

THE POLITICAL ECONOMY OF BRAZILIAN TRADE POLICY: DOMESTIC
DETERMINANTES, WORLD AND REGIONAL STRATEGIES

by

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Abstract

This dissertation discusses the political and economic forces, both external and domestic, that shape Brazilian trade policy. It focuses on Brazil's trade strategy vis-à-vis the world scenario, marked by concurrent multilateral and regional integration processes.

The discussion is carried out, especially, in the North-South negotiations the country was involved in the 1990s and 2000s, in a context of changing world economy, against a backdrop of domestic institutional framework. Therefore, despite exogenous forces, e.g. Washington Consensus structural reforms, which have changed economic policymaking toward the path of orthodoxy, I claim that certain policies are a function of the slow-changing domestic characteristics; hence, they have preserved characteristics of the past. Trade policy, for instance, after a steep unilateral drop in tariffs in the late 1980s and early 1990s, experienced piecemeal change; whereas, "industrial subsidies" were maintained and even reinforced in the period (1988-2005). I describe how these domestic policy choices shaped Brazilian strategy in world affairs: the country opted for an autonomous position, characterized by a regional integration initiative (Mercosur) and by a firm negotiation position at the multilateral sphere (World Trade Organization), while it shirked from commitments with developed countries (at the Free Trade of the America and at the European Union-Mercosur negotiations).

I applied political economy theories and methods from Economics, International Relations and Political Science. This interdisciplinary approach is expressed in the combination of different methodologies in the study.

Initially, I explicate, using a historical-comparative narrative, economic development choices (import-substitution industrialization), the domestic economic

institutions and bureaucracies and their interaction with interest groups as determinants of trade policy. Secondly, I explain the interaction of “globalization” and world economy forces with Brazil’s domestic responses. Afterward, panel data econometric analysis, with data of ten industrial sectors over seventeen years, is used to understand the position of these sectors regarding trade policy. Neoclassical international trade theory (Heckscher-Ohlin and Ricardo-Viner), as well as more modern trade theories (new growth theory), assumptions are tested to the Brazilian case. Results show that collective action and factor endowments variables explain patterns of protection/support. Finally, I discuss contemporary Brazilian foreign trade trends using descriptive data

Introduction

Section I - The Research Problem

The purpose of this dissertation is to understand the contradictory political and economic forces that shape Brazilian trade policy, with an emphasis on both external and domestic influences. It will focus on Brazil's trade strategy vis-à-vis the world trade scenario, marked by concurrent multilateral and regional integration processes. My fundamental aim is to explain the ways in which trade tariffs have been gradually liberalized in Brazil since the 1990s, while subsidies in some product lines are still the norm. This dichotomous trend has evolved against the backdrop of a predominantly mercantilist and protectionist discourse that has prevailed over this time period. Through an analysis of ten manufacturing sectors that I conduct here, I infer that tariff liberalization is largely a result of Brazil's increasing commitment to global trade integration under the auspices of the 1994 Uruguay Round agreement and the World Trade Organization (WTO), whereas the government's maintenance of hefty trade subsidies reflects the continued resistance of domestic producers to deeper levels of trade integration. Taking the global context into account, throughout this dissertation I emphasize that Brazilian trade policy preferences and negotiation strategies are a function of the country's domestic political-economy and institutional characteristics.

Concurrently with the domestic forces, Brazilian trade strategy is also shaped by phenomena, known broadly as *globalization*, which influence the content and the subjects of negotiations and the outcomes of the agreements themselves. Broadly speaking, economic globalization brings about forces that affect the flow of trade and investments among countries. These new trends are tackled at the agreements, spurring more encompassing rules that go beyond tariff and border measures. Thus, in addition to traditional themes such as tariffs, contemporary trade agreements have

been characterized by *new* themes also called *deep integration* issues. These new themes have impacted on the North-South negotiations Brazil was engaged recently, that is, the Mercosur-European Union agreement and the Free Trade Area of the Americas (FTAA). The discussion of the negotiation setback is a main source of concern of this dissertation. Additionally, how these contemporary North-South trade negotiations have interacted with other trade policy fronts, especially at the multilateral level (WTO). Finally, how the external trade policy agenda impacts in policies toward domestic economic sectors and in the domestic reforms that were implemented in the 1990s.

What are the new trade themes and why have they become so important for a developing country and emerging market economy such as Brazil? Broadly speaking, the new trade themes involve regulations, rules, and standards, some of which pertain to international legal norms, rather than trade in actual physical goods. Deep integration issues encompass not only the flow of goods, but also the overall regulatory environment for carrying on business. For example, rules surrounding investment are included in the category of new trade themes because these affect the decision of multinational companies to establish overseas subsidiaries engaged in the production and trade of goods and services. The same explanation holds for Intellectual Property Rights (IPRs): the greater the protection for intellectual property, the more likely foreign investors will transfer sensitive technologies to their overseas subsidiaries. These examples highlight the differences between traditional trade issues, such as market access or tariffs, and the new trade themes. Certainly, the traditional trade issues can also involve standards and regulations, as in the case of Non-Tariff Barriers (NTBs). But for my purposes, the main distinction is between

negotiating over traditional physical goods and new trade-related rules and regulations.

These new trade themes have important implications, not only for international economic relations, but also for domestic economic structures and evolving institutional frameworks within the emerging market countries. In fact, one prominent explanation for the rapid proliferation of regional integration agreements (RIAs) in the 1990s is that they facilitate the adoption of rules governing new trade issues by the developing countries. Not surprisingly, the new trade themes have been taken up most vigorously in the context of North-South international trade talks (e.g., NAFTA, Mercosur-EU, FTAA). Both in the multilateral setting and within more recent regional integration arrangements, developed countries have been pushing for more comprehensive rules around IPRs, investment, and services in order to adequately protect property rights in such sectors as telecommunication, software and pharmaceuticals. These areas are intensive in knowledge requiring large investment costs in terms of R&D, labor force training and even sunken infrastructure costs. As economic theory explains, risk-averse economic actors, when making decisions to invest in emerging markets, wish to minimize the possibility of losses. From this it follows that the adoption of rules under trade integration agreements by developing countries signals their willingness to respect those property rights that are crucial for direct investment decisions.

In spite of the North-South divide and the clear comparative advantage of the developed countries, deep integration issues raise vital questions concerning technological externalities and economic productivity gains. In other words, in that they shift domestic regulations toward more efficient, market oriented economic and institutional structures, new trade themes raise questions that affect both North and

South. Moreover, it is believed that economic and institutional evolution may be enhanced with closer integration of a developing country into the world economy, as recently discussed in the literature on economic regionalism and economic development. Other aspects of RIAs, such as imperfect markets for competition, increasing returns to scale, the geographic clustering of industries are crucial to these trade themes. In a world economy dominated by capital and knowledge-intensive sectors, the dynamic features of localization of productive plants and intra-industry trade seem to provide a major rationale for the growing interest in regionalism, which in turn has pushed new trade themes to the top of the negotiating agenda.

Given the dynamic potential of these new trade issues, some sectors in the less developed countries are clearly eager to exploit scale economies and enhance their levels of international competitiveness. But other sectors in Latin America fear the distributional and adjustment costs. This is especially true for Brazil, where those sectors related to the new trade issues remain highly protected (capital intensive sectors such electronics and the automobile industry). The next section summarizes some of the main international and domestic influences on Brazilian trade policy.

Section II - The Brazilian Case

In the first half of the 2000s, Brazil was negotiating the creation and/or the deepening of trade integration arrangements with a number of commercial partners, including: regional negotiations for the FTAA; negotiations with the European countries as part of the Mercosur-EU agreement; and, negotiations between Mercosur and other Latin American Countries (Mexico, Chile) and with the Andean Community. With the exception of the last agreement, these talks experienced delays and are currently stalled. Concurrently, Brazil has been much active on the

multilateral front at the World Trade Organization (WTO). Historically, Brazil's trade strategy has been to promote the multilateral forum of the GATT/WTO as the best option for developing countries to challenge the economic hegemony of the developed countries. The Labor Party government, led by President Luiz Ignacio da Silva ("Lula"), has been most forthright in pushing this line of the Brazilian economic foreign policy, even more so than his predecessors. Brazil's more assertive stance has been especially apparent since the launching of the Doha Development Round in 2001.

At the Doha/WTO meetings, Brazil and other similar developing economies moved to form the G-20 group, its purpose being to present a joint proposal for the liberalization of crucial markets (agriculture) and to protest the distorting consequences of subsidies upheld by the developed countries. Within the G-20, Lula's government has pursued a bilateral trade rapprochement with India, Russia, China and South Africa, in a move that indicates its renewed commitment to South-South integration. This shift has even been criticized by some as a "third world" bias of the Labor Party government foreign policy. However, as I will show in the dissertation, an independent foreign economic policy has been a long-standing concern of the Brazilian diplomacy, notwithstanding the incumbent government. Brazil's emphasis on a multilateral and autonomous strategy is understandable since its diversified portfolio of trade partners now renders the country a "global trader". See, for example, table 12 in chapter three, showing the breakdown of Brazil's exports by region of destination from 1997 to 2005. In 2005 it was: 22 percent to the

EU; 18 percent to the US; 14 percent to Mercosur, Chile and the Andean Pact, and 12 percent to Asia¹.

Clearly, as regionalism has become an increasing tendency in the international political economy, Brazil has joined step and actively sought membership in RIAs. Curiously, prior to the debt crisis of the 1980s, Brazil rarely engaged in RIAs and instead opted for an autarkic trade strategy that sought to exploit the considerable size of its domestic market. In 1990, the Collor administration could no longer ignore the failures of protectionist policies. Unilateral trade liberalization was launched concurrently with the creation of Mercosur---a South-South RIA that formed a common market between Brazil, Argentina, Uruguay and Paraguay. After an initial phase of intra-regional boom within Mercosur, both in terms of volume and prices, this RIA fell on hard times in the late 1990s. These difficulties were caused partly by external macroeconomic shocks, such as the Asian and the Russian crises, but also by the misaligned macroeconomic (exchanges rate) and fiscal policies of the Mercosur partners.

Although Mercosur continues to experience both political and technical difficulties, it did signal an end to protectionist import-substitution-industrialization (ISI) strategies in these countries. At the same time, some analysts are quick to point out that Mercosur has upheld a number of trade exceptions that are more characteristic of the past. To the extent that this is true; the discussion of new trade issues and future integration options for Brazil are highly relevant. The enlargement of Mercosur, the possible joining of Venezuela and Bolivia, adds complexity to the problem, since the former has adopted a bold confrontational discourse towards negotiating trade talks with the U.S.. On the other hand, other Latin American

¹ The emphasis here is to show that Brazil is a global trader. In chapter four, I also discuss differences in product content, market destination and technological intensity.

Countries (Central America, Chile, Colombia, and Peru) have opted toward bilateral trade agreements with the U.S., showing how polarized the Western Hemisphere trade policies are becoming.

The biggest challenge for Brazil to overcome will be the political and economic obstacles intrinsic to integration with the more advanced economies. Obviously, the prospect of joining a free-trade area with the biggest and most advanced economy in the world---that of the United States---creates opportunities but also inevitable tensions within business and governmental sectors in Brazil. The negotiations for an FTAA were a prime example of the attempt to bridge this North-South divide. In line with this endeavor, U.S. trade officials made it clear that the goals of the FTAA and in the bilateral agreements should be the pursuit of a WTO-plus outcome involving issues of deep integration. For many small Latin American nations with non-diversified economies, the stakes for achieving a WTO-plus outcome are very high. Perhaps, the best strategy would be to accept the injunctions of the new trade issues and foster new knowledge based sectors, while also seeking the best possible terms on market access and agricultural trade. The North-South division of comparative advantage is taken as given: the North sells high value-added goods and services, while the South sells agricultural, mineral and other low value-added products.²

Nonetheless, countries such as Brazil, Mexico and Argentina have considerable industrial strength and even possess some important knowledge intensive sectors. The explosive growth of intra-industry trade and the importance of geographical location add dynamic complexity to the formerly simple notion of the North selling high value-added industrial goods and the South selling agricultural and

² According to neo-classical trade theory, specialization, brought about by trade liberalization, enhances world welfare despite inflicting distributive gains and losses within individual countries.

low-skill products. Thus, the negotiation of RIAs linking North and South may raise difficult distributional issues, but the benefits related to the transference of technology, adoption of best practices, and the prospects of heightened flows of foreign direct investment are also creating domestic incentives and lobbies for liberalization.

On the other hand, Brazil and, other Latin American countries, have maintained trade and industrial policies that are more aligned with the an “interventionist”, state-led development model, that clashes with the “market driven” globalization forces. This policymaking choice benefits some special interest groups, but stalls market reforms, especially the so-called second generation reforms (SGR). I discuss the connections and complementarities between market reforms and deep integration issues, which were overlooked by Brazilian economic actors and policymakers in the trade discussions of the first half of 2000s. The reluctance to tackle the discussion of deeper integration themes within the WTO, the FTAA and also the EU-Mercosur is a function of the domestic political economy forces - including policymaking discretion -, which I will discuss in this dissertation

Although the Lula administration has committed to pursuing these new trade issues at the WTO, with the breakdown of the Doha ministerial meetings, North-South regional integration agreements could have been a more promising path for deepening market reforms in Brazil and the rest of the region. Just as an RIA like Mercosur was the first step toward locking in Brazil’s economic reforms, North-South RIA path in the form of the FTAA or a Mercosur-EU agreement would be the next logical steps for an emerging market country such as Brazil, willing to foster domestic reforms. However, this logic economic step has been stalled by political and ideological inclinations of the foreign policy decision makers and of interest groups,

derived from either misperception regarding contemporary international economic order or clear rent seeking behavior. In this dissertation, I will examine the political economy forces that may have influenced such outcome, using institutional-historical and statistical approaches.

The literature review in the next section will provide the main theories regarding the political economy of multilateral and regional trade agreements and institutional and economic development, so that I can put the Brazilian case in a comparative perspective.

Section III - Literature Review

In this section I review the most relevant political economy literature with regard to:

1. Multilateral and regional trade integration, with a focus on the latter;
2. Trade liberalization, domestic reforms and the role that domestic actors play in this process;
3. Economic and institutional development, including trade, technology and innovation strategies.

Given the broad scope of these themes, my purpose here is to offer an overview of the literature as it relates to the Brazilian case. Throughout the dissertation, I will make use of the literature reviewed here and provide additional sources.

Multilateral and Regional Trade Integration

From the standpoint of the IR/IPE literature, Hegemonic Stability Theory (HST) is perhaps most pertinent to my study. HST argues that the presence of a hegemonic leader in the IPE is a necessary and sufficient condition for the establishment and maintenance of a liberal economic order (Krasner 1976; Keohane 1997). This was the basic structure of the IPE after World War II, when the Bretton-Woods institutions were created under the auspices of US leadership and a liberal democratic ideology. One possible explanation for regionalism, from the HST perspective, would be that a declining hegemon undermines the liberal order and leaves weaker countries little choice but to gather around the area of influence of a regional hegemon. At the same time, HST tells us that the consequence of a declining hegemon for the international trade system will be mounting protectionism at the international front, whereas preferential trade agreements abound (Baghwati and Panagariya 1996).

Another point of view emerges from the Liberal-functionalist literature within IR/IPE. Here, countries co-exist in an anarchical international environment, and thus seek forms of cooperation through international institutions so as to offset asymmetric information and uncertainty within the international system (Keohane 1984). According to the tenets of Liberal-functionalism, the search for institutions holds whether or not the international arena is dominated by a single hegemon and even in the case of a declining one.³ Thus, countries seek to establish multilateral, minilateral and bilateral institutional mechanisms (Yarbrough and Yarbrough 1987), also called regimes (Ruggie 1982), to guarantee a more stable international system. Since RIAs are minilateral initiatives, the advent of regionalism in international trade can be understood on these grounds. Having said this, and in light of the decreasing tariffs in

³ This strand of theory qualifies the use of power in different issue areas. For example, in the area of continental trade the use of power by a hegemon has been posited as subtle, what Tulchin (2004), quoting Joseph Nye, call “soft power.”

Latin America since early 1990s, it seems clear that a decline in hegemony – U.S. shares economic hegemony with other world players - will not necessarily bring about protectionism. But the rise of RIAs also demands further explanation.

According to traditional economic integration theory, trade creation and trade diversion are the overriding effects of preferential trade agreements and customs unions (Viner 1950, Johnson 1965)⁴. RIAs are, therefore, second best alternatives, and unilateral opening and/or liberalization via the multilateral trade system offer better efficiency/welfare gains (Bhagwati and Panagariya, 1996). Yet, in line with a new wave of research on RIAs, in the absence of trade diversion effects and discrimination against third parties, RIAs may create the same level of efficiency and welfare; Krugman and Obstfeld 2003; Feenstra 2004). This is due to the dynamic effects of deep integration and the greater possibilities of engaging in constructive collective action at the regional level (Wise 1998; Wise 1999, Schiff and Winters 2003, chapter 2).

The debate about the choice and consequences of the RIA route has become a main theme in the IPE literature. Various analysts have asked: are RIAs complementary to the multilateral system or are they a more subtle form of protectionism? Are they building blocs or stumbling blocs to the multilateral order? Answers to these questions do not come easily, as empirical analysis of RIAs makes many qualifications necessary. In the early post-Second World War era, RIAs were security oriented and thus designed to complement the multilateral trade rules embodied in the GATT, as exemplified in the design of the European Community (Moravscik 1991). In the case of Latin America, RIAs demonstrated a similar trend: a

⁴ Trade creation occurs when two countries joining an RIA trade more than previously because there has been a positive effect from the removal of tariffs, i.e. both countries are using their factors of production more efficiently. Trade diversion results when two countries trade more due to the imposition of higher tariffs on non-member countries; the latter could still provide more efficient goods were it not for the application of tariffs related to the RIA.

first phase of RIAs were mainly defensive attempts to foster a development model based on import-substitution-industrialization (ISI) and thus relied heavily on tariff walls and restrictions on FDI. More recently, RIAs were launched under the aegis of open regionalism and as a response to external shocks and the need for deep structural adjustments (Edwards 1995; Haggard 1997; Haggard 1998; Wise 1998; Wise 1999, IBD 2002).

Trade liberalization, Structural Reform and the Role of Domestic Actors

This recent upsurge of RIAs can thus be understood within the new context of economic globalization and the domestic preferences of countries that adhere to this trend. As trade liberalization and intra-industry production in Latin America have placed a premium on increased economies of scale and the clustering of factor inputs (Schiff and Winters 2003, chapter 5), policy preferences have changed (Mansfield and Milner 1999). From the perspective of economic theory, the idea of clustering has been a key element of growth and innovation since the works of Schumpeter (Schumpeter 2004; Day 1984). From this standpoint, RIAs could be seen not as failure of the multilateral system, but rather as a direct consequence of the success of multilateralism and a way to guarantee its survival (Ethier 1998, 2001, Baldwin 2006). As those with a vested interest in the new trade issues lobby governments to join an RIA (Milner 1997, Chase 2003), the expansion of regionalism in Latin America can be understood in terms of the preferences of national policymakers and those domestic interest groups engaged in global trade. In the case of industries characterized by increasing returns to scale, for example, joining a free trade area could lead to more dynamic outcomes because it increases the size of markets and the rate of productivity growth.

The variations in trade policy among countries with different resources spawned a literature on how factor endowments influence the policy outcome. Known as endogenous trade theories, these consider the political arena as a market where there exists a supply and demand for protectionist policies. These theories can be applied to understand reforms in the areas of structural adjustment and trade liberalization in Latin America. Ronald Rogowski (1989), for example, uses the Heckscher-Ohlin (H-O) model to explain how trade affects policy outcomes and the political behavior of domestic actors. In short, these political actors who own the poorly endowed factors of production will lobby against trade integration; conversely, those who own abundant factors will support and benefit from trade. Free trade decreases the welfare of the owners of the scarce factor and increases that of the owners of abundant factors. Lobbying may occur along factor lines---capital vs. labor--as in the application of the Stolper-Samuelson theorem; or it may manifest along industry lines (e.g. import competing versus export oriented sectors) – which is the crux of the Ricardo-Viner-Carnes hypotheses (Magee et al 1989). In another variation, Grossman and Helpman (1994) derive an equilibrium structure of protection as a function of the state of industrial organization (market power), trade dependency and the elasticity of import demand or export supply. The Magee et al approach means that trade policy may vary dramatically with a change in government. The Grossman-Helpman (1994) model implies that political capture gives rise to an unchanging or slowly changing equilibrium trade policy (Noland 1997).

The broader context for the enactment of endogenous trade policies is that of a two-level game in which the government needs to deal simultaneously with its domestic constituencies and its international institutional commitments (Putnam 1988; Rosendorff and Milner 2001). Some authors have found that endogenous trade policy

can have important implications for developing countries; for example, Grether, de Melo and Olarreaga's (2001) work on the Mexican case, and Chen and Feng's (2000) research on China. Yet, earlier liberalization influences policy outcomes and the whole process should be understood in a dynamic and complex framework. In the Mexican case, for example, the owners of the scarce factor, capital, lobbied policymakers in favor of trade liberalization because of their deepening engagement in intra-industry commerce and production with the US (Pastor and Wise 1994); a first round of deep liberalization in 1985-87 then set the stage for the country's later entry into NAFTA. Bearing in mind the principal lines of endogenous trade theory, a closer look at the relationship patterns between business and governments in the developing world, in Latin America, indicates a significant variation in terms of trade policy preferences and strategies (Maxfield 2004, Sáez 2005).

