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**THE POLITICAL ECONOMY OF TRADE  
AND INDUSTRIAL POLICY REFORM  
IN BRAZIL IN THE 1990s**

**Winston Fritsch  
Gustavo H. B. Franco**

Proyecto Regional de Reformas de Política Pública  
ECLAC / Government of the Netherlands

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## PREFACE

The objective of the Regional project on Policy Reforms to Increase the Effectiveness of the state in Latin America and the Caribbean (HOL/90/S45) , which ECLAC is executing with cooperation from the Government of the Netherlands, is to identify reforms that allow the States of the region to implement effective policies for pursuing the interrelated goals of macroeconomic stability, changing production patterns for attaining sustained growth, and social equity.

With this objective, the project seeks to analyze actual processes of public policy reform, from the perspective of an explicit view of state reform and how it relates to interest groups and social actors, in the context of the challenges facing the countries of the region during the current phase of their development, and the new functioning of their economies.

To achieve that objective, reform processes in different areas of public policy are analyzed in a number of countries in the region that have undertaken such reform. The areas selected are: tax reform, privatization of public enterprises, reform of trade regimes, labor reform and reform in areas of social policy. The countries chosen are: Argentina, Bolivia, Brazil, Colombia, Costa Rica, Chile and Mexico.

In turn, comparative analyses -between countries- are made of reform carried out in each of the instrumental areas selected, for the purpose of drawing lessons applicable to each policy area, on the basis of the different national contexts.

Finally, analyses of reform processes in each country are integrated into a multidimensional view of the reform of the State taking place in each of them, in order to draw conclusions about the determinants and possibilities of State-reform strategies in Latin America and the Caribbean.

## I. INTRODUCTION

This paper discusses the political economy issues involved in the reform in the Brazilian trade and industrial policy regime undertaken at the onset of the 1990s. It is shown that this reform responded to a deep crisis in old forms of public intervention -unveiled by the fiscal crisis, stagnation and hyperinflation of the eighties- and that the resulting search for a new pattern of intervention paved the way to the definition of a far less *dirigiste* model of trade and industrial promotion policies.

We start by reconstructing, in section 2, the trends through which major tensions between state and society degenerated into hyperinflation and a broad regulatory crisis during the 1980s. In Section 3, the main features of the traditional regulatory framework of trade and industrial policies in Brazil are highlighted. Section 4 discusses the sources of Brazilian competitiveness, and, particularly, influence of trade and industrial policies. Section 5 describes the ongoing reforms and discusses the political economy issues relating to the design and implementation of the new policies. Finally, Section 6 sums up the main conclusions.

## II. HYPERINFLATION AND THE COLLAPSE OF STATE INTERVENTION IN THE 1980s

The remarkable deterioration in macroeconomic performance in the 1980s was certainly the most important single element leading the political agenda towards change. The growth machine of the 1970s, able to deliver average annual growth rates over 10%, was derailed to a point of barely maintaining income per capita constant in the 1980s, and experienced the rare disease of hyperinflation. No observer of the Brazilian economy at the end of the 1970s could possibly forecast these outcomes for the 1980s. In fact, even later, in 1984, when the first civilian government in two decades was about to take office, the economy was experiencing the early phase of a vigorous recovery, the budget deficit was under reasonable control (between a zero and 1.5% of GDP)' and inflation, despite a rising trend, was still moderate, no one could possibly forecast that, five years later, at the end of the Sarney's presidency, the fiscal situation would become unsustainable (with the budget deficit -operational concept- approaching 10% of GDP) and Brazil would experience the seventh worst hyperinflation in history.<sup>2</sup> What extraordinary chain of events could possibly produce this outcome ?

The answer to this question should start by observing that the influence of external factors, particularly the debt crisis, to the generation of hyperinflation in Brazil far less important than usually held. Although the fiscal counterpart of debt transfer were significant to the worsening of fiscal account in the early part of the 1980s, the opposite was true during the "New Republic", i. e. after 1985: fiscal and external burdens of debt transfers were actually reduced, as seen in Table 1.

Note that the deterioration in public savings during 1970-1985, when they were reduced from 6.1% of GDP to minus 0.4%, is comparable to the one observed from 1985 to 1989, when they reached minus 5.8% of GDP, and the overall public deficit reached 8.9%. The first round of fiscal deterioration may rightly be associated with the domestic fiscal counterpart of the transfer problem created by external shocks and the debt crisis. The truly puzzling aspect of the Brazilian crisis is the further deterioration occurring after 1985, which was a product of domestic factors, comprising increased public spending and reduced deficit financing capability, leading fiscal accounts to a chaotic situation in the end of 1989.

Table 1  
GOVERNMENT CURRENT ACCOUNT, OPERATIONAL CONCEPT, 1970-1989  
(% of GDP)

|                           | 1970       | 1975       | 1980         | 1985       | 1989        |
|---------------------------|------------|------------|--------------|------------|-------------|
| current revenues          | 27.1       | 25.8       | 23.6         | 22.3       | 21.2        |
| current expenditures      | 21.0       | 21.1       | 21.4         | 22.0       | 27.0        |
| .debts' servicing         | 0.7        | 0.6        | 1.1          | 3.8        | 3.3         |
| .wages                    | 8.3        | 7.5        | 6.2          | 6.8        | 9.7         |
| .social security          | 8.2        | 7.0        | 7.6          | 7.1        | 7.5         |
| .other                    | 3.8        | 6.0        | 6.5          | 4.4        | 6.5         |
| <u>government savings</u> | <u>6.1</u> | <u>4.7</u> | <u>2.2 -</u> | <u>0.4</u> | <u>-5.8</u> |

Source: Ministério da Economia, National Accounts.

A disturbing coincidence in the Brazilian crisis, is the fact that macroeconomic policy degeneration coincides with the return to democracy after two decades of authoritarian rule. Indeed, democracy, with its concomitant of labor demand and political competition for public resources, is certainly a factor in Brazilian inflation, much like it was, for instance, in Weimar Germany. In the latter, the extraordinary increase in unions' affiliation and activity immediately after the 1918 revolution provoked a very strong drive towards recovering the level of real wages prevailing before the war, which was about twice the prevailing level. This was a strong inflationary influence on its own right, and one that turned even more difficult the adjustment effort necessary to meet the reparation obligation.<sup>3</sup> In the Brazilian case it is also true that union activity was considerably increased in the second half of the 1980s, and also that this increased "resistance" on the part of workers to wage cuts required by external adjustment is clearly felt.<sup>4</sup>

The comparison between Brazil and Weimar Germany is suggestive but should not be stretched much further. Two peculiarities of the Brazilian case should be noted. One is that the order of magnitude of this "distributive conflict" effect on inflation, if we judge by the size of the external obligation, was much less important in Brazil than those present in Weimar Germany.<sup>5</sup> The other is that the budget served as a buffer to distributive conflicts, as typical of societies of corporatist tradition as Brazil, in a fashion quite different to what was seen in Germany. In fact, the crucial mechanisms by which democracy seemed to have facilitated inflation in Brazil ran through the fiscal accounts given the undeveloped state of fiscal and monetary institutions, which were not designed to enhance discipline especially in a regime of open political competition for public money and regulation. This institutional weakness was magnified during Sarney's presidency - the first civilian government after two decades of military rule- by virtue of the fragile authority of a president elected on the basis of a very shaky coalition of a multitude of political parties. The origin of the Brazilian fiscal crisis -which most observers agree to be a leading part of a larger crisis of the relation between state and society in Brazil- is a story still deserving a full account this paper is far from pretending. Yet, some aspects of this theme are relevant to the degeneration and reform of trade and industrial policies, foremost among which the institutional framework within which a process of decentralization of policy governance took place. As regards fiscal policy, for instance, a very strong pro- inflation bias resulted from the combination of:

i) a the budgetary process lacking reasonable limits to the competition for public resources, or the means through which the quantity of demands could be made consistent to available resources. For this reason, budgets drafted were, and still are, invariably unrealistic, as the tendency is to accommodate all pleas.

ii) the budget being only an "authorization", not a mandatory document; which gives the Executive great discretion in fiscal affairs and creates a "political market" for the execution of the budget and, more specifically, for the rationing of public spending.<sup>6</sup>

iii) the absolute lack of transparency in the actual management of fiscal accounts, greatly enhancing the Executive's discretionary powers in this area.<sup>7</sup>

iv) The lack of Central Bank independence as regards the government - federal and state- financing needs was at that time, and still is, a serious institutional weakness of the Brazilian economy that certainly facilitated the development of hyperinflation.

