twofold: a reduction of the level and variance of protection and a full engagement in regional and multilateral negotiations. Mercosur should remain as an important part of the agenda, an objective that would be facilitated by tariff reform, but agreements that involve north-south trade should have the highest priority, given their more promising gains.

The limited openness of the Brazilian economy, evidenced by both trade-to-GDP ratios and gravity model estimates, suggests that the payoff of this agenda would be considerable. Its translation in rapid growth, as in the past, will fundamentally hinge on the country's ability to consolidate the process of macroeconomic stability and institutional building initiated in the mid-90s. A point well worth repeating judging by the country's record.

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