The literature on structural reform in Latin America sheds light on the changing tastes of policymakers and interest groups with regard to the direction of economic policy.⁵ The literature on structural reforms in Latin America, also known as the "Washington Consensus," is extensive. Overall, such reforms included a macroeconomic component in the search for monetary stability, fiscal balance and real exchange rate adjustments; on the microeconomics side, the reforms were geared toward trade openness/liberalization, privatization of state owned assets, and economic deregulation. In short, stabilization and fiscal-macro reforms were easier to implement because the future gains were more perceptible and the pain of adjustment was spread across the entire population. Trade-regulatory reforms, on the other hand, involved more localized distributive consequences that left small, but vocal, groups

⁵ For a summary and overview of the content and preliminary outcomes of this project, see Rodrik (1996) and Kuczynski and Williamson (2003). On the logic of collective action, protection of localized interests, see Olson (1967).

worse off. Thus, logic of collective action – protection of localized interests - would hinder such reforms (Olson, 1967).

The critical turning point was the deteriorated macroeconomic conditions that led to the 1982 debt crisis, which in turn created a series of incentives and payoffs conducive to reform. In contrast to the political economic stalemate characteristic of the pre-debt crisis era, some political actors finally agreed to bear the adjustment burden associated with deep economic reform (Alesina and Drazen 1989). In the case of trade liberalization, the policy shift stemmed not only from macroeconomic difficulties---high inflation, fiscal deficits and overvalued exchange rates---but also from microeconomic imbalances, including the declining terms of trade and lack of competitiveness of Latin American goods on world markets (Rodrik 1994). Thus, after implementing unilateral trade liberalization, countries quickly sought RIAs in order to “lock in” policy modifications and to signal to international investors and financial institutions their willingness to credibly commit to market friendly policies and institutions (Edwards 1995). In the Western Hemisphere, this trend can be observed in the case of NAFTA and Mercosur. This example also applies to the smaller European countries that have more recently sought membership in the EU.

The political economy literature has more recently turned its attention to the importance of further reforms---the so-called Second Generation Reform (SGRs) agenda---in order to advance productivity gains and competitiveness, as well as to improve living standards and human development (Navia and Velasco 2003; Sachs and Vial 2002; Pastor and Wise 1999; IMF 1999). To the extent that SGRs include institutional and human capital improvements, they may enhance innovation and

technology absorption, both of which are essential inputs for economic development⁶. In addition, SGRs are related to the deep integration agenda, since RIAs have increasingly encompassed institutional and regulatory improvements, such as rules governing investment. For example, concerning a country's ability to attract FDI, a RIA can help not only in the crafting of the proper regulatory environment, but also in dissuading a given firm from investing elsewhere (Blostrom and Kokko 1997). Although there are debates concerning the direction of causality, the political economy literature has shown a high degree of correlation between institutional improvements and integration into the world economy---which may or may not occur within an RIA framework.⁷

Economic and Institutional Development

Since my study concerns RIAs, it is worth discussing a previous academic debate that relates to openness and development. As in the case of institutional evolution, this relationship is somewhat unclear, with endogeneity and causality going both ways. There is agreement that the simple removal of tariffs is insufficient to promote growth and that other factors contribute to economic development, including differences in the institutional framework and the actual content of trade policies (Rodrik 1993; Rodriguez and Rodrik 1999; Baldwin 2003). Bardhan and Udry (1999, chapter 14), in a literature review, report mixed results concerning the effect of trade on development and they state that a certain level of protection, in some selected

⁶ The recent literature on economic development has been attempting to explain differences in growth and development among countries using non-traditional economic variables, such as the level of education of the population, institutional design and even the accumulation of social capital (Temple 1998; Fukuyama 2000; Easterly and Levine 2001). Authors such as North (1990) and Pierson (2004) also emphasize the historical importance of institutions (*path dependence*) in economic development (North 1990; Pierson 2004).

⁷ The consequences of closer integration into the world economy can vary depending on whether a country or region pursues a unilateral, regional or multilateral framework. Integration under the auspices of an RIA, for example, offers a different set of economic and policy incentives (Lawrence 1997; Schiff and Winters 2003, chapter 6).

moments and sectors, may be optimal for developing countries. On another note, Frankel and Romer (1999) argue that, controlling for size and the geographical characteristics of countries, the impact of trade opening on income is positive.

The degree of integration of a country into the world economy seems to be an important source of economic development because it spurs dynamic changes throughout the economy. New Growth Theories suggest that international knowledge spillovers can occur as a result of trade in goods and FDI (Romer 1990, Grossman and Helpman 1991). Coe, Helpman and Hoffmaister (1997) and Greenaway, Morgan and Wright (2002) applied these insights to the developing countries, observing that the growth of Total Factor Productivity (TFP) in developing countries is positively related to the stock of R&D capital of industrial countries.

Consider, for example, the case of intellectual property rights, one of the principal themes of the deep integration agenda. There are multifaceted implications for the protection of IPRs, FDI flows, the absorption of foreign R&D, and economic growth (Gould and Gruben 1996; Smarzynska 2005; Maskus 2000). Overall, these studies indicate the positive effects of IPR protection on FDI, foreign R&D absorption and growth. Bardhan and Udry (1999, chapter 14) indicate mixed results, though, according to them not granting foreign IPR may be optimal for developing countries in certain moments. The literature also discusses that the integration in the world economy does not exclude domestic efforts in innovation and R&D investments. Diao, Roe and Yeldan (1999) verify that the positive effect of trade openness in the absorption of foreign R&D stock will be greater if countries are able to process the body of foreign knowledge according to their own characteristics, which opens the way for the generation of domestic R&D. Similarly, Ocampo (2004) observes the importance of linkages between inward and outward oriented sectors for TFP growth

in Latin America. Katz (2000) highlights the existence of national systems of innovation in the recent experience of industrial policy and trade liberalization in Latin America as posits these as necessary conditions for beneficial integration with the world economy. Finally, Lederman and Maloney (2003; 2006) examine patterns of R&D investment and development. Their findings verify that, although rates of return for R&D investments are higher for developing countries, other institutional variables count in R&D investment decisions. They suggest that countries with national innovation systems and institutions may be better equipped to integrate into the world economy.

In brief, the literature seems to indicate that openness is a necessary but not sufficient condition for economic development. Other policies and the institutional background of the countries matter and play a crucial role. Due to the knowledge intensive characteristics of the dominant sectors of the world economy, educational and R&D policies and institutions are increasingly required to spur the benefits of trade integration. Otherwise, the absence of complementary policies may reinforce the adjustment costs and the possible deleterious effects of sudden and excessive trade liberalization on developing countries (Ocampo and Taylor 1998), not to mention the differential adjustment burden that falls on small and medium-sized enterprises (Nugent 2002).

Locating the Brazilian Case in the Political Economy Literature

The literature that I have thus far reviewed seeks to present a rather generic view of the possible effects of integration on the countries concerned, but what results can we expect for an emerging market country such as Brazil? Recent studies suggest that there has been TFP growth under unilateral trade liberalization and as a result of Brazil's membership in Mercosur (Ferreira and Rossi 2003; Lópes-Córdova and

Mesquita Moreira 2004). Other studies suggest that trade liberalization has reduced skill differential earnings, improving the returns of unskilled in comparison to skill-intensive labor and that tariff decreases have impacted more intensively in relative prices of skill-intensive sectors (Gonzaga, Menezes Filho and Terra 2006).

Yet, further trade liberalization mechanisms, such as those envisaged with the country's participation in an RIA such as the FTAA remains hotly contested, while the issue of trade policy has been regarded as more of a political than a technical matter. Some Brazilian policy actors argue that deeper integration and trade liberalization could increase the absorption of foreign R&D and spur growth, whereas others consider it as a threat to the country's ability to carry out autonomous domestic development policies. During the early 2000s, the Brazilian financial media exposed the cautious position of the country's team of trade negotiators toward the deep trade agenda under discussion in the FTAA negotiations. According to these negotiators, such new trade themes should only be discussed within the multilateral context of the WTO.⁸ In brief, to many in Brazil, particularly those nested and the policymaking circles, the new trade themes touted by the FTAA and EU-Mercosur discussions boil down to the following: a polarized debate that casts developing countries as imposing its policy preferences for a deep integration agenda in new trade issues where these countries clearly have comparative advantages, while simultaneously conceding little in areas that matter most to Brazil (e.g. market access, subsidies and, principally, agriculture).

My task in the dissertation will be to analyze the process and outcomes of Brazil's stance in world trade politics by utilizing the relevant political economy

⁸ See, for example, Clóvis Rossi, "Brasil rejeita a ALCA teológica e ataca os EUA," *Jornal Folha de São Paulo*, October 1, 2003, p. B02. See also Clovis Rossi "Ceder na ALCA é hipotecar futuro, diz Amorim," *Jornal Folha de São Paulo*, February 15, 2004. p. B02. On the official position, Guimarães (2004), Deputy-Minister for Foreign Affairs, also presents a skeptical view of the FTAA.

literature and methods. From the standpoint of the dissertation, the findings from this literature will be applied, compared, and contrasted with the political economic dynamics that underpin the prospects for Brazil's foreign trade policy. First, I will locate Brazil's development process historically within a region where industrial development was invariably carried out by a "developmental state" that relied on significant protectionism (Evans 1995; Schneider 1999; Chang 1999; Wade 2004).⁹ Despite more than a decade of efforts at trade liberalization, the managed trade and industrial policy still characterize Brazil's regional integration strategy, as witnessed in its actions within Mercosur and in the positions that Brazil espoused at the FTAA and EU-Mercosur negotiating tables (Masi and Wise 2004, Wise 2004).

Second, my assessment will provide evidence on the ways in which the preferences of certain sectors of society and government have shaped Brazil's trade strategy (Fishlow 2004; Guilhon de Albuquerque 2003, 2006; Viola and Pio 2003). As evidenced in the historically protectionist nature of Brazil's foreign economic policy, protectionist producers in the importing competing sectors have aligned with some segments of the state bureaucracy in determining the role of the country in the international political economy (Motta Veiga 2004). Of necessity, this longstanding status quo has gradually given way to a more open trade strategy, although there is scant research on the inner working of this process. In the dissertation I intend to explain the differences within the Brazilian government and society regarding deep integration vis-à-vis the FTAA and the EU-Mercosur, including the conflicting ideologies that have become embedded in the negotiation process and the complex political economic cleavages that drive them.

⁹ Historically, state intervention provided mixed results in terms of development, as reflected in the different economic performance records of East Asia and Latin America. This differential performance is the source of much unsettled debate in the literature concerning the efficacy of state versus market-oriented approaches to development (Schwarz 2000).

Third, in pursuing these research questions I will rely on both qualitative and quantitative methodologies, as well as on inter-disciplinary analysis. For example, in addressing the role of ideas and policy preferences in shaping Brazilian foreign economic policy, I will use a set of qualitative theories, as well as historical explanations. But at the same time, I will attempt to quantify the degree of causation between such variables as domestic tariffs, state subsidies, collective action, factor endowments and trade shares (exports and imports) of industrial sectors and the possible consequences of all these variables for policy outcome in the country.

Section IV - Methodological Organization of the Dissertation

Objectives

The main contribution of this study to the field of lays in the application of the theoretical and empirical political economy tools to the Brazilian case study. Given the political and economic relevance of Brazil in international economic relations, such a case study promises to enrich the literature on emerging markets, trade integration, and Latin American development. In carrying out an interdisciplinary study of this nature, a main goal will be strengthen the dialogue between such fields as political science, international relations and economics.

My dissertation will seek to inform the controversial policy debate in Brazil over the question of trade liberalization/integration. In this respect, the dissertation will also be policy oriented, i.e., concerned with discussing current and relevant events intrinsic to policy-making process and the possible application of empirical results into actual policies. Although Brazil has undertaken any number of trade negotiations, its decision to join trade free trade areas or to commit toward deep integration issues has been stalled due to political economy forces, which might be holding out potential gains, for example, in terms of productivity enhancement or

modernizing changes in the country's institutional structure. Unveiling the forces that hold out the process, can inform the negotiation strategy of the country toward a more rational path. In the end, although Brazil will be my main focus, the results of my study may be useful for other developing countries seeking to reap the gains and mitigate the losses associated with new trade liberalization and deeper North-South integration.

Hypothesis and dependent variable

This dissertation will evolve around three clusters of theory described in the previous literature review:

- 1) Endogenous trade policy and economic explanations for trade policy and politics;
- 2) New growth theories of economic and institutional development due to international economic integration;
- 3) Institutional-bureaucratic politics and ideas-ideology influencing trade policy outcomes.

The underlying working hypothesis of the dissertation is divided into two main arguments:

- 1) International economic shocks/trends and the demise of domestic economic models (ISI non sustainability) change policymaker's and interest groups' preferences, hence, opening up the opportunity for (trade) policy reforms.*
- 2) However, entrenched domestic institutional/bureaucratic actors and structures, as well as the ideological biases embedded therein, have prevailed against further liberalization and therefore preserved some features of Brazil's traditional economic model into the currently new economic era.*

In short, the dependent variable of the dissertation is the *Brazilian trade policy*: how it is endogenously determined by the institutional-historic characteristics of the domestic economic policymaking and by the domestic interest groups and how it is constrained and modified by exogenous shocks of the world economic relations.

Plan of the Dissertation

In chapter one, I will depict institutional-historic characteristics of trade policy formation in Brazil and how it relates to a broader economic development strategy. Chapter two discusses theoretical and empirical literature on trade liberalization/openness and economic development and the debate about multilateral versus regional trade negotiations in the international economic relations. In chapter three, I discuss the North-South regional agreements Brazil was involved, focusing on the FTAA, but also relating to the EU-Mercosur talks. Finally, in chapter four, I will provide stylized facts and quantitative evidence about the foreign trade structure of Brazil and how factor content (labor, capital), collective action variables and trade shares of industrial sectors may affect trade policies. In the next paragraphs, I elaborate on the chapters.

In order to understand the current stance of Brazil in the world trade negotiations, one has to analyze the domestic characteristics of the Brazilian foreign trade policy. In its internal aspects, Brazilian trade policy must be understood not only as clashes of interest groups that aim to influence policy outcomes, but also as part of a particular institutional-bureaucratic environment and of a broad array of public policies aiming at economic development. Therefore, in the first chapter I am going to analyze the domestic characteristics of trade policy formation in Brazil, particularly in

the last two decades. For that matter, I will also describe the main characteristics of the import substitution industrialization (ISI), regarding trade and industrial policy, and explain the policy changes that happened since the late 1980s. The last two decades of the twentieth century were characterized by the deepening of the economic globalization, by international financial turmoil, and an ongoing process of structural adjustment carried out by several policymakers in Latin American and Brazil. Meanwhile, intrinsic domestic characteristics of Brazilian trade policy, in a sort of institutional-bureaucratic inertia, went scarcely unchanged. Despite substantial drops in average tariffs, there have been important exceptions that make Brazilian trade policy maintained several characteristics more attuned with the old ISI model than to the liberalizing blueprint of the Washington Consensus. Furthermore, the responsibility of formulating and, principally, negotiating in international commitments, was kept under the domain of more conservative and even protectionist sectors within the Brazilian state. Thus, these groups' world views deeply influence the outcomes of trade and industrial policy and the negotiations in which the country is engaged. On the other hand, the more pro-market and pro-liberalization groups within the Brazilian government and society have not carved a stronghold on trade policy definition. How these different groups interact within the government and society is my task in the first chapter.

The aim of chapter two is twofold: I provide a theoretical and empirical account about trade liberalization/openness and economic development; and I describe how these theories apply to contemporary international economic relations. I depict the current debate within the political economy literature on the pros and cons of trade liberalization under multilateralism and under regionalism. There is a mushrooming literature in Economics and Political Science aiming at understanding

these apparent contrasting strategies, which I briefly mentioned in the literature review. Neoclassical economic theory prefers unilateral trade liberalization but in this debate it opts for multilateralism, defending that this strategy is welfare- enhancing vis-à-vis regionalism (Krishna 1998, Panagariya and Findlay 1996, Bhagwati and Panagariya, 1996). However, in a world characterized by lobbies and large transaction costs, rarely is it the best outcome that prevails. Furthermore, joining trade integration agreements raises apprehension among state agents about losing policy discretion, particularly in agreements which are supposed to be WTO-plus. Conversely, integration into the world economy is believed to launch dynamic powerful forces inside countries, such as: economies of scale, R&D spillovers and externalities, learning-by-doing, clustering of economic activities. Thus, part of the literature, believes trade liberalization under regionalism promotes these positive economic changes (Ethier 1998, Baldwin 2006). In short, this chapter aims to apply the theoretical debate on multilateralism and regionalism vis-à-vis the current world economy scenario, characterized by phenomena such as the stalemate of the multilateral negotiations, the increase of regional integration agreements and the upsurge of China and India as powerful economic forces.

My task in chapter three is to describe and critically assess Brazil's participation at the North-South agreements: the FTAA and at the EU-Mercosur discussions. As the FTAA was believed to have the most intense economic and political consequences for Brazil, I present a more detailed account on that integration project. I provide a more detailed account of the role of the most powerful country in that process - Brazil's largest single trade partner - the U.S. I also describe the apparent contradiction of Mercosur for not opting for a trade agreement with the European Union, as the EU sponsors a model of integration that goes beyond trade

issues, which is emulated by Mercosur in its attempt to create a common market and an economic union. I contrast the differences between two models of regionalism which entail different forms of economic governance – one the “Anglo-Saxon” market driven regionalism, epitomized by FTAA; and the other the regulated institutional order of supranational institutions of the EU. I close the chapter with a recapitulation of Brazil’s cautious reforms and the resilience of domestic groups in shaping trade policy outcomes.

Finally, chapter four offers a quantitative discussion. A first aim of this chapter is to test some of the theories presented in previous chapters. Using panel data econometric methods, I examine the impact of variables related to trade content, industrial concentration and factor shares of ten industrial sectors on Brazilian trade policy - my dependent variable in the empirical exercise. The two proxies for trade policy are: the level of protection (Brazilian MFN tariffs) and state-support of industrial sectors (subsidies granted to industrial output). The empirical models tested here tie up with the theories previously discussed in the previous chapters. Following endogenous trade policy models, I wish to determine the extent to which capital intensive sectors receive more protection (or support) vis-à-vis labor and land related industrial sectors. Following new growth related theories, I also wish to test whether or not sectors with more intra-regional trade and technological content have different policies than other sectors. The empirical tests use panel corrected standard error (PCSE) and seemingly unrelated regression (SUR) models as the more appropriate due to the characteristics of my data and to check for the possibility of endogenous correlation between explanatory variables and the equation residuals. Hence, this chapter includes comprehensive methodological and statistical sections. The second task in this chapter is to analyze destination and characteristic of Brazilian trade

flows, based on data (1990-2005) from the Economic Commission of Latin America (ECLAC). As I disentangle the structure and destination of flows, I argue that, if Brazilian trade strategy wants to spur the value-added intensity of exports, regional trade integration with the Western hemisphere is the logical path. Finally, the conclusion offers some prospects for Brazilian trade policy in face of the doomed negotiation experiences of the 2000s and of a depressed world economic order.

Chapter 1 - Understanding Trade Policy in Brazil: The Historical, Regional, and Domestic Context

Introduction

In order to understand the Brazilian position in hemispheric trade negotiations, especially regarding the new trade themes, the country's commercial policy must be analyzed as part of its broader development strategy. Moreover, an understanding of trade policy in Brazil requires some background knowledge of the structural reform wave that swept Latin America in the last two decades of the twentieth century. Therefore, this chapter will discuss the essential elements of Brazilian trade policy, first, according to its historical, institutional and bureaucratic determinants; second, as part of a broader economic development trajectory; and third, in the context of structural reforms undertaken since the early 1990s. Although I discuss how Brazil's trade policies and politics relate to the international economic setting, the focus of this chapter is on the domestic political economy. The following chapters of the dissertation discuss the regional and multilateral aspects of Brazilian trade policy.

The chapter begins with a short methodological explanation followed by a brief account of the origins of Latin American protectionism and a more detailed description of the underpinnings of import substitution industrialization (ISI) and how these related to national economic development strategy in Brazil. I then turn to the structural reforms of the late 1980s and early 1990s, with a focus on trade liberalization, macroeconomic stabilization, de-regulation, privatization, and fiscal reforms. The chapter concludes with an analysis of the political economy of foreign economic policymaking in Brazil, a distinction between trade and financial bureaucracies/institutions, the role of social groups and special interests, and how this

domestic environment has shaped positions and preferences concerning the integration of the country in the world economy.

Section I - Methodological Foreword

Theories of endogenous tariff formation posit that trade policy is a function of the pressures that interest groups exert on policymakers. Lobbying can occur according to the factors of production – the Heckscher-Ohlin (HO) hypothesis (Labor x Land x Capital) – or along sectoral lines – the Ricardo-Vines (RV) hypothesis (import-competing versus export-oriented sectors). The demand for protectionism is also a function of inter-industry factor mobility; in the HO hypothesis the factors of production are mobile whereas in RV, factors are rigid. Hence, in the former, owners of different factors tend to have opposing views regarding liberalization (capital versus labor), while in the latter the effects of trade will position the owners of the same factor in different industries/sectors, or even regions, against each other (Hiscox 2001). An example of the latter case is the anti-liberalization bias among the owners of small mortgage institutions (abundant factor– capital) in economically failing regions of the US, which part ways with their financial counterparts in more capital abundant US regions and oppose trade liberalization because it threatens to further their economic downturn in real estate assets (Scheve and Slaughter 2001).

Endogenous trade policy models with their roots in neoclassical economics and public choice theory can provide insightful albeit static explanations of trade politics. That is, such models offer a “snapshot” of reality, rather than a dynamic, institutional-historical explanation. A basic assumption of this dissertation is that in addition to factor and sector determinants, trade policy is embedded in a set of

domestic institutional-historical variables that determine the way trade policy is carried out over time. Pierson (2004), for example, notes the permanence of politics and policies over the time as a process of path dependency. While exogenous shocks can certainly alter this policy path, there is a sort of inertia to domestic politics. For example, in Brazil the long lasting characteristics of the Ministry of Foreign Affairs and the control of foreign policy making by a career diplomatic corps have influenced trade policy more, or at least as much, as contemporary political-electoral cleavages and business lobbies (Guilhon de Albuquerque 2003, 2006; Lafer 2000; 2003).