In light of the above and given the circumstances surrounding Mr. Sarney's inauguration as president, the lack of political support, both in Congress and from society at large, resulted in weakening quite considerably the commitment on the part of the Executive for fiscal discipline, and its resistances to corporatist demands. It seems an established fact that during the Sarney presidency there was an uncontrolled multiplication of fiscal and regulatory favors much beyond any possibility of global consistency of pleas. Given that no institutional mechanisms (a sound budgetary process for instance) existed to regulate the competition for fiscal and regulatory favors, "private" arrangements proliferated, through which a remarkable decentralization of fiscal and regulatory powers took place. Spending units, as well as regulatory agencies, progressively enjoyed more autonomy and, simultaneously, a closer relation with "interested parts" in the private sector.

At the end of the Sarney's administration, this process of "privatization of the state" by well entrenched corporatist groups advanced to a point that Brazil faced both an unsustainable fiscal situation -with which one could associate the concrete threat of open hyperinflation- and, as seen in detail in the next section, also a major regulatory crisis stemming from the uncontrolled multiplication of regulation designed to protect established interests. Indeed, the attempts to revert these two interlocked halves of the deterioration of state intervention in Brazil constituted the major issue facing president Collor and Itamar. The former's more specific actions regarding trade and industrial policy, and the resistances facing his "modernizing" measures will be extensively reviewed in the next sections. It is useful, however, to conclude this section with a cautious note on both presidents' initiatives on the fiscal area, depending on the success of which, on-going stabilization policies may be successful and some difficulties created by continuing high inflation to trade and industrial policy reform may be by-passed.

As matter of fact, unfortunately, the Executive's initiative on the fiscal are a have been few and confuse. At least up the Constitutional Revision, in late 1993, Brazil will most likely live in the current situation of "repressed hyperinflation". What actually distinguish the latter from an open hyperinflation is not the state of the budget but a phenomenon that finds the technical denomination of "fiscal repression".<sup>8</sup> This meant a situation of a more or less balanced budget "on a cash basis" , despite the existence of large potential deficit at an "accrual basis", thanks to the fact that a quite substantial portion of budgeted expenditures are rationed, left undone, or delayed. This paradoxical combination of actual fiscal balance, thanks to "fiscal repression", and the generalized perception that there is a large underlying fiscal disequilibrium and potential hyperinflation is one of the distinguishing features of the recent Brazilian inflation, and is against this background that the proposed reform in the trade and industrial policy framework have to be seen.

### **III. THE EVOLUTION OF THE REGULATORY FRAMEWORK**

The Brazilian trade and industrial policy framework obeys the major trends outlined in the last section. The corporatist appropriation of regulatory functions is perhaps the key political economy issue to be highlighted. The following two sub sections address trade policy and industrial policy separately.

#### **1. The trade regime**

Since the reforms of the mid-sixties the Brazilian trade regime displayed three basic features: i) a very restrictive import regime based on discretionary import licensing, which was used as a partial but crucial element of industrial policies; ii) very active export incentive schemes including subsidies and import duty exemptions; last, but not least, iii) a fairly well managed crawling peg which avoided, except for very brief episodes, the damaging exchange rate appreciations.

An important development in the nature and operation of instruments of Brazilian import policy is observed during the 1970s and early 1980s namely the marked diversification and decentralization of administrative

obstacles to imports. Instruments as quotas, prior permits, tariff surcharges, financing requirements, in addition to many sector specific restrictions, were superimposed on these administered by CACEX and on the tariff structure and managed often on an uncoordinated fashion by different government agencies following sometimes conflicting criteria. Foreign exchange rationing, evidently, pervaded the actions of all, but industrial policy conceptions, and surely sectoral rent seeking considerations, governing the use of this wide array of discretionary instruments were also present.

Two important consequences of this process of decentralization of trade regulation should be singled out. The first is related to the tariff structure. As a consequence of the all pervasive operation of administrative import controls, the relatively high Brazilian tariff became a secondary line of defense within the Brazilian protectionist system. By generating an import structure basically formed by non-competitive goods, this system created an important distributive distortion: importing firms invariably applied for tariff exemptions or reductions under "especial import regimes". 42 such import regimes were in existence in 1989, when nearly 70% of all Brazilian imports entered the country with tariff reductions or exemptions. In 1984, when the average "legal" tariff was 90.0%, the average "true" tariff, i. e. revenues of import taxes as percentage of the value of imports, stood at 19.1%, as shown in Table 2. Through this mechanism, import rationing is largely made by measures that do not seem to raise very significantly the cost of imports that happen to cross the barrage of administrative controls.

Another crucial by product of the decentralization of trade regulation is its subordination to sectoral concerns. This is very clearly seen in the operation of the so-called "law of similars", according to which any imported product should be subject to an exam to assess the extent to which one could find "similar" national products. If this can be proven in "similarity exams" carried out by a CACEX expert chosen in conjunction with the business associations involved, then the import is forbidden.<sup>9</sup> The threat to use this procedure was often used to enforce schemes of import ceiling with domestic producers and, when large scale projects were under consideration, CACEX managed to negotiate with importers and business associations the so called "participation agreements", through which a "local content" level was agreed for the whole project.

Table 2  
Brazil: Legal and "true" rates of protection, 1984

| Sector                | Nominal     |             | Effective   |             |
|-----------------------|-------------|-------------|-------------|-------------|
|                       | Legal       | True        | Legal       | True        |
| All manufacturing     | 90.0        | 19.1        | 165.6       | 34.5        |
| Light manufacturing   | 130.5       | 10.1        | 246.1       | 35.2        |
| Food                  | 84.2        | 16.9        | 212.3       | 43.4        |
| Textiles              | 176.9       | 3.3         | 268.4       | 1.1         |
| Heavy Industry        | 71.9        | 23.9        | 114.4       | 32.4        |
| Paper                 | 82.2        | 39.4        | 212.9       | 110.9       |
| Chemicals             | 34.2        | 11.5        | 95.2        | 24.6        |
| Non-metallic minerals | 98.7        | 29.5        | 182.1       | 41.5        |
| Metallurgy            | 72.8        | 12.7        | 91.1        | 24.0        |
| High tech             | 98.5        | 8.5         | 137.1       | 14.1        |
| Machinery             | 81.2        | 14.9        | 121.3       | 19.1        |
| Transport equipment   | 115.9       | 2.9         | 217.7       | -9.6        |
| <u>Agriculture</u>    | <u>57.3</u> | <u>22.6</u> | <u>63.3</u> | <u>26.7</u> |

Source: Fritsch & Franco (1989a) using raw data from Braga et al (1988, pp. 674-77). Weighted using shares in total value added.

Interestingly, the "law of similars" procedure implied some "delegation" to the private sectors of the discretionary power to restrict imports, which was considerably advanced over the years. This tendency reinforced the autonomy of sectoral agencies to set their own guidelines and policies, and to experience a certain degree of symbiosis between regulators and their subjects.

The most impressive by-product of this process is the "market reserve" policy enforced in the informatics industry. The control over imports of loosely defined "informatics goods" by the Special Secretariat of Informatics (SEI) has given such a leverage to the latter that, in addition to usual practices such as, for example, requirements for a very high local content, it has introduced specific procedures to the regulation of the computer industry such as restrictions on technology transfer contracts and, most importantly, to foreign ownership in some segments of the industry. This has represented a major departure from Brazil's traditionally liberal stance towards foreign investment, and has raised a huge amount of controversy.

The high levels of protection in force during the 1980s created a generalized anti-export bias, that is very clearly perceived in the figures for effective rates of protection in Table 2. Indeed, on average, one may observe a small positive anti-export bias for the Brazilian economy for as late as 1980-1981, with, however, a large dispersion -i. e., with sectors highly inward oriented and others on a more or less neutral stance.<sup>10</sup> Interestingly, however, this bias was offset in specific industries by export incentives that placed such industries in a more or less neutral regime. In 1984, the aggregate value of all export incentives reached 48.7% of the FOB value of exports, 35.5% referring to rebates and exemptions of indirect taxes, 9.1% referring to benefits associated with draw-back operations and the rest (4.1%) produced by subsidized credit and income tax reductions.<sup>11</sup> In addition, it has been found a positive and significant (rank) correlation between effective rates of protection and rates of export promotion -0.626 for 1973 and 0.723 for 1977-1981- suggesting therefore that export incentives are a *sine qua non* to sustain export performance under the prevailing structure of protection.

It was observed that "the official justification for the concession of such benefits has been based on the argument of the necessity to offset the cost pressures derived from the tariff structure".<sup>13</sup> This situation - high protection as a rule and high export subsidies as a glorified exception for exporters - is in itself a double distortion on the classic static sense calling, according to the canonical formulae, for a devaluation *cum* removal (or reduction) of export subsidies and tariffs. The traditional obstacle to this simplification of the trade regime has been the alleged inflationary consequences of real devaluations.