Schamis (1999), in analyzing the politics of structural reform in contemporary Latin America, draws upon a similar line of criticism. He argues that neoclassical models treat liberalization as a public good, since market reforms will hurt some special interest groups in the short run while ostensibly benefiting the majority in the long run. While small interest groups will thus exert pressure to block such reforms, the more disperse majority will not be able to organize in favor of welfare enhancing liberalization. Interest groups protected by closed economic regimes are well positioned to hinder liberalization, and hamper social welfare (Alesina and Drazen 1991). However, this collective action problem, as Schamis and others have presented it, does not consider that previously protected interest groups can adapt to new economic circumstances, as has been the case in Latin America since the early 1990s.

In this dissertation, I draw on these various approaches to analyze the Brazilian case and how long standing characteristics of domestic politics have been increasingly affected by world economic conditions. The Brazilian story is one in which actors that had previously been protected by an autarkical economic regime came to support trade liberalization as long as they could perceive the benefits. Changing economic phenomena such as globalization, regional integration and

increasing intra-industry trade flows offered new opportunities to these actors, as groups holding mobile assets were able to shift from decaying to booming economic activities; liberalization did not hurt them as much as it did the owners of rigid factors, such as labor. Although factor mobility will tend to benefit incumbent powerful economic groups that will lobby for the continuing benefits of trade liberalization, other long lasting political characteristics of the trade policy-making apparatus may hinder further liberalization. In this dissertation I will attempt to show that it has been the entrenched interests of those losing market shares that have prompted the blocking position of Brazil in several trade talks, and particularly the FTAA. Summing up, I believe this methodological view based on domestic institutional variables is complementary, rather than conflicting, with endogenous trade explanations.

Despite these entrenched characteristics of trade policymaking, it is undeniable that Brazil and some other Latin American countries have gone through a substantial change in economic development strategy during the last two decades of the twentieth century. From an autarkical model characterized by heavy state intervention in economic activities, Latin American countries have implemented *laissez-faire* reforms aimed at enhancing market forces. Among measures such as macroeconomic adjustment, financial sector restructuring, labor and welfare reforms, de-regulation of public utilities markets and privatization of state owned enterprises (SOEs), trade liberalization is believed to be of crucial importance because it contributes to macroeconomic stabilization in the short run and fosters the competitiveness of domestic firms and productivity in the long run¹⁰. Generally

¹⁰ According to this view, trade openness ($X+M/GDP$) is considered a crucial component of economic growth and performance. Yet, as Rodrik (1996) notes, the benefits of a more export-oriented model were not yet fully apparent in the beginning of the 1980s. Moreover, an outward orientation requires much more than a simple strategy of *laissez-faire* (see Rodriguez and Rodrik, 1999; Ocampo 2004; Rodrik 2004).

speaking, these economic reforms happened in tandem with a shift from authoritarian to democratic regimes. In Latin America, newly democratic countries carried out neoliberal reforms, despite the belief that reforms are easily implemented by authoritarian regimes (Weyland 2002). Democracy may offer greater opportunities for special interests to push for protectionist policies, but it can also help to promote more awareness about the positive effects of liberalization (Baker 2003). Thus I will discuss how new political economy cleavages in the post-democratization era have influenced trade policymaking in Brazil.

Finally, an influential literature in comparative development points to the importance of technocratic autonomy in carrying out development projects (Evans 1995, Kohli 2004, Schneider 1999, Wade 1990,). State “developmentalism” is part of the Brazilian economic policy-making ethos; it was highly prominent during the import-substitution industrialization (ISI) years (1950-1980) and continues to influence policy orientation, even in the aftermath of structural reforms and the advice to the contrary from international financial institutions. While the generation of structural reforms in Brazil stemmed more from insulated technocratic decision-making inspired by the “Washington Consensus,” these reforms clashed with entrenched interests and policymaking/institutional characteristics, thus generating a piecemeal approach to reform.

To summarize, I will analyze the political economy of Brazilian trade policy according to this broad set of questions:

- 1) Factor endowments and sectoral lines as policy determinants: What are the political forces and groups that have historically shaped Brazilian trade policy? Do the causal variables appear to cluster along factor explanations or along

sectoral lines? Have export-oriented interests prevailed over importing competing groups, and if so, how?

2) Structural reforms and change in policy preferences: What role has trade policy played in the context of structural adjustment and economic turmoil of the last two decades of the 20th century (macroeconomic disarray in the 1980s, stabilization in the first half of the 1990s, and international financial crisis in the late 1990s)?

3) Institutional and bureaucratic characteristics: How have institutional and bureaucratic components shaped the specifics of Brazilian trade policy reform? How are the institutional and bureaucratic characteristics of Brazil's commercial bureaucracy related to other branches of foreign economic policy?

As I have spelled out in the literature review/introduction, this dissertation adopts the following working hypothesis:

1) International economic shocks/trends and the demise of domestic economic models change policymaker's and interest groups' preferences, hence, opening up the opportunity for (trade) policy reforms. However, 2) entrenched domestic institutional/bureaucratic characteristics, as well as the ideological biases embedded therein, are able to prevent further liberalization and therefore preserve some features of an old economic model in a new economic era.

In this chapter I focus on the domestic aspects of this working hypothesis. In doing so, I apply the three questions above and probe the Brazilian policymaking system and structural reform dynamics so as to elucidate on my dependent variable: Brazilian trade policy.

Section II – The Origins of Latin America Protectionism and the Import-substitution Industrialization (ISI) Years

The Tradition of Inward Looking and Managed Trade in Brazil and Latin America

Latin America is a region that has been historically characterized by high levels of trade protectionism. During the nineteenth century, the explanation for high tariffs can be found in the necessity of financing independent nation-states, which were recovering from independence wars and social upheaval. Even after the consolidation of nation-state structures in most countries, tariffs remained high by the end of the nineteenth century and were combined with other restrictive non-tariff measures, such as licenses and quantitative restraints. The heavy taxing of imports and exports reflected the ease of collecting these revenues: production passed through few ports and did not require a complex tax system or administrative apparatus. In Brazil, during the nineteenth century and first decades of the twentieth century, the federal authorities generally set domestic tariffs. However, sub-national (state) governments were mainly responsible for the administration of national customs, with considerable differences emerging in terms of administrative practices. Table 1 shows the average tariffs in selected periods in Latin American countries; table 2 depicts the revenue from customs as part of the total revenue in selected Latin American countries during different periods.

Table 1: Latin America - Average Implicit Tariffs (percent). Selected Economies, 1880 - 1928.

	Argentina	Brazil	Chile	Colombia	Mexico
1880*	26.4	38.0	23.4	45.7	39.7
1900**	31.9	36.1	22.3	-	20.1
1913***	20.8	34.2	20.0	46.0	20.1
1928	17.3	25.4	20.5	28.1	22.8

Notes:

*Argentina: 1881; Brazil: 1872-1873; Colombia: 1880-1881; Mexico: 1884-1885.

**Brazil 1901
 ***México 1912-1913
 Source: Abreu (2004a)

Table 2: Foreign Trade Revenues as a Share of Total Revenue, Central Government (percent). Selected Economies, 1880 - 1928.

	Argentina	Brazil	Chile			Colombia	Mexico		
	Imports	Imports	Imports	Exports	Total	Imports	Imports	Exports	Total
1880	61.7	53.8	35.9	3.5	39.4	70.2*	-	-	59.6
1900	55.9	54.4	31.9	29.6	61.5	68.7**	41.7	3.2	44.9
1913***	57.0	49.6	37.1	22.6	59.7	76.4	43.8	2.9	46.7
1928	47.0	42.4	18.4	14.9	33.3	63.7	25.4	4.5	29.9

Notes:

*Total “aduanas” 1880-1881

**Total “aduanas” 1897-1898

***For Mexico, 1910-1911

Source: Abreu (2004a)

Despite the general view that local landowners engaged in agricultural exports benefited from openness, this does not necessarily mean that Latin America as a whole had laissez-faire policies during the late nineteenth and early twentieth centuries – the golden era of Pax Britannica economic liberalism (Coatsworth and Williamson 2004). Endogenous trade theory provides feasible explanations for the widespread use of tariffs in Latin America: capital and labor, the main inputs for industrial goods, were scarce and hence subject to higher levels of protection. Yet, tariffs were high across the board, suggesting that institutional analysis can enrich our understanding of this period.

Monetary and macroeconomic variables can also shed some light on the reasons for high levels of protection. During the Pax Britannica era, the Brazilian currency was pegged to the gold standard. The only fully convertible currency under this currency regime was the British pound, meaning governments were willing to accumulate pounds. Policymakers justified protectionist policies due to the balance of payment disequilibria that were intrinsic to the gold standard, which often provoked

the loss of international reserves. Trade deficits were a major source of macroeconomic instability. The basic idea: a pegged exchange rate imposes strict discipline on domestic monetary policy. Money supply depends on foreign exchange reserves, which would finance domestic credit. To maintain the peg, the monetary authorities must offset an increased demand for foreign currency – to purchase imports -. Otherwise, the exchange rate would suffer pressures toward devaluation. If domestic demand outstrips the supply of local currency, reserves become depleted and the monetary authority is no longer able to intervene in currency markets. Summing up, high tariffs made sense under a pegged exchange rate system because these facilitated the management of aggregate demand, albeit in a mercantilist manner.

In Table 1, it is clear that Brazil had very high tariffs, even by Latin American standards. High tariffs curbed domestic demand for imported manufactures, limited the access to capital and intermediary goods used as inputs and hindered the full development of many sectors. With production costs kept down due to elastic supply of labor and an abundance of land, and with generous subsidization from provincial governments and national fiscal policy, landowners in Brazil worried little about the overall level of tariffs or the higher input prices (Leff 1997). Despite the anti-export bias of macroeconomic policy and the maintenance of high tariffs, landowners were able to enrich themselves at the expense society as a whole.

In terms of the management of its primary commodities, Brazil's position as a price-maker in the world coffee markets and its protectionist stance helped keep prices for that commodity high. Economic theory holds that in a case such as this, net welfare losses are smaller because production and consumption distortions are partly compensated for by increased world prices. The price of protection was paid by world consumers of coffee and by domestic consumers of Brazil's imported manufactured

goods. Therefore, high tariffs in Brazil did not lead to the usual deterioration of export sector income. In fact, many coffee growers diversified into the industrialist sector so as to protect themselves against exchange rate instability and to reap lucrative rents in the protected market for manufactures. This situation laid down the economic basis for ISI policies in Brazil and provided the historical explanation for the country's absence of an explicit lobby for trade liberalization (Abreu 2004a).

Williamson and O'Rourke (1999) explain the alleged free trade era of the nineteenth and early twentieth centuries by comparing the various positions of the owners of factors of production (land, labor and capital). Thus, land abundant Latin American countries would benefit from the liberalization of agricultural goods, while land scarce Europe raised protective walls against staple imports from the New World. Therefore, Latin American groups endowed with abundant land would benefit and lobby for closer ties with the world economy, while the owners of scarce factors - labor and capital - would veto trade liberalization and fight to keep tariffs high. Indeed, the political economy literature has shown that in Brazil landowner groups benefited from protectionist policies and oligarchies were able to influence the state apparatus and to defend their interests: the policy of maintaining high governmental stocks of coffee in order to prop up the price that commodity in world markets enriched landowners at the expense of the rest of society (Leff 1997).

But the historical record also suggests that trade policy is not just a function of factor ownership, sectoral cleavages, and their equivalent lobbies. In the nineteenth century Brazilian policymakers engineered the institutional mechanisms, exerted policy discretion over them, and followed their ideological impulses in crafting development models. Policymakers and their constituents were no doubt aware of the intellectual legacy of the American federalists, who defended trade control as a

mechanism to stimulate domestic industries. At the same time, several Brazilian intellectuals of the late nineteenth and early twentieth centuries were inclined toward the liberal doctrine of Adam Smith and argued the benefits of free trade. The Old Republic political coalition (1889-1929), for example, was based on the liberal ideology of an export-oriented oligarchy. Yet, this ideological commitment proved ephemeral, as tariffs were extremely high and the overall economic policy was decidedly restrictive (Leff, 1997: 51). In fact, the ideological basis of Brazil's early Republican years was equally based on the positivism of French sociologist Augusto Conte, who emphasized the need of a powerful state role in guiding society.¹¹

Obviously, Brazil's superficial commitment toward liberalism early on can be explained by deep-seated ideologies and institutional structures.¹² Protectionist policies can be understood as part of a mercantilist tradition that saw international trade as closely related to security issues, and justified not only to amass hard currency (bullion) and to allow a primitive accumulation of capital, but also to buffer the country from foreign threats (Viner 1948). In fact, hostility toward *laissez faire* and preferences for state intervention in economic affairs date back to colonial times in Brazil: the plantation system involved large sunken costs and economies of scale, requiring high outlays and state support for initial investment. In the case of sugar, for example, the commercialization of output was centralized in the hands of few traders directly tied to a monopolist enterprise from Portugal (Companhia das Índias Ocidentais). In sum, in Brazil's colonial economy trade was monopolized in the hands of a few landowners, intermediaries and the state.

¹¹ The high ranks of the Brazilian military were particularly keen on this ideology, and in fact used it to justify the importance of the military in the country's industrialization process in later decades. (Fausto 2001).

¹² The literature about the nature of colonial institutions in Brazil is extensive. See, for instance, Furtado (1963), Prado Jr. (1953) and Faoro (1976). An excellent source in English is Maxwell (1973).

In a sign of the institutional inertia that had set in, these restrictive characteristics changed little after political independence. According to a one eminent commentator (Faoro 1976), the main characteristic of the Portuguese-Brazilian political-institutional system was patrimonialism, whereby political actors exerted superiority over social actors and state institutions were used to dole out particular privileges. The ability of the bureaucratic elites (*estamento burocrático*) to craft economic and social policies according to their own aims rendered privileged access to the ranks of public employment as one of the most cherished goals. In this respect, Brazil maintained several traits of its Portuguese heritage, including an in its institutional framework that encompassed economic dirigisme and trade monopolies. After independence and during the oligarchic agrarian order, politicians paid lip service to liberalism while free trade was restrained to protect landowner interests, increase governmental revenues, and to appease incipient industrial interests.

The more recent empirical research on development attributes laggard growth in these countries of Spanish and Portuguese colonial heritage to the restrictions placed on market exchange, the existence of state monopolies and the inward orientation of economic institutions (Acemoglu, Johnson and Robinson 2001). Recent institutional theory also points to the lack of economic development in Latin America as a function of the excessive outward orientation of economies based on the plantation system. This required high initial state investments and economies of scale, and contributed to income concentration and the stalling of innovation in the domestic market (Eagerman and Sokoloff, 1997). This literature highlights the deleterious consequences of a monopolist monoculture system for the development of domestic market institutions. In contrast, the legacy of other European colonizers was the

ability to create domestic markets and engage in free trade in ways that fostered higher levels of development.

Stemming from the original work of Douglas North (1990), research on institutional economics provides important avenues of explanation for dismal growth rates in Latin America and Brazil. Ineffectual institutional frameworks during the nineteenth century also explain the disparate economic performance of Latin America compared to North America (Haber 1997; 2000). Regarding Brazil, Summerhill (2000) and Haber (2000) point to the inability of governments over time to construct solid institutional incentives to spur economic growth. For example, these authors note the way in which a lack of financial stability and insufficient capital markets has hindered long term investments and the completion of crucial infrastructure projects. Weak property rights, law enforcement and unclear investment rules explain the absence of medium and long term public and private expenditures in roads, ports, and railroads. The cumbersome application of French civil law codes in Brazil and the regulated nature of Brazil's newborn financial institutions hindered economic exchange. In a recent review of the political economy of Latin American growth, Rodriguez (2003) stresses the infrastructure deficit which, when combined with geographic limitations, hampered domestic and overseas transactions, and furthered an inward-looking economic model. Acemoglu et al (2001) also argue that economic development was harmed by geographical characteristics, since European colonizers could not adapt to tropical conditions and were hence not able to establish market-enhancing institutions.

In summary, despite being exporters of primary goods, Latin America was not able to fully reap the benefits of free trade and to reach the same income levels of European offshoots or those developing countries with an Anglo-Saxon heritage. The

data help to clarify this debate. Table 3 from Maddison (2000) depicts GDP growth rates by region and shows that from 1820 to 1913 – the golden era of *Pax Britannica* liberalism – Latin America's growth rates were smaller than those of the European offshoots. Table 4 presents selected Latin American countries and Anglo-European offshoots GDP growth per capita. The tables show that Latin America performs much better on GDP growth during the 1913-1973 interlude, which comprise part of the ISI era. The substantial growth of the sub-continent during the core ISI years (1930-1973), particularly in Brazil and Mexico, may explain the reticence of policymakers and sectors of society to surrender that model. It is also noticeable that, after 1973 Latin America is per capita growth slows when compared not only to the European offshoots, but also to other regions of the world (besides Africa and Eastern Europe). Some countries even experienced negative GDP growth per capita (Argentina, Peru, Venezuela). According to Table 10, the GNP growth rate of Brazil in the 1990s, after the Washington Consensus structural reforms, was frustrating, standing at a meager 2.6 percent average from 1991 to 1999.

Rodriguez (2003) emphasizes the positive correlation between the investment rate and economic growth, and both neo-classical and endogenous growth models defend this causality running from investment to growth. A drop in investment, compounded by Brazil and Latin America's low savings rates, seem partly to explain for the structural slowdown that beset the region in the last decades of the twentieth century (figure 1).

Table 3: Phases of Growth by Major Region, 1820-1992 (Annual average percentage growth rate).

	1820-70	1870-1913	1913-50	1950-73	1973-92	1820-1992
GDP						
Western Europe	1.7	2.1	1.4	4.7	2.2	2.2
Western Offshoots	4.3	3.9	2.8	4.0	2.4	3.6
Southern Europe	1.0	1.5	1.3	6.3	3.1	2.1
Eastern Europe	1.6	2.4	1.6	4.7	-0.4	2.0
Latin America	1.5	3.3	3.4	5.3	2.8	3.0
Asian	0.2	1.1	1.0	6.0	5.1	1.9
Africa	0.4	1.1	3.0	4.4	2.8	1.9
World	1.0	2.1	1.9	4.9	3.0	2.2
Population						
Western Europe	0.7	0.7	0.5	0.8	0.3	0.6
Western Offshoots	2.8	2.1	1.2	1.5	1.0	1.9
Southern Europe	0.3	0.4	0.9	1.4	1.4	0.8
Eastern Europe	0.9	1.3	0.4	1.2	0.7	0.9
Latin America	1.3	1.8	1.9	2.7	2.3	1.8
Asian	0.1	0.6	0.9	2.1	1.9	0.9
Africa	0.3	0.7	1.9	2.4	2.9	1.3
World	0.3	0.8	0.9	1.9	1.8	1.0
GDP per Capita						
Western Europe	1.0	1.3	0.9	3.9	1.8	1.5
Western Offshoots	1.4	1.8	1.6	2.4	1.4	1.7
Southern Europe	0.6	1.1	0.4	4.9	1.7	1.4
Eastern Europe	0.7	1.0	1.2	3.5	-1.1	1.1
Latin America	0.2	1.5	1.5	2.5	0.5	1.1
Asian	0.1	0.6	0.1	3.8	3.2	1.0
Africa	0.1	0.4	1.0	2.0	-0.1	0.6
World	0.6	1.3	0.9	2.9	1.2	1.2

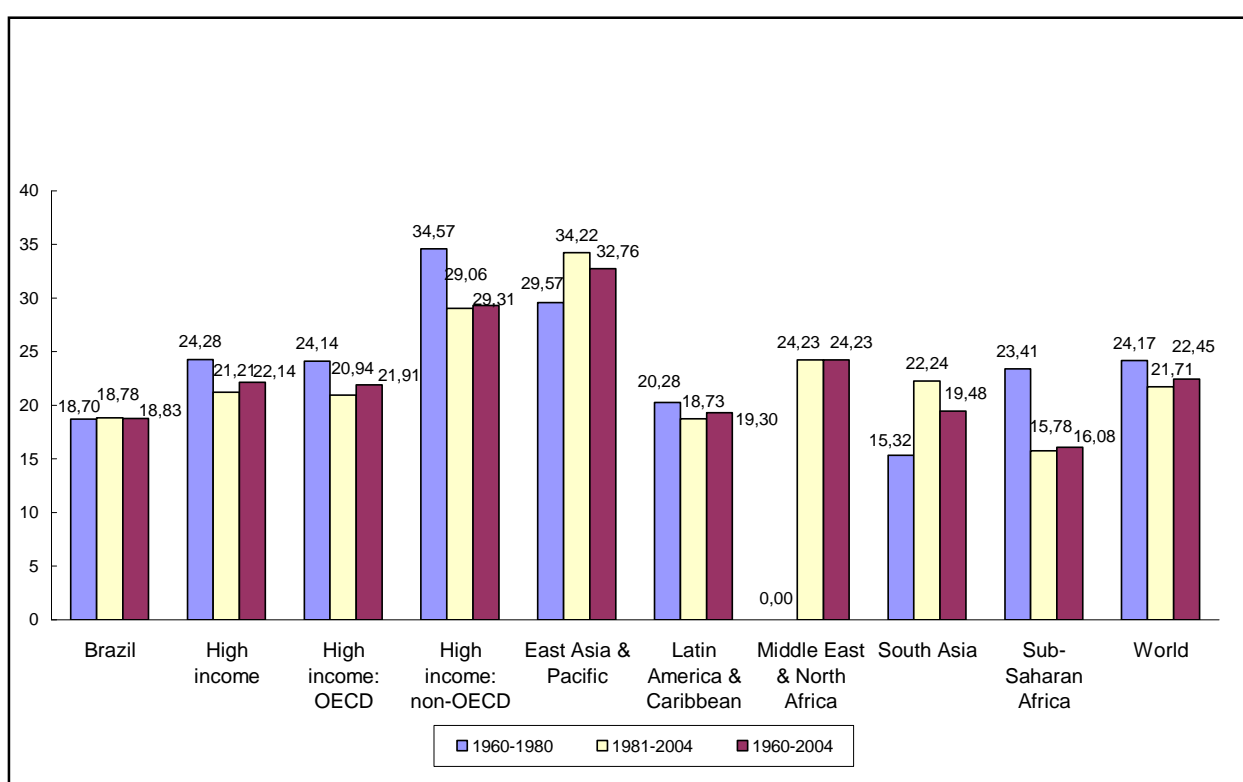
Source: Madison (2000).

Table 4: Per Capita Real GDP Growth in 11 Sample Countries, 1820-1992
(Annual average compound growth rate).

	1820-70	1870-1913	1913-50	1950-73	1973-92	1820-1992
Western Offshoots						
Australia	1.8	0.9	0.7	2.4	1.4	1.4
Canada	1.2	2.2	1.4	2.9	1.5	1.8
New Zealand	n.a.	1.2	1.3	1.7	0.5	1.2
USA	1.3	1.8	1.6	2.4	1.4	1.7
Average	1.4	1.5	1.3	2.4	1.2	
Latin American countries						
Argentina	n.a.	2.5	0.7	2.1	-0.2	1.3
Brazil	0.2	0.3	1.9	3.8	0.9	1.4
Chile	n.a.	n.a.	1.0	1.2	1.9	1.4
Colombia	n.a.	n.a.	1.4	2.3	1.9	1.9
Mexico	-0.1	1.7	1.0	3.1	1.1	1.4
Peru	n.a.	n.a.	2.1	2.5	-1.7	1.0
Venezuela	n.a.	n.a.	5.3	1.6	-0.8	2.0
Average	n.a.	1.5	1.9	2.4	0.4	

Source: Madison (2000).

Figure 1: Gross Savings as Percentage of GDP.



Source: World Bank Development Indicators 2006.

Trade policies are best understood within a given country's broader institutional context. In the case of Brazil, high trade tariffs are just one component of the overly regulated and restrained characteristic of domestic economic institutions, a legacy that dates back to the colonial era. The political economic cleavages that continue to characterize Brazil's trade policy reflect the fact that public institutions most often serve private interests, with patronage and clienteles determining state intervention in economic and social life. In Brazil, hence, due to the magnitude of the state vis-à-vis private social actors, interest groups with strong ties to the bureaucratic elite are able to obtain higher benefits at the expense of the rest of society. In short, Brazil's economic institutional framework has perpetuated this privatization of the state (Faoro 1976).

While these institutional characteristics go a long way toward explaining protectionism and the inward orientation of the Brazilian economy in the first decades of the twentieth century, the literature on modern political economy also emphasizes the importance of international shocks in defining policy choice. International macroeconomic and financial shocks, for instance, can have a crucial effect in shaping new development strategies and policy orientations (Haggard and Webb 1994). Hence, the Wall Street crash of 1929, followed by the depression of the 1930s, provoked a pronounced shift toward a more autonomous development strategy in Latin America and Brazil. The origin of the term "export pessimism" was motivated by a concrete international crisis. The abrupt decline in international prices for the region's main commodities (coffee, sugar, cocoa, rubber, copper, guano) provoked a foreign debt default all over the sub-continent. This international shock caused a severe worsening in the terms of trade, a crisis in most Latin American economies, and a total disruption of the regional trade system. A reaction from governments and

elites ensued. New groups (industrialists), struggling to make their voice heard, allied with reforming politicians in defining a new ideological framework for economic policy characterized by increasing levels of state intervention.

Thus, in the 1930s, the origins of the ISI strategy can be found in the new perceptions of Latin American elites about the world order, and in the social status of those groups that were now attaining political and economic power. Rogowski (1989) affirms that during the 1930s, in many parts of Latin America, the coalition between workers, industrialists, military actors, and displaced landowners resulted in an inward-looking and autarkical development project. In Brazil, social upheavals that brought President Getúlio Vargas to power in the 1930s reflected new tensions between export-oriented agrarian oligarchies and these ascendant urban social groups, which supported modernizing and autonomous policies.

Although the relative economic backwardness of Latin America at that time demands a more complex explanation based on domestic institutional framework, as I have briefly discussed here, the new economic and political elite blamed the constraints of the international system. In the 1940s and 1950s, the structuralist school in Latin America began formalizing these assumptions about the pitfalls of an export-oriented model. As they saw it, the outward model was responsible for the severe concentration of domestic income, as these disparities were reinforced by an over-reliance on primary goods and foreign consumer markets. They assumed a tight connection between the landowning elite and the international markets. It was undeniable that the rents from Latin American trade had accrued to just a few, however, instead of tackling other regressive features of the outward model (e.g. extreme land concentration derived from the monoculture system), a full-scale shift toward an autarkical orientation seemed more expedient. The search for economic

autonomy would influence the political economy of Brazilian trade policy for decades to come.

Trade Policy and Economic Development Strategy in Early ISI Years

Latin America's import substituting industrialization (ISI) strategy comprised more than just trade policy. It epitomized a shift toward a different economic development strategy altogether and a political economic reorganization characterized by direct state intervention in productive activities and social life. In Brazil, state dirigisme and the construction of cooperative ties between workers and capitalists mediated by state institutions had a long-standing effect on the political economy. Initially, however, the ISI strategy was also spurred by pragmatic motivations and focused targets. The basic idea was to build an industrial basis to supply the domestic market, in order to save international reserves, ease the deleterious consequences of cyclical balance of payments crises and, consequently, promote capital accumulation. The project aimed at weaning Brazil's dependence on international markets for primary goods, characterized by periodic price and declining terms of trade shocks. ISI policies were based on three pillars: macroeconomic policies meant to keep exchange rates stable and overvalued; high tariffs to protect new industries; and active industrial policy granting tax holidays and subsidies to industrial producers (Cardoso and Hellwedge 1992, Bruton 1998). Apart from the third item, these measures were already a part of Brazilian foreign economic policy. What changed with the rise of Vargas was the plethora of policy mechanisms now embraced by the state. Direct forms of intervention took off with the creation of state owned enterprises (SOEs) taking an active part in industrial activities and infrastructure projects. Indirectly, this

period saw the proliferation of a thick web of regulations in economic life. In this part, I examine some features of the political economy of the ISI model in Brazil.¹³

The new economic and social groups that had ascended to political power in the 1930s were against the continued dependence of the country on the export of primary goods (cocoa, coffee, rubber, sugar), and the import of manufactured goods from the U.S. and Europe. Despite the lack of a fully laissez-faire orientation in the standing commodity export model, in the wake of the Great Depression, Latin American elites in general were disenchanted with the so-called benefits of the liberal order and export oriented growth. Thus, in addition to the focus on stabilizing the balance of payments from wild swings in demand and prices on raw material exports, the main policy objective of ISI was to build a more efficient and growth strategy based on higher levels of industrialization (Skidmore, 1975).¹⁴

Certainly an incipient process of industrialization had been underway in Brazil and Latin America since the end of the nineteenth century, particularly in light manufactures and food processing. Constant balance of payment shocks had precipitated this earlier trend toward industrialization and import substitution, since landowners had started small-scale industrial ventures as a cushion against frequent interruption of supply in consumer goods (Furtado 1963). During World War II, this natural acceleration was further reinforced by the disruption of the supply of consumer and capital goods from the Northern countries. These phenomena provided a big push for new industrial projects and substantial state intervention. The creation

¹³ The theoretical assessment of ISI in this section is based on Cardoso and Hellwegde (1992), and Bruton (1998), Hirschman (1968), Edwards (1995), Arndt (2000) and Krueger (1994).

¹⁴ A quick methodological note: my emphasis on how trade policy should be viewed as part of a broad strategy for economic development does not rule out an endogenous policy explanation. In fact, the owners of scarce factors in Brazil – Capital, and to a lesser extent Labor – influenced the policy preference shift, which soon would be translated into concrete actions to protect these factors of production.

of a large-scale state owned steel industry in Brazil dates from the early 1940s, with the foundation of the National Steelmaker Company (CSN). Furthermore, Brazil became an exporter of light consumer goods for northern markets, strained by the war effort. As a consequence, Brazil accumulated foreign reserves during this period (Skidmore, 1975).

Macroeconomic and structural imbalances, however, continued to plague Brazilian policymakers, some of these being directly related to the ISI model itself. Inflation accelerated due to mounting budget deficits and the political inability to expand the tax basis to pay for sizeable governmental subsidies. In fact, in the 1940s and 1950s, despite the new urban-based power coalition, landowners' income continued to be protected by the government's policy of propping up coffee prices in the world market. An overvalued domestic currency was used to tame inflation, despite its adverse effect on exports. In turn, currency overvaluation instilled an anti-export bias as well as constant devaluation pressures coming from export-oriented producers operating mainly in the agricultural sector. A solution for this problem was the design of multiple exchange rate systems, a policy that would last up to the 1960s. As the trade portfolio was still predominantly composed of primary goods, the country was not able to generate a sufficient trade surplus, which was essential for garnering the savings necessary to promote full-scale development. It was evident that the shallow nature of industrialization would not solve the country's structural limitations and low investment capacity; hence, policymakers believed that this process should be deepened. So as to promote the production of durable consumer and capital goods in the domestic market, tariffs and other administrative measures such as import licenses were used to limit domestic demand for imported capital goods. Greater autonomy in the production of these goods would save hard currency and ease

balance of payment problems. With the purpose of intensifying industrialization, the direct participation of SOEs in heavy industrial areas, infrastructure and capital goods – capital intensive sectors - was ubiquitous from the 1950s to the 1970s (Abreu 1983).

In addition to direct state intervention, a restrictive regulatory framework in infrastructures and public services markets was enacted. SOEs were granted monopolies, subsidies and tax breaks. This period saw the creation of several state companies, for instance, the state oil company (PETROBRAS) was founded in 1953 to tap into domestic oil drilling. Soon it would expand its activities to refining, distribution and commercialization. Later, during the 1960s and 1970s, other public services and infrastructure related SOEs were established to operate in markets such as energy generation and transmission (ELETROBRAS), communication and telephony (TELEBRAS), railroad transportation (RFFSA), and shipbuilding (Lloyds do Brasil S.A.). High entry costs and the restrictive regulatory framework protected these firms from competition and guaranteed a captive market. As public service tariffs had great influence on inflation, federal authorities persuaded SOEs to limit price increases as well as imposed price caps and controls. These measures appeased urban consumers but had deleterious consequences for the finances of these companies in the mid- and long term.

The omnipresence of SOEs is part of an ideology that assigned the state the leading role in economic development. In fact, the creation of PETROBRAS was surrounded by an ample national campaign whose motto was: “O petróleo é nosso” (The oil is our property). Despite the highly ideological tone, the justification for the closed regulatory framework and heavy state participation lay in the fact that infrastructure activities such as mining, oil drilling, steel production, electricity generation, heavy transportation and so on provide key inputs to other economic

activities. Since they are used by several economic sectors, the proper supply of these activities creates positive spillovers to the whole economy. In fact, infrastructure and capital goods might be considered public goods, that is, they are non-rival and non-excludable in the consuming. Finally, the imperfect characteristic of these markets, involving high sunken costs and large economies of scale, provided justification for direct state intervention in order to correct a situation of capital scarcity and information asymmetries. Therefore, the notion that these economic activities should be mainly carried out by state monopolies became widely accepted. The undersupply of infrastructure and capital goods is a market failure that justified state intervention.

It is worth noting, however, that a state led economic-development strategy was not a consensus point in Brazil even in the initial years of this endeavor. The policy debate among liberal (monetarist), structural-developmental and nationalist views was in fact a source of clashes between public opinion and the governmental ranks, often provoking the dismissal of an incumbent minister within the government bureaucracy.¹⁵ Most often, new appointments to the Ministry of Finance or the Ministry of Planning espoused one of the two main economic orientations (liberal or structuralist) and frequently attempted shifts in policy orientation. Yet the restrictive inclination of Brazil's economic institutions offered little policy space for true liberal economics. With the deepening of ISI, the heavy regulatory framework and the increasing participation of the state in the economy, "developmentalism" and nationalism became preeminent. Several bureaucracies, such as the Banco do Brasil, responsible for financing agriculture and often subject to blatant political patronage, clearly espoused a developmentalist view. This conflicted with the more

¹⁵ Skidmore (1975: chapter 5) notes these contentious domestic policy debates during the 1950s and 1960s, and they have continued up to the present as sources of tension amongst economic policy-making elites in Brazil.

economically liberal Finance Ministry, constantly hindering its attempts at fiscal adjustment. Therefore, the weight of ideas became ingrained in the state institutions and bureaucracies, quite often mixed with fiscal irresponsibility and corruption.

Summing up, Brazilian economic nationalism and state developmentalism translated into concrete policy reforms in the post-World War II period. ISI policies were initiated in the 1930s and deepened in the 1950s and 1960s. Brazil's economic growth strategy during the second half of twentieth century was characterized by sizable direct state intervention in industrialization and infrastructure and by restrictive regulatory rules in several economic activities. Albeit justifiable from a developmental point of view, such strategies coddle powerful groups within labor and industry who demand to be subsidized by the state. The political groups connected to finance – particularly national capitalists - were able to realize their policy preferences. Meanwhile, politically displaced groups, such as landowners, were also able to influence the state apparatus and received compensatory measures, such as subsidized credit for agriculture. In fact, as I have mentioned, the owners of land continued to exert important political leverage in Brazilian politics. This also occurred because, despite the big push for industrialization, primary goods continued to be important elements of the Brazilian trade portfolio up to the 1960s.

Political Economy, Policy Ideas and the Administrative Organization of the State

During the dictatorship of Getulio Vargas (1930-1945) there was a full scale administrative re-organization of the state apparatus (tax, fiscal, tariffs, public service) towards the centralization of the federal executive, which seized these policy instruments to carry out a national strategy. For example, a reorganization of the customs and the tax system was fully implemented within the Ministry of Finance

(Skidmore, 1975). Rudiments of planning, welfare and state reform policies were designed. Social policies, for example, were enhanced with the creation of new Ministries (Labor, Education and Health) and the establishment of the minimum wage in 1940. The state forged ties with trade unions, in order to appease latent social (communist) movements, but also with the new industrial classes. A true corporatist state was designed in Brazil, intellectually influenced by the Europeans. For example, new labor legislation in Brazil was based on the Italian Carta del Lavoro.

Biersteker (1993) argues that during the twentieth century countries were inclined toward three political economic models: Liberal, Corporatist and Communist. Integration into the world economy is a function of the domestic political economy. Post-World War II Brazil was predominantly corporatist with a few sparks of liberalism. In a similar vein, although from a liberal-pluralist orientation, Hall and Soskice (2000) emphasize a “varieties of capitalism” approach in explaining the comparative political economy of OECD countries. They distinguish two basic types of capitalisms: “liberal market economies”, those characterized pluralistic and decentralized group interests acting in a market economy; and a “cooperative market economy”, in which interests between groups are decided by “negotiations” – often mediated by the state. This dichotomy can be often summarized in a “*pluralistic*” versus a “*corporatist*” society; differences in economic institutions will determine policy outcomes¹⁶. Though applied to a domestic policymaking context, this approach

¹⁶ Hall (2006) summarizes the main features discussed by the literature of “varieties of capitalism. One feature is the size, strength, and diversity of labor organization. A second is the organization of capital, which includes patterns of financial intermediation, corporate governance, and inter-firm organization. A third is industrial relations, the institutionalized relations between capital and labor that include procedures for wage bargaining, education, and training. These three features concern institutionalized processes in decision-making. Finally, scholars also distinguish different degrees of government intervention in specific policies such as regulation, industrial policy, and social policy.

can explain the policy preferences of countries when they interact in international economic negotiation forum.

Therefore, a Latin American “variety of capitalist” is one that is not only mediated by the “State” but one characterized by an attempt to create an autonomous domestic economic order that can shield itself from the vagaries of the world economy by adapting and creating productive capacity in several economic sectors. The experience of ISI in developing countries may be regarded as an attempt to create state capitalist institutions, under a nationalistic and developmentalist ideology, aiming to spawn a consensus among interest groups toward economic development. Both capital and labor are to be guided by this “developmental” motto, and deliver to the Executive the task of trade negotiations. Again, this consensus shapes the manner in which a country participates in the international economy.

In order to carry on this process of economic development, crucial bureaucracies – often regarded as “pockets of efficiency” - were created in the 1950s. The principal one was the BNDES (National Bank for Economic and Social Development) was founded in 1952 to establish investment priorities, finance infrastructure and support ISI policies, not only in consumer goods, but also in capital intensive and intermediary goods. The BNDES deserves special treatment in any study about the political economy of Brazilian economic development. Established under a model of “bureaucratic insulation”, BNDES was detached from old-fashioned bureaucracies and congressional pressure. The BNDES was often autonomous even from the Finance Ministry, whose monetarist stances often clashed with the spending priorities of that institution (Nunes 1983; Martins 1984).¹⁷

¹⁷ The Brazilian state organization, particularly after the military coup of 1964, is characterized, by a division in **direct administration** (Ministries; the central government) and **indirect administration**

This leads to another important point on the comparative political economy of development: state led strategies are more common under authoritarian rules and consequently are characterized by a lack of transparency. Martins (1976) uses the concept “conservative modernization” to emphasize the detachment from societal actors, the lack of transparency and the technocratic approach to economic policy-making. From 1945 to 1964, the democratic regime followed suit, developing projects carried out by highly insulated technocratic groups. The BNDES was instrumental in using task force groups to plan national strategies, directly connected to the Presidential cabinet, shielding them against political pressures and conducting the process under strictly technical grounds. This policy expedient underpinned the Presidency of Juscelino Kubitschek (1956-1960), during the first national plan of development (PND). The subsequent military regime deepened the process of conservative modernization and technocracy. During the Presidency of General Geisel the second PND was launched and conducted by skilled bureaucrats at the Secretariat for Planning (SEPLAN), along with the BNDES. Summing up, authoritarian modernization was a hallmark of the Brazilian industrialization experience, similar to other Latin American and East Asian countries (Haggard 1990).¹⁸

The establishment of semi-autonomous state institutions/actors to carry out particular policies was part of a dynamic of state intervention and specialization. State owned enterprises (SOE) also adopted autonomous investment and administrative

(banks, SOEs). Basically, the direct administration is responsible for policy formulation, while indirect administration is more operational. In practice, however, several indirect administration branches are quite autonomous for policy making. It is often believed that the indirect administration is less inclined to clientelism and there is more room for technical decision, while political appointments characterize direct administration. This might be true in the case of the BNDES, or later on in the Central Bank, but several bureaucracies within the indirect administration were characterized by political appointments. Conversely, economic ministries have been inclined toward technical staff appointments (Nunes, 1983).

¹⁸ Yet, authoritarian mechanisms did not hamper economic actors from lobbying. Interest intermediation was exerted directly upon the BNDES, which, possessing financial and administrative autonomy, was able to filter these demands according to their policy objectives.

actions. The institutionalization of mechanisms of protection, such as quantitative restraints, licenses, and high tariffs, provided an impetus to these autonomous entities. Brazilian state-owned enterprises, such as CSN (steel maker) PETROBRAS (oil), ELETROBRAS (electric energy generation) were forthright in influencing trade and investment policies toward their own benefit. Quite surprisingly, their position sometimes was against protectionism and import substitution. For example, state steel makers, eager to acquire imported and better quality machinery, often exerted pressure for more flexible rules on the import of capital goods. ISI financing programs carried out by the BNDES, aimed at acquiring autonomy in capital goods production, were implemented at the expense of these SOEs. But most often, SOEs were comfortable with monopolies and the subsidies granted by the federal government.

The State as Supporter of Exporting Activities and the Role of FDI

ISI should also be understood as the process of capitalist expansion and the integration of Brazil into the international economy, whereby the state supported economic actors – both private and public– in new ventures involving foreign markets. After the 1964 military intervention, this statist trend deepened significantly. New mechanisms of state financing were designed, including a tax on industrial goods (the IPI) and a tax on services (the ICMS), both regressively applied to several stages of production. The issuing of public bonds in domestic financial markets also increased during this period. The enlargement of the Brazilian state happened concurrently with a period of liquidity in international financial markets in late 1960s and early 1970s, when financial resources, due the deposit of oil producing countries into European banks, were made available. Brazil, along with the other larger Latin American countries borrowed widely to finance huge infrastructure outlays and development projects.

Several SOEs, which had full-fledged administrative autonomy, took advantage of this trend, and in fact the expansion of SOEs in Brazil was part of this boom in international capital flows. As a consequence, there was a mushrooming of SOE subsidiaries and the diversification of productive activities. For example, PETROBRAS created subsidiaries to tap into chemical and fertilizer markets, which had huge domestic demand. This supply of foreign credit allowed SOES to implement a vertical integration strategy. CSN, the state owned steel maker, for instance, expanded into complementary activities establishing subsidiaries in transport (railroads) and trading, but also pulp, paper and reforestation industries. Some SOEs also established service-oriented companies, such as insurance. The restrictive regulatory framework of the country kept markets captive, as high barriers to entry hindered competition, SOEs charged monopoly prices whenever possible. Therefore, this logic of business expansion reinforced the highly regulated nature of Brazil's economic institutions.

Export promoting policies should be understood within this context of state-led capitalist expansion, which characterized the late ISI years in Brazil. Despite the so-called inward orientation of the ISI model in Latin America, Brazilian policymakers were forthright in seeking out external markets, so as to acquire hard currency and tackle balance of payment problems, but also for microeconomic reasons. Export promotion, by creating economies of scale and supplying to more sophisticated markets, provided an outlet for manufactured and valued added products and increased the productivity and competitiveness of domestic companies. It was a highly desired aim of policymakers to increase the participation of manufactured and value added goods in the trade portfolio of the country because, having higher income elasticity, they are less susceptible to price swings and unfavorable terms of trade. In

fact, governmental authorities created a myriad of incentives to help Brazilian products climb up in the knowledge ladder and reach more demanding and specialized markets. The aircraft and weapons industry is a successful example of an alliance between SOEs, private companies and governmental institutes in the quest to enter more specialized international markets (Goldstein 2002). Durable consumer goods, such as the auto industry and appliances, also benefited from export financing.