An important instrument conceived to by-pass the structure of protection was the BEFIEX programs. It consisted basically in allowing tax exemptions on imports and the full clearance of "similarity" examinations for inputs and capital goods in exchange for export commitments assumed by importers never below the double of the value of allowed imports. The commitments are drawn in multi-year contracts that, initially, were mostly signed by MNCs affiliates. Over the years the program has turned into a "mechanism through which national firms seek to reduce import taxes on capital goods imports and to circumvent "similarity" examinations",<sup>14</sup> i. e. a scheme through which exporting firms could get access to imports without which competitiveness would not obtain and that would be otherwise unreachably. The program's effectiveness can be assessed by the fact that, as seen Table 3, exports under the program increased more than tenfold from 1974 to 1981, and fourfold during 1982-1989. This resulted in a fourfold increase in the trade balance under the program from 1978 to 1980,

Table 3  
EXPORTS AND TRADE BALANCE UNDER BEFIEIX  
AND OF FOREIGN FIRMS, 1972-1989

| BEFIEIX Program |                  |                 |                |                 |      |              |           |
|-----------------|------------------|-----------------|----------------|-----------------|------|--------------|-----------|
| year            | program exports* | % of for. firms | trade balance* | contracts total | MNCs | mnf. exports | % BEFIEIX |
| 1972            | 2                | 100             | -10            | 2               | 2    | 898          | 0.0       |
| 1973            | 70               | 100             | -100           | 3               | 3    | 1 434        | 4.9       |
| 1974            | 212              | 100             | -72            | 3               | 2    | 2 263        | 9.4       |
| 1975            | 335              | 100             | 63             | 4               | 3    | 2 584        | 12.9 i    |
| 1976            | 456              | 98.5            | 174            | 11              | 4    | 2 776        | 16.4      |
| 1977            | 655              | 90.2            | 348            | 5               | 3    | 3 840        | 17.0 '    |
| 1978            | 865              | 88.4            | 222            | 10              | 5    | 5 083        | 17.0      |
| 1979            | 1 119            | 82.2            | 646            | 16              | 3    | 6 645        | 16.8      |
| 1980            | 1 793            | 74.3            | 1 068          | 35              | 12   | 9 928        | 17.9      |
| 1981            | 2 581            | 77.5            | 1 188          | 35              | 4    | 11 884       | 21.7      |
| 1982            | 2 343            | 70.6            | 1 031          | 79              | 25   | 10 253       | 22.4      |
| 1983            | 2 935            | 60.6            | 2 110          | 25              | 7    | 11 276       | 24.8      |
| 1984            | 3 872            | 58.0            | 2 865          | 44              | 11   | 15 102       | 26.1      |
| 1985            | 4 851            | 54.2            | 3 603          | 44              | 15   | 14 062       | 35.5      |
| 1986            | 5 128            | n.a.            | 4 405          | n.a.            | n.a. | 12 386       | 41.4      |
| 1987            | 7 629            | n.a.            | 6 912          | n.a.            | n.a. | 14 831       | 51.4      |
| 1988            | 9 573            | n.a.            | 8 714          | n.a.            | n.a. | 19 902       | 48.1      |
| 1989            | 8 979            | n.a.            | 8 119          | n.a.            | n.a. | 19 594       | 48.3      |

Sources: Neves & Moreira (1987, tables 5,7 and 8) and Gazeta Mercantil, May 25th, 1990. The sample includes all exporting firms with foreign control \* Millions of dollars.

and another sevenfold increase from 1982 to 1989. The share of MNCs in the program's exports fell significantly after the mid 1970s, and the program's share in manufactured exports increased from 16% in 1975-1979, to 23% in 1980-1984 (approximately 3% of imports), reaching slightly over 50% in 1987, where it remained since.<sup>15</sup> The experience clearly suggests that a binding element in export oriented projects was the very restrictive structure of protection in operation.

## 2. The industrial promotion schemes

During the formative years of Brazilian industry, the classical interaction between inward looking policies and small market size relative to best-practice optimum scales led to high levels of concentration in almost all the new sectors from the outset.<sup>16</sup> The creation of a relatively stable oligopolistic structure was reinforced by the combination of i) a high level of multinational penetration in response to restrictive import barriers coupled with relatively little r c.. , interference in the foreign investment process; ii) the creation of "national champions" by the special protection-cum-domestic subsidies treatment given to domestic firms in some import substitution projects and stimulated by the concern with the creation of industrial "enclaves" that could be formed by vertically integrated MNCs affiliates; iii) state ownership in sectors requiring large initial investment outlays, which created in fact monopolistic public enterprises.<sup>17</sup>

The basic features of the framework of incentives and regulations were refined and consolidated during the very active policies followed from the late 1960s and, especially, in the 1970s, as a response to the perceived

structural balance of payments problems created by the oil price rise, giving an impressive boost to investment in heavy intermediate and capital goods industries, and in the 1980s as a response to challenge of adjustment to the debt crisis. Among these features it is apt to emphasize: i) the pervasiveness of fiscal incentives granted in credits by the state development bank BNDES and directly by some government bodies; ii) regulation enhancing non-contestability of markets, particularly the investment licensing limitations imposed by sectoral or regional bodies or by the mechanism of "sectoral agreements" coordinated by the price control authority (CIP-Interministry Council of prices);<sup>18</sup> and iii) most importantly, the imposition of local content requirements (*índices de nacionalização*) by BNDES -defined as the ratio between local cost components and total cost of a given product<sup>19</sup>- as a requirement for the access to its FINAME line of subsidized credits for acquisition of capital goods, and by other government bodies (CDI) and state enterprises especially in the context of public procurement contracts. A 1988 decree would actually turn local content requirements enforceable in the production of all goods receiving any form of subsidy, purchased by any public body or receiving any sort of financing from official institutions.<sup>20</sup>

Two important and interrelated issues are raised in this connection. The first is the fact that the rather extensive industrial regulation enhances the non-contestability of markets, especially in the modern segments of manufacturing. Regulation clearly establishes a clear pro-incumbent bias, reinforces natural entry barriers, prevents exit by distressed firms and crystallizes market positions.<sup>21</sup> This very large degree of trade and industrial regulation and government interference with the competitive process maintained for so long in Brazil seems to have had a fundamental negative impact on entrepreneurial behavior and industry efficiency, as it rewarded rent seeking and inhibited managerial awareness of the strategic importance of the acquisition of technological capability. It is for no other reason that anti-trust or competition policies could never be actually implemented in Brazil: the government is the first and foremost intervenient in the market process.<sup>22</sup> This is particularly dramatic at a time when there are very rapid changes in the post-war technological paradigm upon which Brazilian industrial capability was built, and when continued manufactured export dynamism rests fundamentally on technological upgrading. For this reason the reforms to be undertaken in trade and industrial policies in the 1990s seem to place industrial deregulation and competition policy in a privileged place.

A second important issue is that the weight of regulation has been such that several coordination instances developed over the years. Typically, as import substitution in one sector was about to start an agency designed to coordinate all industrial policy instruments affecting the new industry was established. Many such agencies were encompassed in the Council of Industrial Development, which was created in 1969 and extinct in 1988. The Council played an important role in coordinating the actions of other key bodies such as the BNDES, some large industrial public enterprises and CPA, which decided about the concession of trade-related tax exemptions on imported inputs. The Council also operated a number of "sectoral chambers", uniting producers of a given "productive chain" around joint investment plane, pricing policies and local content targets. After 1988, CDI functions were dispersed in other agencies and the culture of "sectoral chambers" advanced with the 1988 decrees known as "The New Industrial Policy", that attempted to create a system of joint planning for vertically integrated sectors (industrial complexes) managed by "sectoral chambers" with powers to establish investment plane (*PSI-Programas Setoriais Integrados*) that would be liable to a number of fiscal and regulatory incentives. These proposed reforms can be thought as an attempt to advance the symbiosis between bureaucracy and regulated firms in a full fledged corporatist system. Interestingly, the coordination difficulties existing within sectoral chambers precluded the constitution of any but one sectoral PSI (in the textile industry) up to 1990.

#### IV. BRAZILIAN COMPETITIVENESS

The very large degree of trade and industrial regulation and government interference with the competitive process described in the previous section seems to have had a fundamental negative impact on entrepreneurial behavior and industry efficiency, as it rewarded rent seeking and inhibited managerial awareness of the strategic importance of the acquisition of technological capability. This is particularly dramatic at a time when there are very rapid changes in the post-war technological paradigm upon which Brazilian industrial capability was built, and when continued manufactured export dynamism rests

fundamentally on technological upgrading. For this reason the reforms now being undertaken in Brazilian trade and industrial policies tend to place industrial deregulation and competition policy -including, prominently, trade liberalization- in a privileged place.

However, the relation between the competitive regime and technological dynamism cannot be settled on the grounds of a *priori* i. e. theoretical, arguments. To probe into such essentially empirical question this section develops three parallel, though by no means unrelated, efforts: i) to review Brazilian trade performance indicators and li) to investigate the determinants of export performance.