In the administrative/institutional realm, in addition to the preeminent role of BNDES in promoting several manufacturing sectors, the federal government established CACEX (Foreign Trade Chamber). Initially conceived as a chapter of the Bank of Brazil, this entity acquired considerable administrative autonomy, in the distribution of sizable foreign trade subsidies. The CACEX is another clear example of bureaucratic insulation and a pocket of efficiency, where technical skilled staff had full discretion to provide export incentives such as duty drawbacks and tax exceptions. CACEX also managed BEFIEEX (Special Fiscal Benefits for Exports) a program in which firms negotiated incentive packages in exchange for long-term export commitments. Finally, CACEX also granted import tariff and tax exemptions (IPI and ICMS) for capital goods, components and raw material imports, even when these inputs were purchased by an interested company in the domestic market. Thus, CACEX had full discretion to bypass the “Law of Similar”, a milestone of Brazilian ISI policy that banned imports whenever a domestic substitute was available (Shapiro 1997). With this policy primacy, CACEX often clashed with other bureaucratic interests: the BNDES and other agencies that regulated industrial policies and the establishment of import quotas, such as the Council for Industrial Development (CDI) and the Council for Tariff Policy (CPA), both under the realm of the Ministry of Industry and Commerce (Motta Veiga 1998).

Foreign direct investment (FDI), alone or in joint ventures with SOEs or national private capital, was part of this process to enhance large-scale industrialization and export promotion. The role of FDI is somewhat contradictory with the initial spirit of ISI, since the ideology of industrialization is enmeshed with an appeal for autonomy, security and nationalism. This policy inclination would change in the 1960s and 1970s, when FDI was pragmatically welcomed to promote the autonomist project. Foreign automakers, for instance, were keen to apply for the subsidies and exporting incentives granted by the Brazilian government. This presence of FDI, however, was predominant in manufactures and consumer goods, while public services and infrastructure activities were kept closed and under state control. In technological areas – such as electronic goods and information technology (IT) – the approach toward FDI was mixed. Brazil attempted to create domestic capacity during the 1970s - a national hardware industry for example. Severe regulations, such as quotas and import licenses, as well as BNDES subsidies were applied. FDI was welcomed in this field, in joint ventures with national capital; however, it was tied to performance requirements and the transfer of technology. Overall, policies for the technology sector were also restrictive and ruled by ideological biases and government planning (Adler 1984, Bastos 1995).

Summing up, multinational companies (MNCs) largely benefited from tax holidays, subsidies and state financing aimed at enhancing industrial capacity and the increased manufactures in Brazil's trade portfolio. The FDI strategy initially complemented the sizable and protected Brazilian domestic market. Later on, MNCs joined forces with private and state owned Brazilian companies to develop an export orientated industrial sector. At times, MNCs lobbied for a less restrictive approach regarding intermediary and capital goods imports, as some consumer goods depend on

inputs such as steel, and limited competition augmented production costs. Automakers were among the groups that complained about licenses, quotas, and the mechanism of national similarity as a way of protecting domestic producers of capital goods. Most often, though, MNCs were comfortable with domestic protection, and transferred to the consumer and to the final product the burden of expensive production inputs.

ISI and the Political Economy of Macro and Micro Inconsistencies

It is indisputable that Brazil and Latin America experienced high rates of growth during the ISI years (tables 3 and 4). Saving rates in Brazil and Latin America, however, were considerably lower than international standards even during the late ISI years (Figure 1). From a macroeconomic angle, state intervention was not sufficient to launch a sustainable process of development, since it deferred aggregate saving. Furthermore, the rigidity of economic institutions hindered the business environment, even though, from a microeconomic aspect, many economists and political scientists acknowledge the benefits of state-led industrialization (e.g. the process of learning-by-doing and technological upgrading) (Wade 1990, Chang 1999, Hausmann and Rodrik 2003). Nevertheless, in contrast to the East Asian ISI experience, which was also characterized by state intervention, trade protection and economic regulation, Brazil and other Latin American countries took much longer to liberalize imports and fiscal profligacy undermined the macroeconomics soundness of the model. In brief, lagging productivity and balance of payments problems soon became apparent.

Despite the incentives to spur value-added activities, the hindrance on capital and intermediary goods imports caused a burden on Brazilian industry. Furthermore, tariffs and regulatory barriers-to-entry kept domestic markets captive to state owned firms in several sectors, decreasing incentives for productivity boosting investments.

The level of tariffs from that period shows that capital and intermediary goods experienced high protection, reflecting the capacity of owners of capital goods to lobby for protection. SOEs were also instrumental in pushing for their own interests. Tables 5 and 6 in the statistical annex portray the level of effective protection during classic ISI years.

ISI policies spawned mechanisms to deal with balance of payment pressures, including quotas and import licenses, export subsidization and multiple exchange rate systems. Economic theory shows that tariffs on imports and subsidies on exports are equivalent to exchange rate devaluation. Under the tariff-subsidy-license alternative, there are incentives for smuggling imports, over-invoicing exports and so on, which do not arise in the presence of a uniform exchange rate (Abreu 2004a). Trade regulations created (negative) incentives and inefficiencies, over-protecting domestic industries, increasing red tape and decreasing domestic welfare. According to critics, trade regulations epitomize the rent-seeking characteristic of the ISI experience in Latin America (Krueger, 1990).

Albert Hirschman (1968), in an assessment of the political economy of import substitution in Latin America, acknowledges the alleged flaws of that economic model:

- “(1) Import substituting industrialization is apt to get “stuck” after its first success, due to “exhaustion of easy import substitution opportunities”; it leaves the economy with a few relative high-cost industrial establishments and with a far more vulnerable balance of payments since imports consist now of semi-finished materials, spare parts and machinery indispensably required for maintaining and increasing production and employment.
- (2) Import substituting industrialization is affected by seemingly congenital inability to move into export markets”

According to Hirschman, the solution for the first setback would be to adopt backward linkages, that is, to encourage investment and productive capacity in heavy

industry sectors that supply inputs and capital goods to downstream industries. For instance, it was not sufficient to build refrigerators and stoves; it was also necessary to acquire productive capacity in steel production and energy generation, to guarantee basic inputs and to build the machines used to produce consumer goods.

As discussed, Brazilian policymakers, either instinctively or as readers of economic literature, followed policies to correct the problems spelled out by Hirschman. The process of import substituting industrialization in Brazil, in different times, had two clear concerns: First, to create backward linkages with huge governmental outlays in basic industries and infrastructure projects in the post-World War II era. Second, by the late 1960s and early 1970s Brazilian officials recognized the necessity to reach out to overseas markets; hence, they established policy mechanisms to support exports, particularly in value added goods and durable consumer goods, such as automobiles.

The strategy of state intervention worked for a while, as many countries, principally those with large domestic markets, were able to build a considerable industrial base. But the lack of competition undermined the microeconomic logic of the model, and macroeconomic instability (overvalued exchange rates, fiscal deficits and high inflation) worsened the picture. The policy inconsistency problem would be magnified by the fiscal constraints of the 1980s and the propensity of vested interests to lobby successfully. Despite some successful industrialization results, balance of payments problems continued and worsened during the 1980s. Severe macroeconomic imbalances, such as rampant inflation and budget deficits were exacerbated by external shocks, such as the second oil crisis in 1979 and the drying up of international liquidity due to US interest rate hikes in 1980. Depressed commodity prices in world markets and high domestic demand for consumer goods put constant

pressure on domestic reserves, worsening capital accumulation. State debt skyrocketed and ISI started to run out of steam in the late 1970s.

In sum, ISI should be understood in a context of political economy coalitions – the urban middle classes, industrial workers, national and foreign industrialists, state owned enterprises – that were able to influence political outcomes and policy orientations. These policy orientations were embedded in statist ideologies that influenced policymakers and economic actors over the years, in a path dependency fashion that seemed to lock politics in place (Pierson 2000). In spite of domestic and foreign shocks, Brazil's contemporary trade policy reflects these deep-seated political, economic and institutional vestiges of ISI. The regulatory and institutional demands of modern trade negotiations such as Doha and the FTAA, e.g. rules of investment, service intellectual property rights, government procurement, clash with this long-standing restrictive framework and political economic cleavages in Brazil. External macroeconomic shocks, reinforced by the domestic structure, also undermined attempts at modernization. In the next section I examine the more recent structural reforms that have been undertaken in Brazil, which have revamped the situation in some respects, but barely scraped the surface in many others.

Section III - The Demise of ISI, Macroeconomic Imbalances and Structural Reforms

The macroeconomic imbalances of the 1980s and the imperatives of structural adjustment in the late 1980s and 1990s are crucial for understanding public policies implemented during this period in Brazil. The political institutions of the country significantly affect policymaking and policy outcomes; hence, the re-democratization

after 1985 and the Constitution enacted in 1988 also played a crucial role. Thus, economic and trade policies should be considered as a function of a new domestic political equilibrium. Additionally, policies have also been influenced by international trends, namely the liberalizing orientation of the Washington Consensus.¹⁹ However, the country followed the agenda in a piecemeal and pragmatic approach, meaning that commitment toward market reforms was only partial and aimed at correcting short-run fiscal problems (Pineiro et al 2004). In short, contradictory forces have affected recent foreign economic policy in Brazil: the long lasting nationalistic-developmental tradition conflicts with state-retrenchment and market oriented reforms, prompted by the forces of economic globalization. The policy preferences of various administrations have been influenced by these conflicting worldviews since the economic collapse of the 1980s. Although reforms have been adopted – more wholeheartedly under the government of Collor (1990-1992) or more cautiously as with the current government of Lula da Silva (2002 - present) – long standing policy characteristics continued to conflict in several areas, such as trade policy.

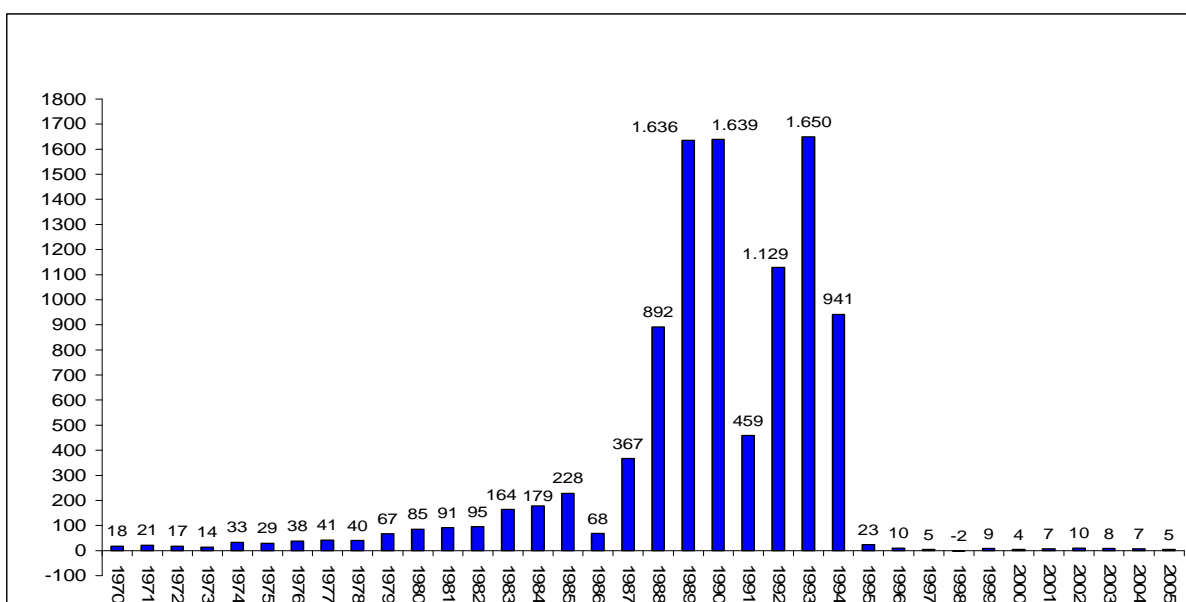
Macroeconomic Imbalances and the Fallout from ISI

The macroeconomic problems of Brazil had both foreign and domestic causes. On the external front, they were triggered by the sharp increase in US interest rates in response to the second OPEC oil shock in 1979. Both events were highly detrimental to net oil consuming countries like Brazil, which faced a dramatic problem of declining terms of trade. This, in turn, prompted a policy of gradual currency devaluations that provoked spiraling inflation rates. Public and private external debt skyrocketed, and the huge state debt fueled fiscal profligacy and the blatant use of

¹⁹ The literature about structural reforms in Latin America – also known as Washington Consensus - is extensive. For a summary and review after ten years after the launching of the project, Kuczynski and Williamson (2003).

seignorage provoked spiraling inflation rates (figure 2). Added to the currency devaluations, hyperinflation and recession ensued – prompting a classic scenario of stagflation. After 1982, the decade was characterized by failed heterodox stabilization programs and a decline in the public sector’s fiscal position. In short, balance of payment problems limited growth and were a main characteristic of the 1980s. Along with severe fiscal constraints and chronic financial crises, these decimated the Brazilian public sector and seriously undermined public investment capacity. Public sector savings shrank by 6-8percent of GDP from 1970-1977, and then dwindled harshly to negative rates in 1985 (Abreu 2004c).

Figure 2: Consumer Price Index in Brazil, 1970-2005.



Observation: in December 1993, inflation reached 2,490.99 percent

Source: Brazilian Central Bank and Economic research foundation/University of São Paulo -FIPE/USP.

The effects of these macroeconomic imbalances on trade and industrial policies were numerous and complex. As ISI policies were based on a series of regulations, quotas, tariffs, tax breaks and export incentives to support domestic production against foreign competition, the troubled situation of the public accounts

provoked financial strain and doubts about the feasibility of continuing these high levels of state support. Albeit potentially justifiable in other contexts, the fiscal constraints and growing skepticism about their social return rendered these transfers subject to criticism from various sectors within the economic bureaucracy (Shapiro 1997). The industrial and trade policy bureaucracies were especially harmed by the credit drought. Nevertheless, CACEX was not extinguished until 1990, while the Council for Industrial Development (CDI) and the Council for Tariff Policy (CPA) were closed shortly before. Thus, despite the prolonged crisis of the 1980s, industrial supporting policies and bureaucracies, in a sort of inertia, were not removed right away.

Notwithstanding the mounting fiscal constraints, over the 1980s, 3-4percent of GDP were still transferred annually to the private exporting sector in the form government spending or non-collected revenue (Shapiro 1997). It is important to note that the total value of exports incentives relative to export did fall after 1982. But the still high incentives of the early 1980s, along with the currency devaluations, were attempts to make up for the dramatic deterioration in Brazil's terms of trade. In 1983, exports minus imports were almost 40 percent lower than the 1970-72 average. A trade deficit of almost US\$ 3 billion in 1980 was moderately reversed in 1981 and 1982 because exports increased rapidly, but import contraction and controls played a major role in response to foreign exchange devaluation.²⁰ The total value of incentives to exports as a percentage of GDP began to fall only towards the end of the 1980s with the phase out of subsidy lines. Public and private external debt also increased sharply: from 1980 to 1986, Brazil saw its stock of foreign debt double from US\$ 64.3 billion to US\$ 111.2 billion. As an example of the country's long history of

²⁰ The numbers in this paragraph come from Abreu 2004c and Abreu and Werneck 2005.

socializing private losses, a significant part of this foreign debt was indexed to the US dollar. In the late 1970s, those borrowers holding debt in foreign currency were allowed to hedge their foreign exchange risks by making deposits in the central bank, in a context in which the premium between official and black market exchange rates exceeded 100 percent. In short, Brazil's foreign debt became the responsibility of the Federal government (Abreu 2004c; Abreu and Werneck 2005).

This example confirms the ability of private groups to extract concessions from the Brazilian state up until the very end of the ISI model. The bureaucratic insulation, initially designed to promote politically neutral and efficient public policies, reinforced these predatory tendencies due to the intrinsic lack of accountability. Thus, it is important to acknowledge that, in addition to the macroeconomic and fiscal constraints, governance problems greatly undermined public policies in Brazil. This institutional frailty was expressed in the poor performance of the insulated state agencies responsible for trade, which became increasingly controlled by private interests. Hence, bureaucratic insulation contributed to the declining management capacity and ineffectiveness of trade policy, which became a field day for clientelist politics. According to Fritsch and Franco (1993), export incentives were indeed important to neutralize the anti-export bias in an environment of high effective protection, but the macroeconomic situation and the lack of co-ordination between bureaucracies turned outcomes frustrating and by the late 1980s the share of imports plus exports over GDP in the Brazilian economy kept at same levels of the early 1960s, around 12 percent (figure 3).

Besides, due to macroeconomic disarray and to public investment freeze, SOEs in the industrial and public utilities sectors were seriously undermined in their ability to expand production and provide services. Yet, SOEs' markets were still

captive by high barriers of entry in the way of tariffs and infrastructure regulations. Price controls on public utilities, as part of the attempted heterodox adjustment plans, also compromised the financial soundness of domestic firms. The consequence was a decline in productivity and in the quality of services delivered to the population.

Despite the apparent failure of the interventionist strategy, the policy debate in the late 1980s was still biased toward the necessity of increasing state investment in order to restore economic growth and to address the blatant levels of social disparity. The presidency of José Sarney (1985-1989), the first democratic administration since 1964, implemented economic packages meant to re-start economic growth. The Cruzado Plan, for example, used price controls and fiscal measures to support the productive sectors and foster aggregate demand. However, these heterodox macroeconomic measures failed to curb inflation or rationalize fiscal policy; public investments and social transfer mechanisms could still not be properly financed.

Amongst these signals of macroeconomic and fiscal disorder, undermining industrial policy and export promotion mechanisms, new trade themes like investment and services were brought to center stage by the US when the Uruguay Round of the GATT was launched in 1986. Notwithstanding domestic competitiveness problems, the “national-developmental” orientation still prevailed in the domestic debate: hence the relationship between intellectual property rights (IPRs) protection and national technological and industrial policies became a stronghold for Brazilian foreign economic policy in the late 1980s. In the domestic realm the Special Secretariat for Informatics (SEI), established in 1979 to formulate and implement national information technology policies, was able to set up regulations and high tariffs to avoid international competition. The country then stiffened its position regarding IPR protection in the multilateral negotiations of the GATT (Odell 1987).

In the 1970s, Brazil attempted to build a domestic hardware industry that relied heavily on copycatting, reverse engineering and technological adaptation at the expense of international patents. The technology policy also protected multinational companies (MNC), such as IBM, which established joint ventures with Brazilian companies and thus kept a sizable domestic market at bay.²¹ Despite technological progress in some areas, such as bank automation, Brazil was not able to establish competitive domestic industries in hardware due to price differentials between foreign competitors. The state owned company COBRA S.A, for instance, which attempted to develop a Brazilian desktop, epitomized this failed attempt. Notwithstanding the better performance in software, Brazil also made some confusing protectionist moves in this field, as in 1987 when SEI denied Microsoft the licensing of the MS-DOS software due to the existence of a domestic substitute.

Ultimately, the SEI was also shut down, as Brazil engaged in negotiations over IPR in the Uruguay Round. As a consequence of this international agreement, the country enacted less restrictive and more internationally harmonized IPR legislation in 1996. But this squabble exemplifies the die-hard influence of the national-developmental approach in trade and domestic industrial policies, despite pressure from international and domestic actors that called for liberalization. The maintenance of stiff regulations in a dynamic market such as IT exemplifies the rigidity of domestic policymaking, despite the fiscal deterioration and poor governance capability of the public sector and lack of competitiveness of the private sector.²² IPR

²¹ The technological subsidization effort in Brazil dates back from late 1960s, when the BNDES established financing lines aiming at improving technological capability of domestic companies (FUNTEC) and acquisition domestic equipments and machinery (FINAME). Even a new subsidiary SOE was founded (FINEP) to tap into the R&D public financing (Bastos 1995).

²² On the other hand, R&D subsidizing has public goods characteristics and creates spillover effects to other economic sectors. Brazilian policymakers were understandably attempting to create an environment for technological innovation similar to that cultivated by the East Asian countries (Korea,

continued to be a controversial issue in multilateral and regional trade negotiations during the 1990s and 2000s, with Brazilian negotiators always referring to the necessity of preserving domestic policy autonomy.

Democratization, the 1988 Constitution and its Effects on Economic Policy

According to the literature on institutions and economic growth, democratic political regimes create strains on public finances, and thus impose a toll on development performance (Campos and Nugent 1999, Weyland 2002, Wise 2003). After 1985, the democratization process in Brazil clearly increased the pressure on the state budget. This impetus was symbolized by a social-democratic Constitution, enacted in 1988, which earmarked several transfers meant to benefit broad social groups. Revenue earmarking is an instrument to deal with the volatility in tax collections and ensure continuity in public policies, particularly during periods of fiscal constraint. For instance, the new Constitution established a minimum level of expenses that had to be upheld for health, education and social security as a percentage of the annual budget. The Constitution also increased labor benefits and transferred federal funds directly to states and municipalities.

In addition to the redistributive mandate, the Constitution had extensive impact on economic life since it attempted to reinforce nationalistic order, one in which the Brazilian state and private national groups would be the main executors of economic development. International investments, for example, were restricted in infrastructure (mining, energy, telecommunications, media, transport), or prohibited, as in health and social insurance. Policymakers' rationale for limiting foreign

Taiwan). Meanwhile, in Brazil, there was a tendency toward excessive government financing in picking winners (supply driven policies) and a lack of contact between public research institutes and the private sector. Besides, high barriers to entry, limited national learning ability and created an additional roadblock for technological upgrading (Bastos 1995; Oliveira 2005).

investments and increasing direct state participation in key economic sectors assumed these were strategic, e.g. addressing market failures such as asymmetric information and externalities. This national provision of public goods may have preserved national economic interests, but not in a constructive manner: high barriers of entry were reaffirmed, inhibiting investment capacity, creating monopoly power and, hence, driving prices up and services/goods provision down.