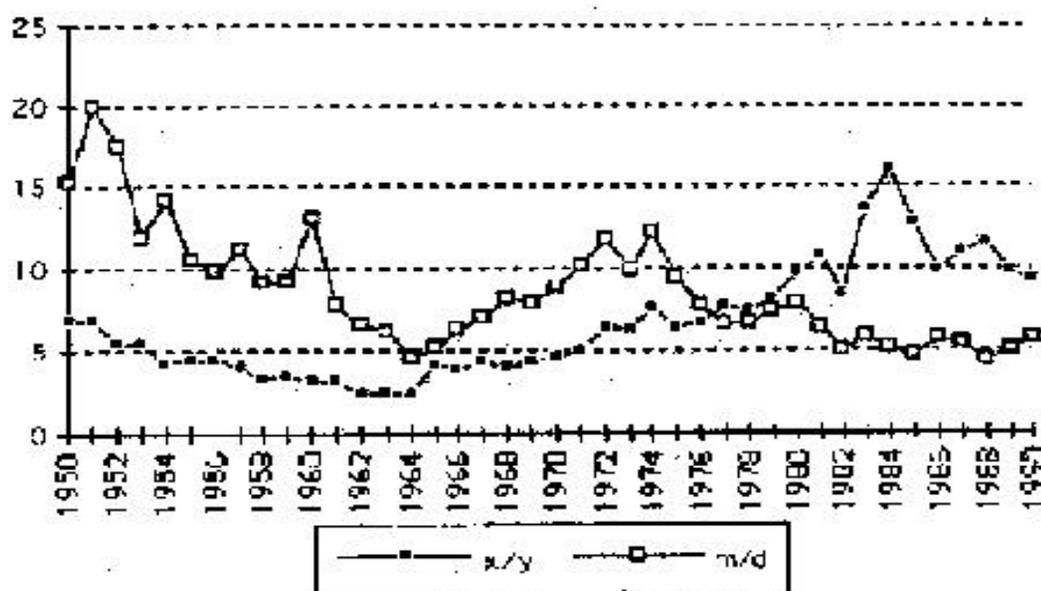
### 1. The changing pattern of Brazilian trade

The dramatic adjustment effort induced by the fall in foreign financial flows in the early 1980s may convey the impression that Brazilian outward orientation is a recent phenomenon. A review of the data, however, reveals that recent changes must be seen as reinforcing longer term changes in tradeability taking place as a response to both structural factors shaping comparative advantage as well as the greater neutrality of incentives to the production of tradeable goods followed since the late 1960s.

The extent of the growth of export propensities and of import substitution - measured by imports as a proportion of apparent consumption - between 1970 and 1985, are shown in Graph 1.

The period lasting from the early post-war (or, indeed, from the inter-war years), to the early 1960s corresponds to the classic import substitution period, where a combination of severe import controls and extremely overvalued exchange rates led to falling import penetration ratios, repressed non-traditional exports, and low and falling manufactured export propensities. Then, from 1965 to the first oil shock, corresponds to a combination of trade de-repression and very fast output and investment growth in manufacturing during the golden years of the Brazilian "Economic Miracle", leading to a virtuous combination of rising import penetration and export propensity, backed by vigorous manufactured export growth. A later phase, from the mid-1970s to 1990, corresponds to the period of a shift to a policy of "heterodox neutrality", combined import repression and aggressive export promotion, as was required to redress the large and recurrent balance of payments imbalances generated by the first oil shock, the sequence of oil price and interest rate shocks of the early 1980s, and the debt crisis from 1982. The result, in terms of tradeability, were a sharp fall in import penetration and a fast rise in export propensity, backed by continuous export dynamism. Thus, the experience of Brazil as an exporter of manufactures, provides a fine example of the achievement of greater export orientation not through the traditional prescription of reducing the anti-export bias introduced by import repression through import liberalization, but by neutralising the anti-export bias of high -and, after 1974, growing- import repression by changes in the export and exchange rate regimes, coupled with selective t intervention in the import regime *for* some producer goods.

Graph 1  
BRAZIL'S INDICATORS OF OPENESS, 1950-1990  
EXPORT PROPENSITY AND IMPORT PENETRATION RATIO



The use of what we labeled above as a policy of "heterodox neutrality" was not peculiar to Brazil and was followed by some other successful exporters of manufactures such as Korea.<sup>24</sup> In terms of comparative performance, however, although Brazil's early experience has been teamed with that of the other East Asian success stories in one of the synthesis volumes of the famous NBER project on trade regimes and development, the situation changed in the 1980s. While manufactured export growth and diversification continued to proceed at a fast and stable pace in the Asian NICs, the years of great macroeconomic instability following the debt crisis witness a deterioration of Brazilian manufactured export performance: in the eight years between 1974 and 1982, real manufactured exports grew at a steady pace at an average yearly rate of 15.9%, while in the eight year interval between 1982 and 1990, growth is not only unstable but slows down to an average of 8.3%.

This deterioration of export performance is not unrelated to the deterioration in the domestic macroeconomic environment in the 1980s. As argued below, rising inflation placed non-negligible constraints on the use of active exchange rate policies, while growing concern with unsustainable fiscal imbalances plus threats of the use of countervailing duties by the United States restrained the use of fiscal incentives to promote exports. This, coupled with strong external pressures for import liberalization, gave impetus to the attempt of dismantling the old policy framework and to shift towards "orthodox neutrality", quite clearly seen in the drive towards a less repressive import regime after the inauguration of President Collor in early 1990. However, the sustainability of these reforms and their impact on Brazilian manufactured export performance are still widely open questions.

## 2. The sources of export growth in manufacturing

A crucial feature of the evolution of Brazilian openness, as seen in the last section, and reaffirmed in the studies using different data bases is that the improvement is uniformly observed throughout the period, the recession and devaluations of the early 1980s having, therefore, only reinforced these long term trends. This section treats macro and microeconomic determinants of Brazilian competitiveness in manufacturing, the operation of which is not mutually exclusive in two separate sub-sections. The first subsection deals with macroeconomic influences on trade performance, namely exchange rate policy, as well as fluctuations in

domestic and external demands It also devotes some attention to the impact of export incentives and of mechanism to by pass the very heavy structure of protection in force. The next sub- section considers determinants of competitiveness associated with market structure as well as with policies and environmental conditions favoring learning and technological innovation.

a) *Macroeconomic and policy factors in competitiveness*

A 1983 survey<sup>26</sup> of the extensive econometric work linking the behavior of aggregate manufactured exports to macroeconomic variables covering the 1960s and 1970s would reveal that, despite the richness of methodological details, the essential elements of these exercises were very similar: a *quantum* index for manufactured exports, and their value at constant dollars, was regressed against variables such as real exchange rates (adjusting for subsidies and tax incentives so as to interpret it as exporters' returns) , world demand, and cyclical influences usually defined as deviations from a productive capacity variable (often potential output). The more recent work uses a supply and demand specification and the results for price and world income elasticities of export demand, as well as price and domestic demand elasticity of export supply have displayed a fair amount of consistency, as shown in Table 4.

Table 4  
LONG RUN MANUFACTURED EXPORT ELASTICITIES: DOMESTIC FOREIGN

| price                      | domestic demand | foreign demand | author                    | period #    |
|----------------------------|-----------------|----------------|---------------------------|-------------|
| manufactured export supply |                 |                |                           |             |
| 1.04*                      | -2.5*           | ...            | Cardoso & Dornbush (1980) | 1960-1977 A |
| 1.19*                      | -2.1*           | ...            | Markwald (1981)           | 1964-1980 A |
| 2.64                       | -4.5            | ...            | Braga & Markwald (1983)   | 1959-1981 A |
| 1.10*                      | -1.3*           | ...            | Rios (1986)               | 1964-1984 A |
| 1.39*                      | -1.6*           | ...            | Zini (1988)               | 1970-1986 Q |
| manufactured export demand |                 |                |                           |             |
| -0.68                      | ...             | 2.53*          | Lemgruber (1976)          | 1965-1974 A |
| -1.12                      | ...             | 2.19*          | Pinto (1983)              | 1954-1975 A |
| -2.82                      | ...             | 2.59*          | Braga & Markwald (1983) 1 | 1959-1981 A |
| -1.38*                     | ...             | 2.31*          | Rios (1986)               | 1964-1984 A |
| -0.31                      | ...             | 4.92           | Zini (1988)               | 1970-1986 Q |
| total export supply        |                 |                |                           |             |
| 0.91                       | -1.0            | ...            | Zini (1988)               | 1970-1986 Q |
| total export demand        |                 |                |                           |             |
| -0.17                      | ...             | 0.75           | Khan (1974)               | 1951-1969 A |
| -0.41*                     | ...             | 1.97*          | Lemgruber (1976)          | 1965-1974 A |
| -0.95                      | ...             | 2.89*          | Zini (1988)               | 1970-1986 Q |

\* significant at 5%. # A stands for annual and Q for quarterly data.