Albeit a symbol of the democratization process after 20 years of military rule, the 1988 Constitution attempted to create a welfare state by decree. The Constitutional debate overlooked the fiscal situation of the Brazilian public sector during the debt crisis of the 1980s, regarding it as a momentary setback rather than a structural problem. Additionally, Brazilian policymakers and legislators grossly overlooked the dynamics of economic globalization of the late 20th century, which were already challenging the financing capacity of national governments and spreading new ground-breaking technologies in public administration and network industries. Wise (2003) remarks that the policy debate in Latin America in the last decades of the 20th century has been characterized by a polarization between state-versus-market approaches – pure interventionism versus free-market fundamentalism, and the Brazilian Constitution epitomizes this trend. A more appropriate discussion would distinguish between an interventionist versus a regulatory state and would look for ways to use public policy to facilitate market failure corrections. However, this discussion was absent from the 1988 Constitution, and it would take a couple of more years until it was seriously incorporated into the policy debate in Brazil.

From a political economy point of view, several lobbies blocked the economic laissez-faire approach during the Constitutional debate. The overriding bias was that SOEs or public institutions should be the main providers of public utilities,

infrastructure and transport services, agricultural and health care financing, and R&D activities. Capital goods, durable and non-durable consumer goods' production was left in the hands of private domestic capital and international companies already positioned in the domestic market. In sum, the Constitution approved an economic order characterized by dirigisme, which would greatly influence the Brazilian trade negotiating position in the late 1990s, not only in the discussion of market access and tariffs, but also in issues such as services, investments and IPR – all of which have close connection with domestic economic institutions and regulations.

Concerning the bolstering of democratic and pluralistic rights, it is auspicious that the Constitution enhanced social and political participation after twenty years of military rule. However, it perpetrated severe imbalances that have taken a toll on economic policymaking and public governance. The Federal Executive had its legislative power greatly enhanced by the mechanisms of provisional measures,²³ though this power is still constrained and checked by the Congress, the Judiciary, public prosecutors and the bureaucracy. Despite this precedence of the Executive, the political capital expended to bypass some Constitutional guarantees, for instance, to enact reforming legislation, revealed the weaknesses of the political system. This trend became evident with the mushrooming of corruption scandals. The Constitution also re-established a tendency toward decentralization in the delivery of social policy (health and education) and it earmarked funds for these policies. While a much-esteemed objective, de-centralization created fiscal constraints for the Federal Executive, which transferred resources to states and municipalities, but policy

²³ The provisional measures (*medidas provisórias*) are legislative decrees proposed by the Executive and were passed to speed up the structural reform process. For a contemporary account of the institutional characteristics of Brazilian democracy see Carroll and Shugart (2006), particularly on the concept of hyper-representation; for the effects of democratization on policymaking see Alston *et al* (2006).

delivery continued to be problematic. Subsequent amendments to the Constitution in the early 1990s fostered the institutionalization of macroeconomic and fiscal equilibrium and established the dominant role of the Executive in economic policymaking. Unfortunately, sectoral policies, such as social policies, continued to be driven by clientelism.

Almston et al (2006) affirm that the policymaking process in post-Constitution Brazil can be separated into four broad categories: “stable but adaptable” (macroeconomic and fiscal), pork (localized interests of congressmen), “hardwired” (mandatory constitutional transfers, principally in health and education) and residual (policies with a more ideological tone, such as land reform and wealth distribution). According to the authors, the post-Constitution political equilibrium allowed the Federal Executive to trade pork and residual policies for macroeconomic stability and fiscal adjustments, while hardwired policies were kept stable. This new political equilibrium was crucial for macroeconomic balance since it granted autonomy to the Federal Executive in economic policymaking. Conversely, it improved societal leverage because sectoral policies were discussed openly in the Congress. However, in the highly burdensome negotiating process between the Executive and the Congress, special interest groups were forthright in logrolling and approving their particularistic agenda, creating inefficiencies and incentives for corruption.

To sum up, in spite of democratic and pluralistic inclinations and the social transference commitments, Brazil ratified a Constitution that constrains the investment capacity of the economy and set the basis for an unbalanced fiscal federalism, in which the states had no incentive or means to establish and provide public goods. Brazil ended the 1980s not only with another move toward

developmentalism but also with a set of political institutions that had a mixed effect on economic efficiency.

Trade Policy, Macroeconomics and Structural Reforms

The regulatory nature of Brazil's Constitution would soon be at odds with the new hemispheric thrust toward state retrenchment and pro-market reforms that took off in the early 1990s. Structural adjustment policies under the banner of the Washington Consensus (WC) became a constant in the discourse of Latin American policy makers at this time. On the macro front, these policies promoted monetary stability, fiscal balance and real exchange rate adjustments; the microeconomic aspects of WC reforms embraced trade openness/liberalization, the privatization of state owned companies, and deregulation of the economy. Brazil, like other Latin American economies, used unilateral tariff slashing to stimulate competition with foreign goods and to curb inflation which, by the end of the 1980s, was running in the three digit range (see figure 2 above).

The early trade liberalization measures were launched under President Sarney (1985-89), the first civilian president after 20 years of military rule. Following a highly polarized election in 1990, the administration of President Collor enhanced the pro-reform and market orientation of Brazil's economic policy, continuing to lower tariffs and deepen the process of privatizing state companies. Political scandals provoked the impeachment of Collor in 1992, but the reforms continued, particularly the unilateral tariff cuts.

The new Constitution reinforced the prominent role of the federal executive in negotiating trade agreements, which then needed to be ratified by the Lower Chamber of Congress and the Senate. Other social and political actors within civil society could work through the Congress in order to input their policy preferences. Meanwhile, the

actual trade negotiation and industrial policy making were, respectively, still highly insulated the Ministry of Foreign Relations (Itamaraty) and in the Ministry of Industry and Commerce. The economic ministries (Finance and Planning) played a marginal role in trade issues. Hence, direct lobbies around the federal executive continued to exert pressure for protection, or at least, to receive compensation for the pain of economic liberalization (e.g. export subsidies and tax exceptions). During the Sarney presidency, for example, there were some attempts to institutionalize the sectoral chambers that represented industrial and trade policy, although this effort failed because of a continued macroeconomic instability. It was still all too apparent that the process of trade liberalization in Brazil would be carried out in a piecemeal format and that industrial groups would hang on tenaciously to their demands for protection (Diniz 2000).

Despite Brazil's gradualist stance, it played a leadership role in the launching of Mercosur in 1990, a customs union initially negotiated between Brazil, Argentina, Paraguay and Uruguay. Mercosur's subsequent establishment of a Common External Tariff (CET), covering almost 90 percent of goods in the internal market, was an important step toward fostering trade liberalization and consolidating domestic structural reforms. It also symbolized a new approach to trade policymaking, one where member governments used trade liberalization as an anchor for macroeconomic stability and with the long run intention of improving domestic competitiveness.

As Edwards (1995) has noted, arrangements such as Mercosur marked a shift in the region, from closed economies, high tariffs, heavy state intervention in productive activities, and overvalued real exchange rates. The initial results of unilateral trade liberalization were impressive, as an upsurge of regional trade integration projects followed. This included the revamping of earlier regional trade

schemes in the Central American and Andean blocs, and the 1994 implementation of the North American Free Trade Agreement (NAFTA). This regional integration trend was both a consequence of unilateral trade liberalization and the overall need for structural adjustment; these, in turn, were logical responses to the debt shocks of the early 1980s and of the outright collapse of an interventionist development model.

As a customs union, Mercosur set a single tariff for all members, which averaged 12 percent by 1995. The Common External Tariff (CET) also granted temporary tariff exceptions for certain industrial sectors (e.g. automobiles and information technology/electronics), allowing them time to restructure and catch up with international practices and productivity trends. The automotive regime, for instance, established a sectoral agreement between Brazilian and Argentine automakers in 1996, which was initially scheduled to end in 2006. This initial deadline was modified (extend till 2011), as the automotive sector in Mercosur has become a contentious aspect of the customs union. As endogenous trade policy asserts, those sectors temporarily exempted from the average CET possess less comparative advantage vis-à-vis foreign competitors (Olarreaga and Soloaga 1997). In short, the continued exceptions to the CET and the automobile regime are examples of managed trade policy and vestiges of earlier protectionism that continue to characterize Brazil and the southern countries in the 1990s (Leipziger et al 1997).

Even so, the first half of the 1990s did see a complete revamping of Brazilian trade policy, including the extinction of old export subsidy programs (BEFIEX), and creation of new GATT-friendly instruments (PROEX).²⁴ The business chambers also underwent a bureaucratic overhaul that established CAMEX (Inter-ministerial

²⁴ PROEX (Program for Export Financing), initially managed by the BNDES, absorbed some of the old financial lines in the financing of capital good exports, but was mainly targeted at interest rate equalization.

Chamber of External Trade) in 1995 (Motta Veiga 1998). These institutional innovations, although important, have still not provided Brazil with the adequate tools to craft a coherent negotiation strategy, or to properly address the new trade themes within multilateral and regional venues. This lack of policy co-ordination became apparent with the collapse of both the FTAA and the Doha negotiations, as the pro-market and liberalizing contingent within some sectors of the bureaucracy clashed with the traditional state led and regulated agenda within others.²⁵

Trade policy would also be deeply influenced by the macroeconomic adjustments after the 1994 Plan Real. This plan, although successful in taming inflation, soon reinforced the lack of consensus among different bureaucracies concerning trade liberalization, also echoed within civil society. During the two administrations of President Cardoso (1995-2002), the debate was clearly between the developmentalists, influenced by powerful industrialists in the state of São Paulo and their entrenched allies within the Ministry of Industry and Trade, and the Ministry of Foreign Affairs, to a certain degree, and the monetarists, pro-market sectors from the Ministry of Finance and the Central Bank. The latter faction had broken with tradition and wanted tighter monetary and fiscal policy in line with the Washington Consensus, despite alleged deleterious effects of such policies on the productive sector (Abreu and Werneck 2005).

The Plan Real, launched in 1994, had elements of both heterodox and orthodox policy, but overall it adopted a more monetarist approach, pegging the new currency (Real) to the US dollar. Unilateral tariff cuts were also made to force domestic goods to compete more forcefully with foreign goods, and to combat

²⁵ As a customs union, Mercosur members should have a single negotiation strategy in multilateral and regional trade talks, but countries have not agreed on joint positions in several issues and, principally, exogenous shocks have been adversely affecting the negotiations.

inflation. Tariff reforms provoked a steeper decrease in the rates of effective protection in several industries and economic sectors (see tables 7 and 8 in the statistical annex). In short, average tariffs decreased from 32.2 percent in the early 1990s to 12.1 percent in 1995 (Pinheiro et al. 2004: table 01). At the same time, meanwhile, several capital-intensive sectors continued to have above average effective rates of protection (Abreu and Werneck 2005).

In addition to this strategy of macroeconomic stabilization in the 1990s, Brazil pursued a microeconomic agenda based on privatizing, deregulating and liberalizing the domestic economy. The launching of the Brazilian national privatization program in 1990 was a major step forward. The selling of steel companies, such as Usiminas in 1991 and Vale do Rio Doce in 1995, were critical landmarks in this process – symbolizing the initial surrender of the Brazilian industrial state. Privatization has passed through several distinct phases, beginning with the industrial sector, and then the public utility companies. According to the official position (Brazilian Ministry of Finance 2002), privatization has been part of broader reform strategy aimed at generating a fiscal surplus and establishing a sound basis for fiscal revenues in the long run. Additionally, privatization contributed to the better quality and reduced prices for products and services, and it attracted foreign direct investment (FDI), which helped to finance the chronic current account deficits of the 1990s (figure 4 below). Governmental regulatory agencies were created to monitor the efficiency of these de-regulated markets. Total proceeds from privatization, comprising sales proceeds and debt transferred, accumulated US\$ 105 billions in 2002. (Ministry of Finance 2002: table 09)

Regardless of these accomplishments, the economic policies embraced during this period were far from the simple orthodox blueprint of the WC. Generally

speaking, state intervention in economic affairs continued, but emphasis was now placed on managerial skills rather than the state's entrepreneurial position (Giambiagi and Moreira 2000; Ministry of Finance 2002). In fact, a more contemporary debate about the tasks and role of the state in economic development was finally initiated in the mid 1990s. During this period, several Constitutional amendments were enacted to allow for more market friendly legislation and private participation in the provision of infrastructure. Yet, neo-liberalism, privatization, and so are expressions that still grate on the political lexicon in Brazil, even within more right wing and conservative circles.

Therefore, despite the so-called shift in the role of the state in Brazil, Pinheiro et al. (2004) stress that structural policy reforms were pragmatic and aimed at resolving urgent monetary and fiscal problems. In other words, policymakers did not commit wholeheartedly to the pro-market agenda. Across Latin America, the bundling of economic reforms was common in this period, but the lack of a more modern and complementary institutional environment was apparent. Hence, the macroeconomic agenda progressed at a much faster pace, while microeconomic and institutional reforms lagged behind. Finally, it is worth noting that social spending, – on health, education, pensions and welfare programs – albeit riddled with imperfections, is a sizable part of the Brazilian budget and comparable or even superior to similar emerging market countries. Reforms in these sectors have been also problematic. Pension reform, made urgent by a spendthrift public pension system, was constantly defeated by the Congress during the Cardoso presidency. Although Brazil's social safety net is thick, the country is attempting to overhaul its welfare and labor legislation in order to improve formal employment and establish a sounder basis for economic growth. Social and labor reforms are imperative for

improving the economic competitiveness of the country in world markets, but they entail complex political economy trade-offs and cleavages. Therefore, a cautious and piecemeal reformist approach was reassured with the election of the Labor Party government led by Luis Inácio “Lula” da Silva in 2002.

Overall, the policy agendas of both Cardoso and Lula have been similar. Both were based on a social democratic platform that promised to tackle inflation and the disarray in public finances and governance; and, although a deeper commitment toward economic liberalism was evident under both, official discourse downplayed the WC influence. Gradualism prevailed, but the bundling of reforms meant that delays in one issue area would damage other policy objectives. For instance, delays in administrative and bureaucratic reform hindered the building up of more effective regulatory agencies. Administrative and bureaucratic reforms were also slowed by the use of patronage appointments to please political allies in the congress. The federal executive took responsibility for advancing the reformist agenda in the Congress, but it had to finesse the opposition each step of the way. Several amendments to the Constitution were necessary in order to allow the privatization of public utilities sectors, and the federal executive was forced to rely on provisional measures and strictly technical terms based on dire fiscal necessity. As a baseline for comparison, other Latin America countries adopted the neoliberal agenda more deeply in the 1990s, such as Argentina and Bolivia (Wise and Roett 2002; Wise 2003).

Additionally, Brazil maintained a system of incentives and subsidies aimed at compensating sectors badly affected by adjustments. As Schamis (1999) argues, the reforms were carried out in order to allow owners of capital to relocate to other more promising sectors. The privatization of state assets in the telecommunications and energy sectors, for instance, was partially financed by BNDES. During the second

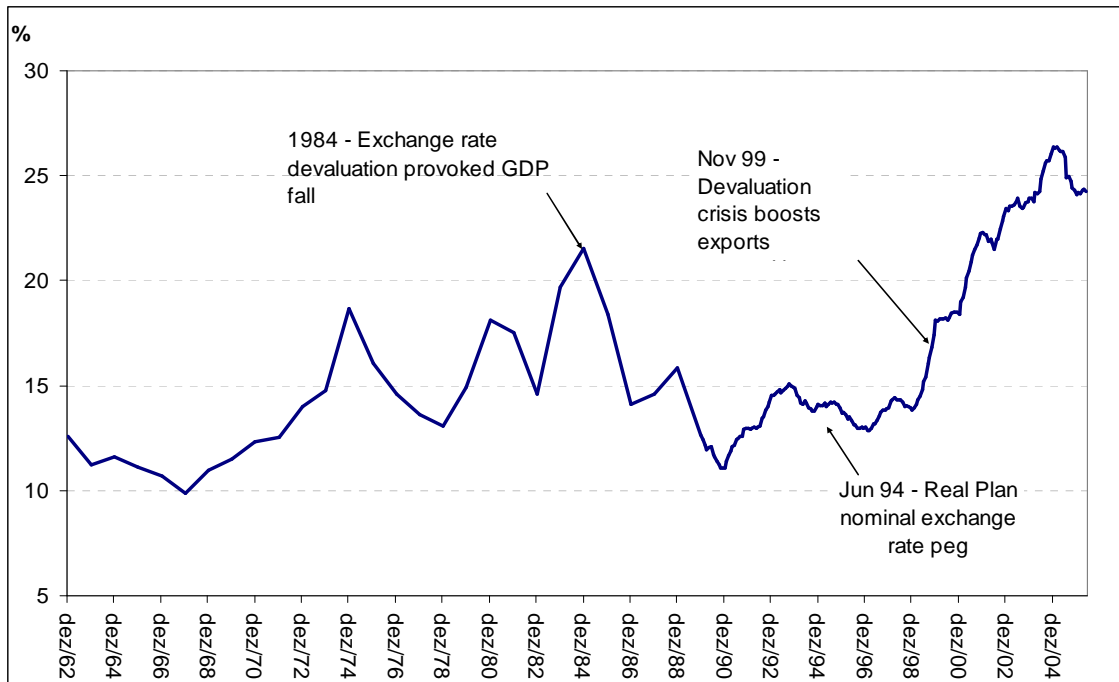
half of the 1990s, the federal government also assumed a series of financial liabilities from bankrupt banks, such as the state owned Bank of São Paulo (Banespa), the private owned Economico, and a massive bail out for the domestic banking sector (PROER). Although these measures were considered important stepping-stones towards a more robust domestic banking sector, and justified by the turmoil and international financial crises of Mexico (1994) and East Asia (1997), the Brazilian state was criticized at home for transferring income to economic privileged sectors.

In brief, Brazil's macroeconomic record during the 1990s and early 2000s was far from negligible. It was able to launch a sweeping monetary adjustment and curb skyrocketing inflation in 1994. Later on, Brazil committed to a targeted inflation policy and to Central Bank independence, signaling a more credible commitment to monetary stability. After a period of pegging the exchange rate, which helped tame inflation, Brazil adopted a floating currency regime in 1999 (figure 5). It has also been steadily increasing the participation of exports and imports in GDP, which hit 25 percent in 2004 (figure 3). More recently, Brazil also shifted the composition of its public debt, decreasing short-term liabilities issued in foreign currency. Together, these measures have led to current account surpluses and Brazil's closer integration into the world economy, and they have decreased the country's exposure to international financial shocks.

Brazil is also more credibly devoted to maintaining a fiscal balance, as reflected in the passage of a Fiscal Responsibility Law in 1998 to lock in a governmental commitment toward balanced public finances over the long run. Yet, despite these accomplishments, Brazil's real GDP per capita growth, averaging 2.1 percent from 1987-1997 and 2.4 percent from 1996-2006 (IMF 2005), has been far from impressive and lower than the ISI years. Brazil's trade opening and the joining

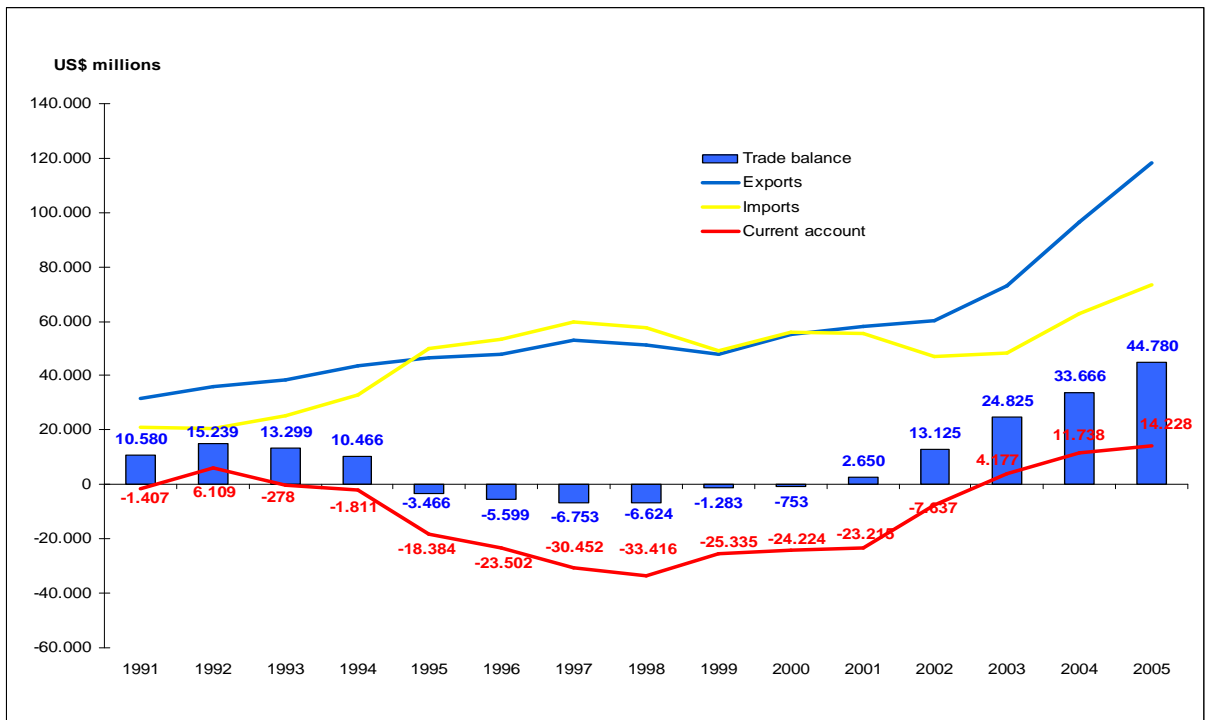
of integration agreements with more advanced economies – both at the multilateral and regional levels – have thus been postponed. For many groups inside the country, this remains a highly contentious issue, as the low growth records in an era of trade opening have fueled suspicion toward further liberalizing measures.