Source: Zini (1988, p. 650)

According to the table, manufactured exports supply price elasticities are slightly above one, and domestic demand was found to be an important negative influence on Brazilian exports, asserting a clear "vent-for-surplus" logic in Brazilian exports, a result to be expected for a country with a large domestic market and in which exports represent a marginal activity for most exporting firms. Estimates of manufactured export demand price elasticities are less homogeneous than the others, ranging from -0.31 to -2.82. Income elasticities of manufactured exports demand, on the other hand, seem to be significantly greater than two, a very high value. The estimates for elasticities of total exports are much lower than the ones for manufacturing in all categories.

The interpretation of these exercises' involve some important issues. The influence of structural factors affecting export performance is not made explicit as these equations generally include only deviations from potential output, in order to capture the "vent-for-surplus" effect, so that productive capacity increases in exporting industries, which are the result of the operation of structural factors, become hidden. A superficial reading of this literature would tend to associate export growth with domestic recessions thus conveying the impression of a contradiction between the export led and domestic market led growth.

On the price side it is important to distinguish between the effects of exchange rate policies and of export subsidies, and most arguments emphasizing "artificial" competitiveness underline the weight of the latter. In this connection it was shown that the value of export incentives in effect in Brazil from the late 1970s on was very substantial. A recent study reports that, for 1984, the aggregate value of all export incentives reached 48.7% of the FOB value of exports, 35.5% referring to rebates and exemptions of indirect taxes, 9.1% referring to benefits associated with draw-back operations and the rest (4.1%) produced by subsidized credit and income tax reductions.<sup>27</sup> Although these values seem high and raised concerns on the fiscal cost of export promotion,<sup>28</sup> it should be considered that 2/3 of the indirect tax incentives are Common in foreign trade operations (the exemption applies to avoid double taxation of the same value added). Note also that these estimates were based on the unrealistic assumption that, in the absence of the incentives, the same amount of exports and imports would have happened that is, that foreign trade has no sensitivity to the presence of incentives. In any event, the important point to observe is that, for a country in which the rate of effective protection is very high, the anti export bias would be generally very high if not offset by export promotion schemes attempting to place exporters on a more or less neutral regime. Direct tax incentives are, thus, important to neutralize protection, as well as import-to-export" schemes, such as the BEFIEX which, as discussed above, played such an important role to manufactured exports growth.

#### b) *Structural influences*

The debate about "structural" elements likely to explain the evolution of competitiveness over time, has centered upon the relative importance of "endogenous" mechanisms related to learning-by-doing and scale economies accompanying the process of "maturation" of predominantly national firms in manufacturing<sup>29</sup> and "exogenous" influences mostly affecting trade propensities of established foreign affiliates through processes of globalization and rationalization of activities within MNCs.<sup>30</sup> The importance usually attached to "endogenous" elements has been reinforced by the recent proeminence of the so called "new trade theories" which devote great emphasis to the role of industrial organization features in creating competitiveness. More specifically, most models along these lines suggest an association between increases, in size, or in rents connected to industrial concentration, or even to protection and "market reserves", to greater efficiency either through scale economies, learning-by-doing or R & D investment.<sup>31</sup> Yet, this deterministic neo-Shumpeterian connection between size and competitiveness (efficiency) is very much open to question on empirical grounds. Besides, the empirical association between industrial organization features, including the trade regime, and competitiveness is not a clear cut one.<sup>33</sup>

The empirical literature addressing the relation between export performance and industrial organization features for the Brazilian case has devoted great attention to the connection between export performance, firm size (or concentration), and foreign ownership. In either case, however, the methods used in controlling for other influences, or to purge multicollinearity problems from cross-section regressions, are crucial to assert the existence of any meaningful connection. The first entries in this literature uses a 1978 income tax database including 15 122 reporting firms from which Braga (1981) sought to investigate the distribution of export incentives according to firm size, ownership and regional location. It was found that incentives were appropriated mostly by larger firms, MNCs affiliates (whose share of incentives was found to be larger than that of exports) and richer regions, but the multicollinearity problems involved were by no means controlled.

This same data were used by CEPAL (1983) to assert the lack of difference in export propensities between national and foreign firms, both directly and through a comparison using the matched pairs methodology. The procedure was heavily criticized for it did not control for firm size,<sup>34</sup> a problem that was not present in Braga & Guimarães (1986), who used an enlarged version of the same data set, to run regressions of export propensities on variables like industrial concentration, scale economies, capacity utilization, foreign ownership, tradeability (proxied by geographical dispersion of production within the country), capital intensity, export incentives and R & D intensity. The study reaffirmed the relation found in earlier studies of

macroeconomic nature mentioned in the last sub-section between export performance and incentives and domestic demands. The study also confirmed the expected positive relation between export performance and firm size variables -concentration, scale economies and R & D intensity- but failed to identify a significant influence of foreign ownership on export performance. However, a serious shortcoming in the identification of foreign firms in the 1978 data set resulted in a very significant underestimation of their presence in Brazilian industry<sup>35</sup> turning, evidently, the conclusions of the studies mentioned above, especially when involving foreign ownership, quite questionable.

A more recent study - Willmore (1985) - using the same 1978 data set, but properly identifying foreign firms, conducted an extensive comparison of national and foreign firms using the methodology of matched pairs with results substantially different from the ones of early studies. Among several important differences between national and foreign firms it was found that the latter exported a much larger proportion of their output than national firms of the same size even though they do ~ receive a larger share of export incentives. In another study, Willmore used a sample of 17,053 firms in manufacturing for 1980, ~ 652 of which foreign, responsible for approximately 3/4 of all manufactured exports. He estimated a recursive model in which the probability of a firm being an exporter is estimated through logit equations and then export performance of exporters is explained. The main findings are summarized in Table 5.

According to the table, foreign ownership and product differentiation are significant positive influences both on the probability of being an exporter and on export performance. Interestingly, foreign ownership increases the odds of exporting by 3.75 (the anti-log of 1.32) times. The average wage, a proxy for skill intensity, is a weak influence on being an exporter and a negative influence on export performance. Capital intensity has negative impact of the odds of exporting, but once the firm is an exporter, it appears with a positive sign. Vertical integration have a strong negative influence on both counts, while concentration, which is omitted in the table, is not significantly different from zero on both equations. Nominal protection appear with a negative sign, as expected, an effective protection with a positive sign.<sup>37</sup> Finally, the influence of firm size is a complex one. Its influence is positive on the odds of exporting over the relevant size range, though regarding export performance its influence is negative when the firm is below the average size and positive when is above. Interestingly, however, the coefficient for size in the second equation is not significantly different from one, this meaning the absence of correlation between export propensity (exports/output) and size.

To sum up, the evidence seems to underline the positive influence of foreign ownership, or "exogenous" determinants operating through foreign firms, to export performance. Regarding other features of industrial organization the evidence is clear on the positive influence of product differentiation and negative influence of vertical integration on export performance. As regards the precise nature of the relation between size, and other firm characteristic or market structure features, on the one hand, and technological strategies, and how the latter evolve into export performance, or more generally into ~ productivity growth, on the other, the mechanisms are much less clear. Between the rather general and exceedingly deterministic nature of models of the "New Trade Theory" type and the rather specific nature of firm case studies of successful technological acquisition <sup>38</sup> there is vast unexplored territory for meaningful explanations.

Table 5  
EXPORT PERFORMANCE AND INDUSTRIAL ORGANIZATION, 1980  
regressions

| independent variable                | Prob. of being an exporter | exports |
|-------------------------------------|----------------------------|---------|
| constant#                           | -32.15                     | 18.66   |
| foreign ownership##                 | 1.32**                     | 0.51**  |
| state ownership                     | -0.76                      | 0.25    |
| R & D intensity (RD expen. % sales) | 0.06                       | 0.26    |
| Product differentiation&            | 28.17**                    | 11.20** |
| Average wage                        | -0.09                      | -0.30** |
| Capital intensity &&                | -0.07**                    | 0.29**  |
| Vertical integration@               | -0.69**                    | -0.88** |
| Size (value added)                  | 2.53**                     | -1.09** |
| Size (value added) squared          | -0.04**                    | 0.06**  |
| Tradeability@@                      | 1.53**                     | ...     |
| Nominal protection                  | -0.44                      | ...     |
| Effective protection                | 0.12                       | ...     |
| R2 (adjusted)                       | ...                        | 0.412   |
| degrees of freedom                  | ...                        | 3.584   |

\*\* significant at 1%. # weighted average intercepts. ## foreign ownership defined as foreign equity share greater than 10%. & advertising intensity. && Non wage value added per worker in the first equation and fixed assets per worker in the second equation. @ value added to gross output ratio. @@ geographical concentration of firms.