Figure 3: Openness (X+M/GDP), 1962-2005.



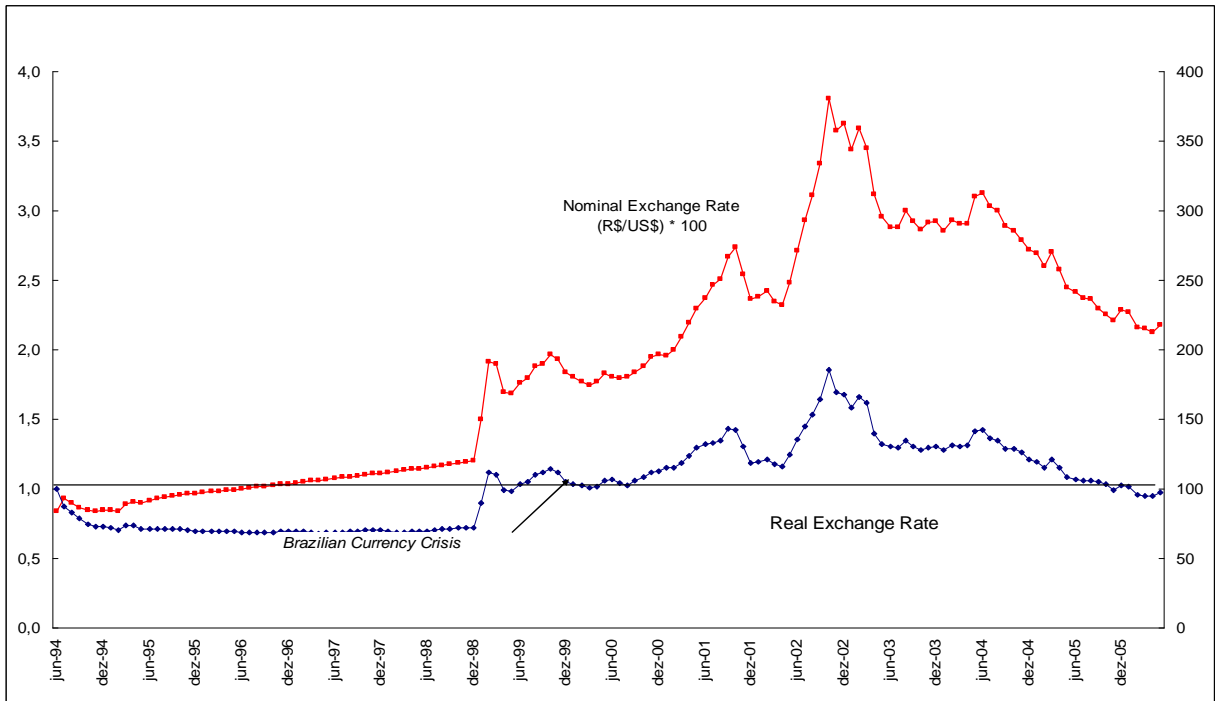
Source: Central Bank of Brazil.

Figure 4: External Sector



Sources: Central Bank and Ministry of Development Industry and Trade of Brazil

Figure 5: Real and Nominal Exchange Rate, 1994-2005¹



Sources: Central Bank of Brazil and Federal Reserve Bank of Saint Louis

¹Monthly averages. Price Deflators: Brazil (IPCA), US (CPI)

Section IV –Trade Integration– Political Economy and Institutional-bureaucratic Determinants

The political economy literature poses a key question: if reforms are beneficial for all, then why are they delayed for so long? The same rationale could be applied to trade liberalization and integration into world economy: if the economic data confirm that these are beneficial for the majority, do they still raise eyebrows in a country like Brazil? Obviously, the answer to this question is a highly complex one. The logic of collective action partially explains this political economy stalemate, as these small groups most affected by reform have a higher capacity for mobilization and are able to obstruct reforms that would benefit the majority (Olson 1967). External and internal shocks can also play an important role, as with the 1980s debt crisis in shifting the delicate political economic support for ISI, and thus quickening its collapse. Increasing integration in the world economy was a consequence of the changing the role of state after the 1980s, when Latin American countries finally faced their macroeconomic problems and embraced a more outward economic model. Yet, even after the success of some structural reforms, localized interests continue to exert pressures for protection. In Brazil, for example, state-bureaucratic actors have emerged as intervening variables, and continue to influence policy outcomes quite autonomously, including the push for managed trade policies. In short, owing to institutional inertia, favored groups continue to reap rents and policymakers still argue for a “developmentalist” state, albeit on a smaller scale and with a different discourse. In other words, despite the impressive changes that the region has undergone in the last 15 years, some traits of the past remain.

In Brazil, as I described in the last section, structural adjustment has followed a gradual approach. As result, the extent of further liberalization and the role of state in the 2000s is a contentious issue. Trade integration with the advanced countries is embedded in this debate. This section analyzes the different positions on trade policy on the domestic front in Brazil, and discusses how second-generation reforms fit into this policy debate.

The Political Economy of Trade and Industrial Policy in Post-Stabilization Brazil

According to the neoliberal political economy critique, the sudden realization of the benefits of a market economy was triggered by the failures of ISI; enlightened policymakers are then prodded to undertake structural adjustments (Krueger 1974). This assumption has been modified by Alesina and Drazen (1991), who argue that postponement of adjustment becomes a war of attrition in which societal and political actors are unwilling to bear the costs of stabilization. Instead, deficits, inflation, and balance of payments crises eventually force socioeconomic groups to take responsibility in solving the problem. Once the payoff of benefits is realized, the stalemate is broken and reforms are undertaken. This model is more related to macroeconomics issues. Stabilization reforms positively impact the whole population, as the costs of spiraling inflation far outweigh the benefits to any one economic faction.

Concerning trade policy, while the aggregated gains of liberalization are considered to be positive, the localized pain for particular economic sectors or industries makes it more difficult to break with protectionist policies. Yet, trade reform can also be launched in a process of macroeconomic adjustment, as the political cost-benefit ratio of protection declines dramatically in a context of

stabilization (Rodrik 1994). Trade liberalization, when implemented along with monetary reform, can help break inflation inertia. In Brazil, support for monetary stabilization under the Real Plan far outweighed the opposition from any displaced groups, in contrast with the mixed opinions expressed about privatization and pension reform, for instance. Thus, these other policy reforms required compensatory measures. With trade liberalization, the unilateral slashing of tariffs created strains on several localized industrial groups, who later demanded special treatment in the application of the CET under Mercosur. Other reforms, such as privatization and deregulation, albeit beneficial for consumers, are not well accepted due to politicized opinions in Brazil about the role of the state in the economy.²⁶

In a later assessment, Rodrik (1996) argues for the need to distinguish between the financial/budgetary/monetary side of structural reforms (macroeconomic policies) and the trade liberalization/deregulation/privatization side (microeconomic policies). He argues that East Asian success was characterized by conservative orthodox management of the macroeconomy, yet greater innovation and flexibility at the microeconomic level, particularly in the realm of industrial and export promotion, but also with policies aimed at enhancing human capital, such as labor training and education. Policy makers in Brazil tend to attribute East Asian success to efficient state intervention in industrial, educational and technological policies, and the selective promotion of foreign trade, rather than the straightforward application of neoliberal precepts. Yet, Brazil's effectiveness in pursuing similar industrial and trade policies during the 1990s was hindered by the lack of governmental coordination, faltering infrastructure, a burdensome tax system and a heavy regulatory environment.

²⁶ Baker (2003) notes that trade liberalization is often regarded by the electorate as more beneficial than privatization, which ranks less favorable in opinion polls, but neither is as popular as macroeconomic stabilization. Also see Latinobarometro (2005).

According to sectors of the Brazilian bureaucracy and society, further trade liberalization within multilateral and or regional agreements may hamper policymakers' ability to carry out active industrial and trade interventions. The rationale for postponing deeper integration is not only Brazil's low capacity to compete with developed country products, but the alleged inability to carry out domestic policies as well. These same sectors, meanwhile, seem to overlook that trade agreements were important for locking in reforms and increased policy effectiveness in countries such as Chile, which has signed bilateral agreements with the US and the European Union, and in Spain and Portugal (Viola 2006; Santiso 2006). In Brazil, even labor-intensive industries, such as apparel and textiles, are suspicious about further integration along the lines of an FTAA or the EU-Mercosur agreement. The rapid rise of China in world trade adds more complexity to these fears: industrialists face stiff competition from Chinese products not only in third countries, but also inside Latin American markets. Furthermore, both foreign and domestic business sectors complain about the high *Custo Brasil* (Brazilian costs) of investing, and this includes everything from poor infrastructure to an overwhelming tax and regulatory environment.

In order to offset some of these costs, Brazil has engaged since mid 2000s in a more pro-active industrial policy, launching an Industrial, Technological, External Trade and policy programs, combined with complementary legislation and measures to increase the access to credit and tax breaks for firms engaging in R&D. These are revamped policy measures aimed at boosting international competitiveness of domestic industries. Although it is too early to gauge the effects of these policies, it seems that the country is now emulating something closer to the East-Asian

developing model. The sound performance of exports – including more value added goods - in the past five years is testimony to this “East Asian” tendency.

The combined effects of trade liberalization and active industrial policies are one of the most contentious points in the international economic relations literature. Neoclassical economists are suspicious about industrial policies aimed at increasing a country’s competitiveness, such as export promotion, while political economists most often argue in favor of such policies. In his study of the cases of Brazil and Korea during the 1960s and 1970s, Rodrik (1993) argues that both countries succeeded in implementing export and industrial promotion policies and creating relatively modern and competitive industrial sectors. These active industrial policies promoted welfare gains domestically, but losses on a world basis. In contrast to the East-Asian experience, however, Brazil’s industrial and trade promotion policies privileged some sophisticated goods with high governmental intervention and subsidies, for example, weapons and aircraft exported to the Middle-Eastern markets. Industrial policies were also combined with trade promotion in traditional goods and commodities, such as iron ores shipped to Japan. In the Brazilian case, state intervention was more expensive since it was targeted at scale intensive activities and sought to exploit remote economic areas of the country, for example, iron mines in the Amazonian region. Land scarce and labor abundant countries such as Korea decided early on to establish labor-intensive industries (apparel, simple electronics, and clothing) that required less costly state action.²⁷ The differences between the two industrial models became evident by the end of the 1980s, when a cash-strapped Brazilian state could no longer promote industries and low levels of public investment reinforced the lack

²⁷ Auty (1995, 2001) critiques the Brazilian strategy and contrasts it with the successful Korean experience.

of structural competitiveness. Despite its diversification in trade partners during the post-war period, Brazil decreased its share in world trade from 2.2 percent in 1945 to 0.87 percent in 2000 (Abreu 2001).

Trade Integration and Second Generation Reforms as Vehicle to Enhance Competitiveness²⁸

The launching of Mercosur in 1990 marked a change in Brazil's foreign economic policy, one that sought to exploit the proximity of neighbors as a logical outlet for Brazilian industrial exports. Additionally, Mercosur was regarded as a vehicle for the modernization of the country's industrial structure. Although trade promotion and industrial policies of the 1960s and 1970s had been successful in diversifying markets and creating economies of scale in some sectors, these failed to generate positive externalities in the highly regulated and distorted domestic market. Trade integration based on liberalization, it seemed, could foster greater export dynamism, not only in high-end sophisticated products, such as aircraft, but also in more mundane consumer goods, such as refrigerators and home appliances.

This scenario departed considerably from the historical experience of trade integration in Latin America, which was regarded as a mechanism to implement ISI strategies: eliminating trade and investment barriers among member countries while maintaining protection against third parties; and, relying on state planning and direct intervention, including the regulation and limitation of FDI (IABD 2002). In short, the "Old Regionalism" yielded low competition, weak economies of scale, poor infrastructure, a lack of private investments (domestic and foreign), all of which actually undermined the early integration schemes of the Andean Community, the

²⁸ This section briefly introduces the debate about regionalism as it relates to Brazil's industrial competitiveness. In the next chapters, I review the current debate about multilateralism and regionalism and how Brazil fits into it.

Central American Common Market (CACM), the Caribbean Community (CARICOM) and the Latin American Integration Association (ALADI). Although a champion of ISI policies, Brazil was not an active participant in these early integration schemes on the continent. Due to the huge size of its internal market and to the country's rich natural endowments in land and labor, Brazil opted for a more autonomous and autarkical development strategy.

Quite differently from this previous experience, Latin American regional integration of the 1990s is based on the liberalization of trade and investment. The North American Free Trade Agreement (NAFTA) is the main example of this trend, and to a lesser extent, so is the Mercosur bloc. In the context of this "new regionalism," trade and investment are regarded as complementary and welcoming of FDI (Bouzas 2000). In view of this, MNCs have played an important role in Mercosur. In sectors such as automotives, foreign companies have been forthright in pushing for special treatment in terms of tax breaks and exceptions from average tariffs (peaks of protection), and in turn have committed to modernize the manufacturing process and the final product. Again, it is important to note that industrial policies, in spite of a "less interventionist" discourse, have remained an active part of Brazilian trade strategy within the Mercosur bloc.

Realizing that state restructuring, principally in terms of fiscal balance and better prepared government bureaucracies, were part of the successful Asian experience and could be complementary to active industrial and export promotion policies, the most successful trade reformers in Latin America are also those that have advanced structural reforms. The example of Chile stands out, as the country followed a "competitive trade strategy" in which state institutions played a key role in promoting its inclusion in world trade, devising a set of active and efficient policies.

Those policies aimed to improve human capital and were targeted mainly toward small and medium companies (Wise 1999). Drawing on the work from Pastor and Wise (1999), SGR in Latin America can be understood in the following terms: 1) market completing measures to bring liberalization initiatives undertaken in the first phase of reforms to full realization; 2) equity oriented programs crafted to ameliorate the region's income gap; 3) and institution building initiatives aimed at "good governance."²⁹ Broadly speaking, SGR can bolster trade-led development by encouraging a modern institutional and regulatory environment so crucial for a technology driven world economy.

Not surprisingly, the challenges intrinsic to the SGR agenda coincide with those that have arisen within multilateral and regional trade talks. In the case of the FTAA, which involved negotiating with the most knowledge-endowed country in the world, i.e. the United States, Brazil faces serious questions as to how its trade and industrial strategy can be made more competitive in the context of regional integration. First, it is now clear that the competitiveness of a country derives not only from low average tariffs or a trade surplus, but principally from a set of institutional advances that make it attractive to business (Vial and Sachs 2001; World Development Report 2005; World Economic Forum 2006). In this regard, and notwithstanding the apparent "open regionalism" approach of Mercosur, the latter has been insufficient for locking in a credible commitment and hence delivering positive spillovers to the domestic economy. Despite progress in terms of increased trade and productivity gains (López-Cordova and Mesquita Moreira 2004), Mercosur's South-South integration model was not able to raise the bar in terms of modernizing the

²⁹ Navia and Velasco (2002) also note the potentially positive impacts on competitiveness when a country pursues the SGR agenda.

regulatory and institutional environment of its members. Quite to the contrary, in the face of severe macroeconomics imbalances like the Brazilian devaluation of 1999 and the Argentinean meltdown in 2001/2002, the bitterness of internal disputes (e.g. anti-dumping complaints within the bloc) undermined the internal business environment. In spite of Mercosur's possible enlargement with the 2006 entrance of Venezuela, the competitiveness and business environment scores of Brazil and Argentina continue to be weak (World Bank 2005; World Development Report 2005; World Competitiveness Report 2006).

Second, the emergence of China and India as world-class players has quickly raised the stakes for Brazil and shed doubt on the competitive strengths of its industries and services. The boom in commodity prices since 2004 has restored growth to Latin America, and Brazil has in fact been benefiting from the huge demand coming from China (CEPAL 2005: chapter 02). But as Ocampo (2004) has observed, it is doubtful that an export-oriented model driven by commodities can sustain advances in productivity and promote the necessary backward and forward linkages to the non-tradable sector of the economy. To the extent that the trade negotiations sought to incorporate those regulatory measures that could help to attract badly needed FDI and to advance domestic reforms, this would seemingly be a welcome opportunity. However, actors in Brazil poorly understand these new trade issues, be it within the WTO, the FTAA, or the EU-Mercosur negotiations. This is problematic since the initial launching of Mercosur was due to a reasonably deep debate regarding the need for Brazil's competitive international insertion and the locking in of first generation reforms (FGR).

FGR were prompted by the long overdue perception of the drawbacks of high inflation and the low quality of consumer goods. By the early 1990s these

macroeconomic imbalances were finally impacting electoral outcomes. As evidence, Karen Remmer (2003) showed a positive correlation between incumbent votes in Presidential elections and macroeconomic performance. Yet the failure to introduce SGRs did not register the same electoral impact, nor did this seem to cause the same distress in citizens' daily life. Nevertheless, the deleterious consequences are evident over the long run. For example, in telecommunications and information technology, despite a steady increase in Brazil's rates of Internet connection, the educated population that has access to this service is ignorant of the fact that the upsurge in this technology was due to a relatively clear and modern regulatory reform prompted by the privatization process (OECD 2005).

In terms of political leadership, there is a crucial difference between the process of implementing the FGRs and SGRs in Brazil. Political responsibility for the implementation of FGRs was carried out with the leadership of the Economic Ministries and the Executive, using the fast-forwarding device of provisional measures. Whereas the political implementation of SGRs is tightly connected to the new trade agenda, and depends on several ministries – some of them politically weaker or characterized by logrolling, such as the Ministry of Science and Technology, and the Infrastructure Ministries (of Transport, of Energy and of Telecommunications). Reforms in the institutional framework also require more consultation with the congress and a long-term negotiation process with civil society and key economic actors. In some sectoral ministries, trade integration is but a small part of an overburdened congressional political agenda that gets crowded out by the unending battles over how to reform the country's regulatory framework.

Finally, the Ministry of Foreign Affairs (MRE), which could logically take the lead with the reform agenda, takes a very cautious approach on such issues. More

recently, in the government of Lula, MRE assumed a more rigid negotiating tone concerning the inclusion of regulatory themes in hemispheric trade talks. Brazil, as a global trader with exports divided between several different partners (table 12, chapter 03), has greater interest in making headway within the multilateral trade system. Its commercial diplomacy has thus stressed that the new trade themes should be discussed primarily at the WTO. As the multilateral trade discussions of the Doha round are now completely stalled, these issues will not be resolved in the short run. In the next section I elaborate on the various positions within the Brazilian bureaucracy regarding free trade.

Bureaucratic Politics and Ideological Inclinations toward Free Trade

The bureaucratic politics model, in which competition among bureaucracies determines foreign policy outcomes, can be useful for understanding Brazilian trade policy and the position the country has adopted regarding RIAs with the advanced economies.³⁰ Drezner (2000) expands on this approach by analyzing the interaction between institutions and ideas in foreign policy, which is clearly relevant for understanding the domestic political dynamics that have played out thus far with the FTAA.³¹ In terms of the interaction between bureaucracies and ideas in explaining trade policy, Drezner (2000) notes that the weight of ideas in determining foreign economic policy outcomes will be limited unless those beliefs are carried out by individuals or groups with political clout. Only when a system of beliefs supporting free trade is rooted in domestic institutions with a political stake in implementing such a policy, can it be brought to life.³² For instance, if a given administration is committed to the idea of free trade, as the Clinton and George W. Bush administrations appeared

³⁰ Allison and Halperin (1971).

³¹ The interaction between ideas and institutions was pioneered by Goldstein (1993) in analyzing American institutions and trade policy.

³² Pastor and Wise (1994), 459-489.

to be, then a concerted effort will be made to leverage the necessary political instruments and reach the desired objectives.

Within Brazil's foreign economic policy apparatus any equivalent commitment to free trade is incipient at best. If not exactly a competition between bureaucracies, there is a noticeable informal system of specialization in the government's international organizations; in particular, financial/monetary affairs are distinct from the trade policymaking apparatus in Brazil. This format was institutionalized over the last two decades, due to the necessity of gaining monetary and fiscal stability to support the country's effort at structural adjustment. Those bureaucratic segments that deal with macroeconomic/monetary policy were granted a good deal of autonomy and have been insulated from the bureaucracy at large. The responsibility for macroeconomic and international issues was concentrated in the upper advisory ranks of the Finance Ministry and the Central Bank. These particular bureaucracies involve a considerable degree of professionalism and institutionalization. Important technical appointments within them are filled by professionally trained economists or by politicians who have economic background.

On the trade side, however, this same degree of specialization and even professionalism is much less evident. Currently, the responsibilities for international trade policy are scattered across at least five different Ministries (Agriculture, Finance, Foreign Affairs, Industry and International Trade and Planning and Budget). The degree of expertise and institutional robustness of some of these bureaucracies has traditionally been lower, particularly in the Ministries of Agriculture and Industry and International Trade. These trade-related ministries have improved over the years but there remain unfinished reforms that pertain to them in the way of administrative and public service career tracks. In the current government, the Ministry of Industry's

status was considerably enhanced vis-à-vis the Economic Ministries, as Lula's more active industrial policy seems to indicate.

Legally speaking, the economic ministries (Finance, Planning, Industry and International Trade) should play a frontline role in the country's trade talks. However, the Ministry of Industry and International Trade has historically been a weaker and less stable bureaucratic entity, dominated mainly by political appointees to manage subsidies for the private sector. As such, this ministry has been subject to lobbying from the business community and plagued by a high turnover of staff. The Ministry of Finance, albeit more professional and institutionalized, has been marginally involved with Brazil's trade policy and negotiations, specializing in fiscal and macroeconomic affairs.