Source: Willmore (1987, pp. 315-318).

## V. THE REFORMS

The end of the eighties witnessed a growing concern with the existing trade and industrial policy regime. The distortions created by state intervention were no longer a matter of static allocative inefficiencies unimportant to growth and development, as usually argued by neo-classic critics of interventionist policies. The process of privatization of the state had advanced to a point that a consensus was built on that the multiplication of fiscal and regulatory favors could not be justified by any rational criteria, and it was a product of the disproportionate influence of special interest groups. Popular disenchantment with the nature of state intervention in Brazil has become instrumental to strengthen the political drive towards a more market oriented economy.

The Collor administration did incorporate these concerns and announced a discontinuity regarding trade and industrial policies. Yet, practical questions regarding the reforms faced profound divisions of opinion, even among allies of the new president, and a delicate political economy. Three important areas should be distinguished: i) classical issues in trade liberalization programs, such as speed, sequencing and industrial restructuring, were given quite specific contours by the simultaneity between liberalization and stabilization policies. ii) the "re-centralization" of trade related measures, the "tariffication" of NTBs, demobilization of sectoral instruments, all posed rather complex political economy issues; and iii) the extent and nature (performance requirements, automaticity of incentives) of industrial targeting would certainly be changed, as well as the interfaces between private and public interests.

Choices regarding these issues were of crucial importance in shaping the "style" of trade policy reform the new government would favor and would be paved by lines of least resistance regarding the political economy constraints involved. The next two subsections consider developments in the areas of trade liberalization and reform of industrial policies.

## 1. Implementing trade liberalization

The reforms started in March 1990 announced a shift of emphasis to productivity growth as the prime objective of policy. This, as the first government document outlining the reforms stated, "requires the radical reform of the scope and of the traditional instruments of the country's industrial policy in which the concern with promoting efficiency gains was, at most secondary ...To overcome this deficiency requires defining a new style of industrial policy geared at stimulating competition as the rule of the game and the quest for competitiveness as the prime entrepreneurial objective".<sup>39</sup> To fulfill these objectives, so the government proposal goes, the new industrial policy would contemplate, on the one hand, a "competition policy" creating "stable and transparent rules for industrial competition" and chiefly based on import liberalization and the enactment of an effective anti-trust policy and, on the other, a "competitiveness policy", which would define "a set of instruments destined to support the growth of competitiveness of national firms", starting with a thorough revision of the current maze of fiscal and credit incentives to industrial production, investment and exports, with a view to narrowing them down to a few selective incentives to investment, and attacking market failures inhibiting technological efforts, through the provision of fiscal subsidies or risk sharing in financing of R & D projects, and creating positive externalities through massive expenditures in technical training.

The implementation of trade liberalization was conceived to take place in a phased way, following a seemingly rather conventional path. First, a rationalization of the import regime would take place, whereby most "special regimes" would be abolished. Then, the actual liberalization process would begin with the abolition of QRs and its replacement by tariffs, conceived to be "the only instrument of import policy",<sup>40</sup> and subsequently tariffs would be progressively brought down. The conventional sequence includes a real devaluation, which the authorities explicitly avoided given its likely inflationary impacts. Some appreciation was even allowed, in the tire few months of the new administration, but levels seen as adequate were enforced since.

The first step in this sequence was made together with the vast array of measures issued in the first day after the new president's inauguration, mostly aimed at inflation fighting, commonly known in Brazil as the Collor Plan. It proposed the end of some import duty exemptions under special regimes (those within investment programs imports of state enterprises and by the broadcast and movie industry), a cut in surtaxes on freight revenues earmarked to finance shipper's purchases from Brazilian shipyards and investments in Brazilian ports, the nullification of the decree authorizing the formation of new export processing zones (besides the existing Manaus Free Zone), and the abolition of the list of forbidden imports,<sup>41</sup> established by CACEX and known as Anexo C.

Although regional and sectoral lobbies succeeded in making Congress to soften the decision on export processing zones and on subsidies to shippers and shipbuilders, the rest was carried out quite rapidly. The abolition of the Anexo C was in effect in May, curiously because the government wanted to instill greater price restraint in some important sectors with forbidden competing imports -notably automobile producers- by using the threat of freeing imports and, thus, had to end import prohibition and "tariffy" the items in the prohibited list. In July, the long-standing quantitative controls administered by CACEX were relaxed, as the government announced that the issuance of import licenses by CACEX would become automatic. Shortly after, financing requirements affecting capital goods imports' were eliminated and important definitions were made to dismantle the special regime enjoyed by domestic producers of the open-ended spectrum of "informatics goods".

An interesting feature of the early phases of the Brazilian program refers to sequencing. Given the decentralized, diversified and sector specific nature of NTBs in Brazil, the sequential removal of NTBs necessarily conferred a targeted character to the Brazilian liberalization. Indeed, the elimination of the Anexo C liberalized mostly consumer goods, while the maintenance of local content requirements (only with a slight reduction in levels practiced by BNDES),<sup>42</sup> of some temporary restrictions on a list "informatics goods" and, at least initially, of external financing requirements, kept the large Brazilian capital goods and the informatics industries in a protected regime. Moreover, with the suspension of new BEFIEX contracts an

important mechanism firms could use to gain access to imported capital goods was eliminated, some segment of the capital goods and parts industry were even more protected than before.

Another feature of the early Brazilian liberalization program is the anti-export attitude visible in the suspension of new contracts in the BEFIEX program, the elimination of some export incentives and financing mechanisms and the slow speed, by the Central Bank, in reversing, during 1990, the marked exchange rate appreciation observed during the last few months of the Sarney administration. Although the appreciation would be reversed some time after, that illustrates the lack of commitment with an aggressive export policy as far as the exchange rate is concerned. This orientation stands at variance with the recent liberalization experience of other Latin American countries, who very explicitly targeted exports liberalizing inputs used therein either through import-to-export schemes or through export processing zones.

Finally, a new tariff schedule, with the projected yearly variations until 1994, was announced on January 1st, 1991 to be in force in February 15th was designed to follow a rule of concentrating the heavier reductions during the first two years on intermediate and capital goods, thus enhancing effective protection and competitiveness of consumer goods sectors. The aggregate result of this exercise is shown in Table 6.

Table 6  
THE NEW BRAZILIAN TARIFF, 1991-1994

| 1990               | 1991 | 1992 | 1993 | 1994 |      |
|--------------------|------|------|------|------|------|
| Average            | 32.2 | 25.3 | 21.2 | 17.1 | 14.2 |
| Mode               | 40.0 | 20.0 | 20.0 | 20.0 | 20.0 |
| Standard deviation | 19.6 | 17.4 | 14.2 | 10.7 | 7.9  |

Source: Coordenadoria Técnica de Tarifas, Ministério da Economia.

It can be seen that the new tariff falls rather gradually over time and protection becomes more homogeneous among goods, witness the fall in the standard deviation of the rates. Nevertheless, if one takes into consideration that the tariff in force after the 1990 round of abolition of QRs had a maximum of 105%, the extent of the projected liberalization looked quite impressive. More recently, in March 1992, the government speeded up the fall in tariffs to reach a maximum level of 35% in mid 1993.

The reform of the trade regime also comprised changes in the extensive gamut of export promotion instruments. The first attack came in March 1990, within the Collor Plan. First, the fiscal incentives conceded as income tax exemptions for export earnings, were abolished together with several other subsidies and tax expenditures as part of a comprehensive fiscal package. Second, the BEFIEX program was terminated but for the contracts then in force.

The second turn came in the June guidelines (*Diretrizes*) document, when the government announced a new export policy. According to the stated aim of this policy, the mainstay of export incentives would be export credit, and while the traditional FINEX credit lines provided by the Banco do Brasil were frozen, it was announced that a new Brazilian Eximbank would be founded under private controls. However, there were non-negligible difficulties with this private Eximbank initiative, mostly derived from the lack of interest of the part of the private financial sector in providing export finance in internationally competitive terms even with the public backing of export guarantees. Thus, to reduce the plight of some segments of the capital goods sector hard hit by the collapse in domestic demand following the early stabilization measures, the BNDES eventually stepped in creating a special line for finance of equipment exports (Finamex). Finally, in early 1992, a major attempt at restoring traditional credit incentives was made with the restoration of "interest rate equalization" financing and improved conditions for draw-back operations.

A difficult problem faced by the Brazilian authorities since inflation began to pick up again in 1991 was that of implementing a major trade liberalization program in the context of a highly inflationary economy, that is, the problem of the optimum timing between the stabilization and liberalization program. In the Brazilian case, the government strategy was designed with the intention of first stabilizing the economy and then, launching the liberalization plans. Indeed, while the stabilization program was launched in the day following president Collor's inauguration in March 1990, the decisive phase of the trade liberalization program, as described above, was scheduled for the period 1991-1994. The expectations at that time were that when tariffs would begin to fall the worst phase of the stabilization program would already be over. The fact that things did not happen according to plan in the stabilization front means that, in practice, Brazil launched a major liberalization program at a time when a strong stabilization effort is still needed. This poses some important difficulties for the management of economic policy which, if not properly addressed, may generate macroeconomic disequilibria which will substantially increase the costs of the trade liberalization program.

The most usual policy difficulty in trade liberalization programs stem from employment problems in industries deemed to shrink after the program is put into effect. Even though these problems may quite localized, they may be important given that the political requirement to block policy reforms tend to be much softer than the one for push reforms ahead. This is precisely the reason why, ideally, liberalization should be made in a growing economy: expanding sectors may absorb labor expelled from declining industries. In the Brazilian case, in which import penetration at the onset of reforms is very low (industrial imports barely over 5% of total industrial supply) and liberalization is very gradual, one may hardly forecast, in normal conditions, employment problems to become very important. During 1989- 1990, the average share of domestic demand in total manufacturing output was around 95%, against 9.5% for exports and only 4.5% for imports. In a economy such as this, the impact of a 20% rise in real imports on domestic output and employment can be countervailed by an increase of less than 1% in domestic demands

However, when stabilization is to be undertaken simultaneously with liberalization, one superimposes the fall in aggregate domestic demand caused by the stabilization program to the sectoral adjustment strains accompanying trade liberalization. The difficulties involved in this could be clearly seen when, in late 1991, the new economic team headed by Mr. Marcilio Marques Moreira implemented a policy mix based on very strict "fiscal repression" and very high interest rates following the end of the price freeze imposed earlier in that year. The success in the stabilization front was quite modest -inflation stabilized on levels slightly above 20%- and the same is true for advances in the fiscal area, considered essential to a lasting the success of stabilization. The recession, on the other hand, was quite dramatic and an important feature of which was that the reduction in levels of employment was much more significant than the one for output levels. The improvement in labor productivity, documented in many studies, is quite impressive. This behavior stands in sharp variance with the experience of other previous recessions in which productivity displayed a procyclical behavior. Apparently, efforts of adjustment to higher levels of import penetration yet to take place, would be commanding these efforts. Indeed, it is a crucial feature of the Brazilian liberalization program that the level of imports behaved quite uneventfully since March 1990. This performance, when compared to benchmark cases, such as Mexico and Turkey, is somewhat puzzling. The recession certainly plays a significant role in explaining this poor import record, but one may surely suspect that non-border NTBs still in place may be preventing a significant change in import penetration. In one way or another, the effect of the recession has been, from the point of view of many domestic producers, similar to what would happen in a liberalization program in normal conditions, though the importance of the domestic market is such that a 10% decrease in domestic demand has the same effect of a tripling of import penetration. The efforts of adjustment undertaken in the last two years seem to respond to this idealized outcome.

The political complaints centered on the consequences of the recession were mostly voiced by state governors who targeted their discontent against trade liberalization even though falling orders and rising unemployment resulted quite clearly from falling domestic demand induced by the orthodox stabilization policies and not from increased import penetration. Indeed, the true villain, as far electoral politics is concerned, is "fiscal repression" -from which state governors suffer quite directly- and high interest rates, but the commitment to orthodoxy or, at least, to avoid heterodox experimentation in stabilization policies, commands a very wide support even governors are not willing to challenge. In this connection, it was

preferable to attack what was seen as a secondary policy commitment, the liberalization program, that is not seen as having the same political weight as the anti-inflation effort.

### 3. New trends in industrial policy

The reversal of the process of decentralization of industrial policy management and generalization of incentives documented in section 3 seems to be essential for the state to regain the capacity to undertake industrial targeting. An "active" industrial policy, as Brazil has indeed conducted since the formative years of Brazilian industry, consists in creating "special conditions" for certain sectors or firms considered as priorities.<sup>45</sup> When, however, such "special conditions" are extended to nearly all producers, the targeting component is lost and the inefficiency and fiscal costs of industrial targeting became paramount. In order to avoid this degeneration of industrial targeting, surely a feature of the end of the New Republic years, "active" policies have to be limited, according to some criteria, to a few industries and/or firms. A useful principle in this connection is that any benefit accruing to "special" sectors, firms or regions of a given country, should be liable to be generalized to all "special" sectors, firms or regions without canceling the benefit. If they are not, this means that benefits are granted on clientelistic grounds. Examples of violations of this principle in past industrial policies, as seen in section 3, have been abundant to a point that one may consider Brazilian industrial policies to have fallen into a "generalization trap", i. e. the incapacity of defining exclusion criteria for selective actions given the clientelistic nature of the government.

It is interesting to see how this same trap made itself present in the Collor administration. The new industrial policy, as defined in the basic guidelines document (*Diretrizes Gerais*) published in June 1990, explicitly mentioned that "strategic choices" would be made regarding industrial targeting, and even advanced some criteria for that. Two groups of sectors should be distinguished: high tech industries - informatics, fine chemicals, precision mechanics, new materials and biotechnology- to benefit from infant industry promotion on a traditional import substitution basis, and industries "in need of restructuring". Broad as they are, these guidelines seem to be made not to exclude any one from targeting, and thus made likely the reproduction of the "generalization trap" mentioned above. In fact, given the clientelistic and corporatist nature of relations between the state and the private sector in the area of industrial policy, it is difficult to prevent industrial targeting to fall into a generalized distribution of benefits. The only obstacle to this was the fiscal crisis, that reduced very considerably the scope for fiscal incentives. A sad but likely development is that regulatory favors be used as *quid pro quo* for otherwise impossible fiscal favorings.

The corporatist nature of relations between industry and the state was also seen in a rather clear fashion in the Executive's initiative, in the early months of the Collor government, of creating the GEPS (*Grupos Executivos de Política Setorial*), sectoral groups formed by bureaucrats and business associations, inspired on the experience of sectoral chambers under the 1988 decree. Some GEPS, as the one for the auto industry, were formed right in the midst of the liquidity crisis following the Collor Plan 1, and served as an active lobbying channel for sectoral demands during these troubled months. Shortly after, in the June *Diretrizes*, the initiative was extended, as the stated government's intention was enforcing a system of "consensual planning" through the interaction of government officials and the private sector within the GEPS. Of course, this was a serious blow on the idea of having a less personal and market based relationship between the government and the private sector. Government officials justified this departure of from deregulation in trade and industrial policy making by arguing that business associations should be co-opted to the modernization project and that there was no danger of granting benefits on a clientelistic basis since the GEPS were only "consultative" (though their denomination did include the word "executive") and that commanded no discretionary benefits to be allocated.

The consolidation of GEPS was blocked by two circumstances, one, already mentioned, the all pervasive fiscal crisis and the government's unwillingness to sustain regulatory benefits such as market reserves. The second was the failure of the March 1990 stabilization plan. The relations between the economic team and industry turned sour as inflation slowly accelerated in the second semester on 1990 and the Executive blamed quite loudly "oligopolies" for irresponsible pricing practices and overindexation.

In February 1991 the government launched another stabilization plan, this one similar to "heterodox shocks" implemented during the New Republic. A price freeze was enforced and a gradual defreeze predicted. While in Congress the new plan incorporated a number of suggestions, importantly among which the creation of "sectoral chambers", initially designed to help the "flexibilization" of the price freeze. The inclusion of sectoral chambers in the Collor Plan 2 was a demand of the *Partido dos Trabalhadores* -PT as part of negotiations with the opposition towards the approval of the Plano. The key novelty was the inclusion of unions within the chambers. Vocal representatives of PT claimed the sectoral chambers to offer a mechanism for a broader policy based on negotiations of all aspects of economic policy: prices, incomes policies, trade liberalization and even the "coordination of inflationary expectations".<sup>47</sup>

The essence of the new sectoral chambers is very much an old story. Business associations of vertically related sectors coordinate their actions towards prices (passing way cost increases) and competition (establishing agreements of "local content" and barriers to entry) so as to act as a unified vertically integrated firm. It is a "mega combine" designed to shift towards the other economic agents the costs of privileges in force within the group. It is an essentially corporatist arrangement through which active minorities exploit unorganized majorities. The inclusion of unions in the "club" changes nothing of the nature of the arrangement.

Quite surprisingly, in light of his very clear liberal orientation, Mr. Marcilio Marques Moreira not only maintained the sectoral chambers but also extended quite considerably their coverage and number. Fifty one sectoral chambers are in existence at the moment, and it is quite paradoxical that the main enthusiasts of this new wave of corporatist institutions are large firms, foremost among which the auto manufacturers, and large unions notably those associated with the *Partido dos Trabalhadores*. One may legitimately ask what do the sectoral chambers of this new vintage do, given that there are no longer fiscal incentives to be granted on a discretionary basis as in the past. The answer is perhaps the key to the compatibilization of the new priorities of trade and industrial policy for the 1990s and the inherited culture in this area that is not likely to disappear very fast. Corporatism is certainly to suffer adaptations to the priorities of the time and some interesting indications in this connection is provided by the recently drawn tripartite agreement in the auto industry, which involved a coordinated reduction in profit margins and in federal and state value added and sales taxation, to produce a reduction in prices. In fact, given that the reduction in profit margins was a gross simulation, given that auto prices overshot inflation quite markedly before the agreement, the thrust of the agreement was a reduction of taxes affecting auto sales. Besides, the industry is pledging to exchange export commitments for a import quota on finished cars plus a import monopoly granted to auto makers plus import tax exemptions for parts. It is very much like a revival of BEFIEX scheme though now, what was seen as the *raison d'être* of this type of agreements, i. e. a very heavy structure of protection, is no longer there. Access to imported inputs is surely a condition to make exports viable, at least as long as the domestic industry complies with *índices de nacionalização* is of nearly 85%. In fact the only reason for such high local content requirements to be obeyed is the long standing alliance between auto manufacturers and auto parts industries which, now, is even stronger given that the presence of unions in sectoral chambers reinforces the concern with a reversal in vertical integration in the sector. Yet, as long as exported cars are concerned, access to imported inputs at world prices may surely be made through now improved draw-back facilities, so this is not really the issue. Domestic producers have been induced to export as the domestic market is very weak, and it is interesting that producers demand from the government, as a reward to their export performance, a "market reserve" in the domestic market. Although, the *Ministério* da Economia was sympathetic to the idea, objections from other segments of the Executive, including the president himself, prevented the arrangement to be turned into law.

## VI. CONCLUSIONS

This essay sought to show first that that the accumulation of distortions in the operation of the trade and industrial policy framework during the 1980s parallels the deterioration of government policies observed in the fiscal area. In both areas, distortions were such that a major effort of reform was to be necessarily undertaken at the onset of the 1990s.

The key conclusion, as far as trade and industrial policies were concerned, was that the political drive towards reform has little to do with liberal conceptions, and only to a limited extent aimed at co-opting foreign creditors or multilateral institutions. It was mostly a result of a domestic urge to revert a process of predatory privatization of the state. Liberalism appeared just as a circumstantial discourse to destroy some of the more damaging "conquests" of corporatism. The evolution of trade and industrial policy reforms has been a struggle to remove corporatist arrangements assuring privileges to interest groups. Not surprisingly, results have been mixed. The very decentralized nature of regulatory arrangements turned this struggle into a long succession of small battles, each one fought in very specific grounds. The deregulation of ports, the Manaus Free Zone, export processing zones, sectoral and regional bodies interfering with import authorizations, as well as issues like intellectual property, foreign investment taxation, privatization "at the margin" in public utilities, all such issues involved long and difficult negotiation processes within which coalitions have to be formed to defeat entrenched interests. There is no other antidote to what was called above the "generalization trap" that a patient case by case work.

## NOTES

1 The official figures registered a small surplus, but the economic team of the first civilian government claimed there was a 1.5% deficit, according to the operational concept.

2 Considering the average inflation rate for all hyperinflations known. Cf. Franco (1990b).

3 For a comparison of European and Latin American hyperinflations see Franco (1991).

4 This is visible in the zeal in maintaining and perfecting indexation, which is the crucial mechanism to assure stability of distributive shares under high inflation.

5 While debt servicing claimed, on average, a third of exports, and never more than 3% of GDP in Brazil, reparations paid by Germany claimed nearly 80%, approximately a quarter of GDP. See Franco (1991, p. 52).

6 That means basically that the Executive could ration public spending on an entirely *ad hoc* basis. This is called *contingenciamento*. It is important to note that the potential for corruption and political favoring involved in practices free of any accountability is huge. The recent wave of corruption cases and scandals in public administration is certainly related to this state of things.

7 Inflation is, in itself, a crucial factor is obscuring the management of public finances. Difficulties in indexing revenues and spending, as well as rules regarding "excess revenues", "supplements" and budgetary guidelines, turned the budget almost into an "endogenous" operation of the political market in Congress. An account of these issues may be found in Longo (1991).

8 See Tanzi (1989).

9 Sometimes, when a similar product is not manufactured, the authorities may "invite" national firms to present a prototype of the product under consideration. If the prototype is deemed acceptable the import is forbidden. In the specific case of the informatics law, to be commented in detail below, often not even a prototype was necessary besides the intention of national firms to manufacture the potential import.

10 Tyler (1983, p. 564).

11 Neves & Moreira (1987, p. 484).

12 Neves (1985, p. 67).

13 Neves (1985, p. 66).

14 Matesco (1988a, pp. 15-16).

15 Neves & Moreira (1987, p. 7) and *Gazeta Mercantil*, 25/5/90.

16 For a discussion of the dynamics of such a process, see Merhav (1971).

17 For a more detailed discussion see Fritsch & Franco (1991).

18 On price control as a device to enforce entry barriers see Fritsch & Franco (1991).

19 In some cases imports are considered at CIF values sometimes not, and the ratios sometimes are computed in terms of weight, depending on the demanding agency.

20 Art. 16, Decree 2433, May 19, 1988.

21 As forcefully argued in The World Bank (1990) *passim*. Non- contestability is used here in the usual sense, namely, as an attribute of markets in which incumbents are not threatened by entry of potential competitors.

22 For a more extensive discussion see Fritsch & Franco (1992).

23 This assessment emerged from a meeting of experts in 1988, see Matesco (1988, p. 14).

24 For a similar interpretation of the Korean policy experience, see Westphall (1992).

25 According to Bhagwati (1978, p. 216), for instance, "one cannot suppress the thought that the success stories of South Korea, Taiwan, Brazil, Singapore and Hong Kong would not have been quite so impressive if they had not been built partly on the failures of the countries sticking overly long to the IS strategy and their associated export (and associated economic) lag". Interestingly, in these same years it was also common to refer to Brazil as an example of "efficient import substitution", a qualification that fell into disuse.

26 Braga & Markwald (1983).

27 Neves & Moreira (1987, p. 484).

28 Concerns have also been voiced on the possibility that benefits were distributed on a regressive fashion. Braga (1981).

29 As hypothesized, for example, in Teitel & Toumi (1986).

30 As explored, for example, by Fritsch & Franco (1992-a).

31 Examples are Krugman (1984) and Rodrik (1992).

32 For a survey see Scherer (1984).

33 "There is no clear cut confirmation of the hypothesis that countries with an external orientation benefit from greater growth in technical efficiency in the component sectors of manufacturing; if combined with the relatively small static costs of protection, this finding leaves those with a predilection towards a neutral regime in a quandary", cf. pack (1992, p. 38). Indeed, the fact that the empirical arguments for defending export promotion *vis-à-vis* import substitution on the grounds of technical efficiency are simply not there, was even admitted by Bhagwati (1988, pp. 39-40). For a more recent discussion reaffirming these results see Tybout (1990).

34 Willmore (1985, p. 620)

35 Firms controlled by holdings established in Brazil but controlled by foreign residents were considered national firms. See Willmore (1985, pp. 624-625).

36 Whose combined exports represented 74% of Brazilian manufactured exports.

37 Note that holding the price of the final product constant, an increase in the EPR means a reduction in the price of intermediate inputs, which is equivalent to a production subsidy given by the capacity to by-pass the structure of protection, presumably, by a special import regime.

38 See Katz (1984) for a review.

39 Exposição de Motivos n. 248, Medida Provisória n. 2158, March 16, 1990.

40 Ministério da Economia (1990).

41 Although the previous government had began reducing the items on the list under OS pressure, the list still comprised over one thousand items out of the 13 500 in the Brazilian tariff schedule.

42 From 70% to 60% in credit operations under the FINAME credit line, designed to acquisition of capital goods.

43 See Fritsch & Franco (1992).

44 See Fritsch & Franco (1992).

45 Industrial targeting is defined here on the lines of Krugman (1987), as the effort to change the allocation of investment among industries so as to favor industries in which the market is believed to underinvest.

46 See Serra & Franco (1991).

47 Aloisio Mercadante "Crise da industria automobilistica e câmara setorial" *Gazeta Mercantil* 28/3/1992 and Paul singer "Câmaras setoriais -pouco demais, tarde demais *Folha de São Paulo* 27/4/1992.

48 Interestingly, the proposed agreement is very similar to the one made in Mexico, an example often quoted in the Brazilian debate. A comparative analysis is certainly interesting but beyond the scope of this study.

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