Conversely, it is the Ministry of Foreign Affairs (MRE), probably the most traditional governmental bureaucracy in Brazil, which has taken the lead on trade policy. Characterized by a rigid hierarchical career track based on merit and seniority, the consequence of MRE's stronger organizational coherence and institutionalization has been its ability to dominate Brazil's trade negotiations. MRE has an important stake and autonomy in assessing how international trade agreements impact the domestic economy. For example, the designation of Mercosur as one of Brazil's top foreign policy priorities had much to do with political preferences within MRE. In short, MRE has been instrumental in setting the pace and defining the substance of trade policy formulation in Brazil.

MRE is also the institutional locus for the generation of ideas about foreign economic policy. The MRE position on commercial policy is directly related to its worldview with respect to Brazil's international status. Here, Brazilian foreign policy intersects with the current trade strategy in the sense that the country seeks to carve

out its own autonomous space both globally and within the Western Hemisphere (Lafer 2003, chapter 04). There is, understandably, a constant effort to reinforce Brazil's autonomy from the U.S., a tension that has been consistently present in trade negotiations at both the international and regional levels. Although some Brazilian administrations may have preferred a closer alignment with the U.S. in various issue areas, in trade summits the discourse and pursuit of autonomous positions has been unwavering.

The Chamber for External Trade (Camex), comprised of the five aforementioned, plus the Ministry of Civil Affairs (Casa Civil), is the organization that coordinates trade policy formulation and negotiations.³³ Yet, officially attached to the Minister of Industry and International Trade, Camex is hardly an autonomous player. It does not formulate trade policy, but is rather a forum for policy debate and the legal endorsement of decisions taken elsewhere. One example of how decisions concerning foreign trade are taken elsewhere is the early 2006 enactment of legislation granting Argentina the right to levy safeguard duties on Brazilian consumer goods (e.g. home appliances), known as the Mechanism of Competitive Adjustment (MAC); aimed at helping Argentinean industries regain competitiveness, this understandably generated acrimonious comments from Brazilian businessmen. The decision, basically, followed the political authority of MRE and underscored Brazil's political commitment to Mercosur, whilst the Ministry of Industry and Trade, more in line with the businessmen interests, simply acquiesced. Moreover, because Camex basically rules on tariff and anti-dumping issues (trade in goods), it has little understanding of the deeper integration agenda that encompass domestic institutional and regulatory matters. As a relatively new bureaucracy, Camex might evolve into a

³³ Camex was created by the decree n.º 1386 of 1995, and modified by decree n.º 4732 of 2003.

more autonomous and effective decision-making entity. As for now, it has little command over those trade negotiations in which Brazil is currently involved.

Section V – Conclusion

This chapter's main assumption is that trade strategy is part of a broad set of economic development policies, and it has been deeply affected by Brazil's institutional structure. As international trade talks have sought to advance a more audacious trade integration agenda that includes investment, services, IPR, labor and environmental issues, and so on, these were rebuffed by domestic sectors with stiff ideological biases regarding foreign economic policy. The realization of a deeper integration agenda will depend on the ability of free traders inside Brazil, including sectors with strong ties to the executive, to link the reduction of inefficiencies in the domestic economy to further integration into the world economy. It is obvious, though, that trade policy and its formulation within regional integration agreements will not resolve all of Brazil's problems of economic governance. But trade opening can correct certain failures and make citizens and economic actors more aware of the possible gains from efficient reforms.

This chapter attempted to put Brazil's trade policy in historical and institutional perspective, starting with the economic development agenda of the old ISI years and up through the ongoing effort at structural reforms. I have argued that the domestic environment is a determinant of the manner in which Brazil integrated into the world economy. This chapter adopted a descriptive approach based on historical-institutional explanation, in which state-led interests seems the main explanatory variable for trade policy. In chapter four I will look at specific industrial sectors in order to gauge possible variations, based on "endogenous trade policy" assumptions of factor endowments as a determinant of policy choice. First, the following chapters

analyze Brazilian trade policy from the standpoint of multilateralism and regionalism and specify how the country has sought to position itself in the international political economy.

Section VI - Statistical Annex

Table 5: Brazil - Effective Protection, 1958-1967 (percentage).

	1958	1963	1966	1967*	1967**
Agriculture	n.a.	n.a.	n.a.	n.a.	n.a.
Vegetable products	-47	-15	-13	-14	-14
Animal products	24	12	16	18	n.a.
Manufactured products	106	183	108	63	48
Mining products	-5	34	24	13	9
Non-metallic minerals	73	34	72	45	48
Metallurgy	61	130	63	35	33
Machinery	22	124	30	32	31
Electrical equipment	83	68	112	67	57
Transport equipment	82	169	103	84	81
Lumber and wood	138	147	120	81	44
Furniture	221	176	251	90	92
Paper	86	367	91	43	42
Rubber	139	169	158	126	182
Leather	248	221	174	127	84
Chemicals	56	405	56	29	20
Pharmaceutical products	17	146	1	10	10
Perfumery	279	60	281	121	74
Plastics	281	453	332	133	117
Textiles	239	298	232	162	88
Apparel and footwear	264	481	321	107	154
Food products	502	6778	423	252	71
Beverages	171	243	183	104	76
Tobacco products	273	469	299	114	79
Printint and publishing	139	305	142	4	8
Micellaneous	88	175	95	47	45
Consumer goods	242	360	230	122	66
Intermediate goods	65	131	68	40	38
Capital goods	53	112	69	56	52
Average all sectors	30	75	44	24	14

Notes: *1969 input-output table; **1971 input-output table

Source: *Fishlow (1975) apud Abreu (2004a)*.

Effective tariff is the ratio between value added taken at post protection prices and value added taken at world prices minus 1

Table 6: Brazil - Effective Protection, 1966-1985 (percentage).

	jun/66	abr/67	nov/73	1980-81	1985
Agriculture	n.a.	n.a.	25	-8,2	-24,6
Vegetable products	35	8	n.a.	n.a.	n.a.
Animal products	164	17	n.a.	n.a.	n.a.
Mining products	25	13	14	-4,3	-10,7
Manufactured products	254	117	47	43,6	42,9
Non-metallic minerals	86	39	46	-19,6	10,3
Metallurgy	58	36	35	34,2	53
Machinery	41	32	32	77	5,6
Electrical equipament	215	97	61	111,9	54,7
Transport equipament	151	75	34	-9,6	-4,4
Lumber and wood	45	25	68	11,7	39,1
Furniture	239	124	74	52,7	53,1
Paper	118	59	50	-18,5	44,1
Rubber	136	116	66	-21,4	43,3
Leather	117	85	81	13,9	29
Chemicals	59	42	19	86,4	63,2
Pharmaceutical products	39	35	17	116,3	117,8
Perfumery	8490	3670	46	91,6	26,3
Plastics	183	58	41	28,3	189
Textiles	379	162	118	36,7	112,1
Apparel and footwear	337	142	29	46,7	231,4
Food products	87	40	83	26,1	45,8
Beverages	447	173	114	-1,1	-1,7
Tobacco products	313	124	83	5,7	-79,6
Printint and publishing	142	67	30	31,9	-5,3
Micellaneous	128	72	37	171,7	96,7
Consumer goods	n.a.	n.a.	67	35,7	39,5
Intermediate goods	n.a.	n.a.	36	42	46
Capital goods	n.a.	n.a.	n.a.	59,6	14,5
Average all sectors	522,13	230,35	55,43	41,55	53,50

Source: Bergsman (1970); Tyler (1976), p.244; Braga, Santiago and Ferro (1988); World Bank (1983, 1990) passim, *apud* Abreu (2004a)

Effective tariff is the ratio between value added taken at post protection prices and value added taken at world prices minus 1.

Table 7: Brazil - Effective Tariffs by Sector, 1987-1993 (percentage)

Sector	1987	1988	1989	1990	1991	1992	1993
Agricultural products	45.8	14.8	2.2	3.0	2.7	2.3	1.9
Mining products	16.9	15.0	4.6	6.3	2.3	0.0	-0.5
Oil and coal Extraction	8.3	-2.9	-5.4	-3.4	-4.0	-4.0	-5.0
Non-metallic minerals	81.7	46.2	39.5	38.8	22.6	13.2	12.2
Steel products	30.9	36.3	18.6	15.8	13.0	9.0	8.4
Non-ferrous metallurgy	34.4	28.0	13.4	12.8	9.0	6.0	8.4
Other metalurgical products	88.4	59.2	44.0	41.5	31.3	22.1	21.7
Machinery and tractors	47.5	50.2	44.0	41.5	31.5	22.1	21.7
Electrical equipment	88.5	61.6	55.6	61.5	50.6	32.1	24.8
Electronic equipment	55.4	51.2	42.5	44.2	41.4	27.6	23.5
Automobiles, trucks and buses	308.1	201.3	244.3	351.1	198.3	93.5	76.5
Parts, components and other vehicles	73.3	43.9	45.1	44.6	36.3	24.9	21.3
Wood products and furniture	53.1	28.9	29.1	29.4	17.0	9.5	9.8
Cellulose, paper and printing	65.5	30.1	23.0	22.6	11.1	8.0	8.2
Rubber products	122.4	58.5	67.1	70.2	49.8	26.0	16.9
Chemicals elements	72.7	30.9	26.6	25.2	18.6	14.6	12.6
Oil refining	62.9	70.0	42.3	38.5	26.8	15.7	12.7
Chemical products	12.3	44.9	33.9	29.4	21.5	14.9	16.4
Pharmaceutical and perfumery products	91.7	51.8	39.8	35.8	23.0	14.8	13.6
Plastic products	31.4	72.1	49.5	50.7	41.4	24.2	20.2
Textiles products	123.1	83.9	85.7	49.2	50.9	31.4	21.3
Apparel	117.2	94.3	95.5	67.0	63.1	36.6	23.7
Footwear	96.9	39.8	38.5	28.8	25.6	16.5	15.0
Coffee industry	73.7	36.2	30.2	30.6	20.9	15.3	12.8
Processing and vegetable products	121.6	86.0	79.7	80.6	64.1	19.1	16.1
Meatpacking	43.6	29.6	20.3	19.4	15.8	9.8	9.9
Dairy industry	74.1	41.6	34.8	35.0	29.8	22.9	21.7
Sugar	83.3	24.8	22.2	23.9	18.8	20.6	21.3
Vegetable products	82.3	24.1	19.5	20.7	5.2	7.6	8.0
Other food products	118.9	98.5	94.2	94.5	82.8	36.5	25.3
Other industries	64.8	64.0	58.2	58.9	47.7	27.9	19.1
Simple average	77.1	52.1	46.5	47.7	34.8	20.3	16.7
Average weighted by value added	67.8	46.8	38.8	37.0	28.6	17.7	15.2
Mean deviation	53.8	36.6	44.5	60.6	36.5	17.2	13.5

Source: Kume, Piani and Souza (2000).

Effective tariff is the ratio between value added taken at post protection prices and value added taken at world prices minus 1.

Table 8: Brazil, Effective Tariffs by Sector, 1994-1999 (percentage)

Sector	1994	1995	1996	1997	1998	1999
Agricultural products	2.4	7.6	7.4	9.9	9.9	9.8
Mining products	-0.1	0.1	1.3	4.4	4.2	4.1
Oil and coal Extraction	-4.9	-2.4	-1.8	-2.2	-2.2	-2.2
Non-metallic minerals	10.5	11.5	11.9	15.5	15.4	15.3
Steel products	8.8	9.1	11.2	14.3	14.2	14.3
Non-ferrous metallurgy	7.5	9.2	8.8	11.8	11.9	12.0
Other metallurgical products	19.7	22.0	21.5	24.7	24.8	24.8
Machinery and tractors	22.4	18.0	16.7	18.6	18.6	17.5
Electrical equipment	25.8	31.3	22.7	25.0	24.5	23.8
Electronic equipment	21.7	21.5	16.4	18.5	17.9	16.8
Automobiles, trucks and buses	27.7	113.8	217.5	177.0	129.2	89.1
Parts, components and other vehicles	21.8	21.8	18.4	20.8	20.5	19.5
Wood products and furniture	10.0	11.6	11.9	15.1	15.1	15.2
Cellulose, paper and printing	8.1	9.7	10.4	14.7	14.7	14.8
Rubber products	15.2	14.9	14.0	16.3	16.0	16.1
Chemicals elements	8.7	6.9	5.4	18.3	24.2	23.0
Oil refining	7.1	3.4	4.3	5.6	5.7	5.7
Chemical products	9.2	9.2	9.1	12.5	12.5	12.3
Pharmaceutical and perfumery products	3.0	7.5	7.3	10.0	10.0	9.8
Plastic products	23.3	21.2	19.1	21.9	21.9	20.7
Textiles products	20.9	21.9	21.8	24.9	24.9	25.0
Apparel	24.5	23.6	23.1	26.1	26.1	26.1
Footwear	15.9	23.9	18.2	20.8	19.4	18.8
Coffee industry	10.1	10.2	12.4	15.4	15.4	16.1
Processing and vegetable products	17.5	16.4	17.8	20.9	20.8	20.8
Meatpacking	7.3	8.3	9.2	12.2	12.1	12.2
Dairy industry	24.8	18.6	19.9	22.1	24.4	23.3
Sugar	9.5	16.7	16.8	19.9	19.9	20.0
Vegetable products	8.5	8.0	8.3	11.6	12.0	12.7
Other food products	19.2	20.3	21.6	24.3	24.1	24.1
Other industries	16.9	15.3	15.0	17.9	17.9	16.9
Simple average	13.6	17.1	19.9	21.6	20.2	18.7
Average weighted by value added	12.3	10.4	14.3	16.6	16.2	15.4
Mean deviation	8.4	19.5	37.2	29.6	21.3	14.6

Source: Abreu (2004b). Simple averages for each sector.

Effective tariff is the ratio between value added taken at post protection prices and value added taken at world prices minus 1.

Table 9: Glossary on Tariff Nomenclature.

Many types of tariffs are mentioned in the literature, this glossary includes the relevant definitions:
Ad valorem tariff corresponds to a percentage of the FOB (free on board) value of imports.
Specific tariff is a tariff based on payment of fixed nominal duties by physical unit of imports.
Average implicit tariff is the ratio between collected duties and values of imports.
Ad valorem equivalent of specific tariff is the ratio at the product level of aggregation between specific duty and value of import
Average tariff is the legal MFN nominal tariff at the sector of economy-wide level of aggregation, weighted, for example, by trade values of value added.
Effective tariff is the ratio between value added taken at post protection prices and value added taken at world prices minus 1.
Implicit nominal protection corrects the implicit tariff in relation to the world price by taking into account production subsidies
Source: Abreu (2004a)

Table 10: Selected Macroeconomic and Fiscal Statistics, 1991-2005.

Figures	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
GDP US\$ millions (nominal)	405,679	387,295	429,685	543,087	705,449	775,475	807,814	787,889	536,554	602,207	509,797	459,379	493,348	604,883	801,556
GDP real (1990 = 100)	101.6	100.3	106.0	111.6	116.3	119.4	123.3	123.5	124.4	129.9	131.6	134.1	134.8	141.5	144.7
GDP growth (% year variation)	-	-1.29	5.74	5.29	4.22	2.66	3.27	0.13	0.79	4.36	1.31	1.93	0.54	4.94	2.28
Monthly Industrial Production (% year variation)	-	-3.73	7.51	7.60	1.83	1.73	3.89	-2.03	-0.65	6.64	1.58	2.73	3.67	7.71	2.69
Accumulated Consumer Price Index (IPCA)	-	1119.09	2477.15	916.43	22.41	9.56	5.22	1.66	8.94	5.97	7.67	12.53	9.30	7.60	5.69
Unemployment rate	-	-	-	-	-	-	-	-	-	-	-	11.66	12.32	11.48	9.83
Trade Balance US\$ million	10,580	15,239	13,299	10,466	-3,466	-5,599	-6,753	-6,624	-1,283	-753	2,650	13,125	24,825	33,666	44,780
Exports US\$ million	31,620	35,793	38,555	43,545	46,506	47,747	52,994	51,140	48,011	55,086	58,223	60,362	73,084	96,475	118,309
Imports US\$ million	21,040	20,554	25,256	33,079	49,972	53,346	59,747	57,763	49,295	55,839	55,572	47,237	48,260	62,809	73,529
Current Account (% GDP)	-0.35%	1.58%	-0.16%	-0.33%	-2.61%	-3.03%	-3.77%	-4.24%	-4.72%	-4.02%	-4.55%	-1.66%	0.82%	1.93%	1.79%
Net FDI US\$ millions	1,102	2,061	1,291	2,150	4,405	10,792	18,993	28,856	28,578	32,779	22,457	16,590	10,144	18,166	15,193
Nominal Exchange Rate	-	-	-	0.64	0.92	1.01	1.08	1.52	1.81	1.83	2.35	2.92	3.08	2.94	2.44
Central Government Public Balance (% GDP)	-6.54	-16.31	-23.96	-10.15	-2.38	-2.56	-2.63	-5.4	-6.87	-3.13	-3.71	-6.44	-2.6	-1.34	-3.56
Gross Central Government Debt (% GDP)	-	-	-	-	-	-	41.95	54.82	58.53	64.49	70.55	71.36	76.94	71.94	74.84
Interest rate - CDI	899.97	1667.47	3371.62	5322.22	54.85	27.28	24.95	29.28	26.26	17.59	17.43	19.05	23.27	16.17	19.01
Selic - Interest rate (monetary policy rate)	-	-	-	-	54.92	27.60	25.17	32.04	26.26	17.59	17.47	19.11	23.37	16.11	19.12

Source: Brazilian Institute of Geography and Statistics (IBGE); Brazilian Central Bank (BACEN); Ministry of Finance; Ministry of Development, Industry and Foreign Trade

Chapter 2 - The International Political Economy and Multilateral and Regional Trade Integration debates

Introduction

In this chapter I will review the theoretical debates over the benefits of an outward economic orientation (e.g. trade openness, investment friendliness) versus the more protected state led model, particularly as these have played out in the context of regional integration schemes. In order to grasp the political economy underpinnings of the world trade discussions, I will turn to the literature on trade liberalization and economic growth. My purpose here is to look at an economic theory that identifies benefits of liberalization and the political constraints trade reformers face and to tie these to the current stalemate at both the multilateral (WTO) and regional (e.g. FTAA) levels. In doing so I briefly analyze the theoretical and empirical economic literature, such as “new growth theory” and general equilibrium models, which predict, among other beneficial effects, technology transfer and welfare gains from trade liberalization and I discuss the extent to which such theories fit with actual trends in the world economy order. I discuss how economic theory seems to indicate that integration to the world economy is beneficial for countries, not only in terms of flow of goods but also in “deep trade integration” disciplines of institutional convergence, whereas world trade discussions are stalled. Finally, in the course of this chapter, I introduce Brazil’s foreign trade policy and strategy, an issue that will be expanded on in the next chapter when I elaborate on the North-South integration processes in which the country was recently involved, attempting to locate the explanations for the trade policy options in the international scene.

The chapter will be divided in the following sections: [1] the next section offers a methodological discussion and connects assumptions of this chapter with the broader hypotheses of the dissertation; [2] a second section describes the *openness x growth* debate, provides data and applies economic theories to the broader international political economy; [3] in section three I turn to an analytical description of the international political economy of multilateralism *versus* regionalism and I locate these options in a discussion about the world economy and globalization. In this part, I also discuss recent trends in of international economic relations, including the upsurge of China and India, the stalled WTO negotiations, and Brazil's role in these processes.

Section I - Methodological Foreword

Following the literature presented at the outset of the dissertation, this chapter tackles three broad questions:

1) Trade liberalization *versus* managed/state led trade policy and the consequences for economic growth: What are the so-called benefits of an outward oriented versus a more protectionist model? Have countries with more open trade regimes (outward/export oriented) grown faster than those that embraced a more autarkical strategy? Do free-market trade policies spur better economic performance over time than managed/state led policies?

2) Factor ownership and/or sectoral lines as determinants of policymaking and trade negotiation positions in multilateral and regional venues: If unilateral trade liberalization is optimal, as much as the literature contends, why have policymakers in both the in developed and the developing countries experienced such fierce protectionist pressures

from domestic economic groups? Assuming that domestic political economy influences trade negotiations, are there differences between the multilateral/WTO and regional negotiations? If so, what accounts for them?

3) New theories of economic growth and institutional development in a regional and multilateral trade integration context: Are regional integration schemes superior to multilateral ones in terms of economic growth, productivity and institutional development? In a regional integration setting, are North-South ties more welfare producing than South-South integration projects?

As I have spelled out in the literature review/introduction, this dissertation assumes three clusters of analytical tools:

1. Multilateral and regional trade integration, with a focus on the latter;
2. Trade liberalization, domestic reforms and the role that domestic actors play in this process;
3. Economic and institutional development, including trade, technology and innovation.

Against this backdrop, it is worth reiterating the broad hypotheses which underpin this dissertation:

1) International economic shocks/trends and the demise of domestic economic models shape the preferences of policymakers and interest groups, which opens up the opportunity for (trade) policy reforms; however, 2) entrenched domestic institutional/bureaucratic structures, as well as the ideological biases embedded

therein, can also slow trade liberalization and therefore preserve features of the old economic model in the new era.

This chapter focuses on the international aspects of these hypotheses, including such exogenous shocks as the 1980s debt crisis, the deepening of financial-economic globalization, the advent of the Washington Consensus, the collapse of the Soviet Union, the financial crises of the late 1990s and early 2000s, and the 9/11 terrorist attacks. Each of these required a response from Brazilian policymakers and domestic groups, who turned out to be quite divided. Whereas many domestic actors resisted giving up the *status quo* and clung to the country's long standing protectionist model, others perceived the opportunities from liberalization and have embraced new realities. In this chapter, I attempt to apply *actor* centered (firms, interest groups) and political economic theories to a broader *systemic/structural* international political economy (IPE) framework. Here, I attempt to merge economic models (e.g. new growth theory), based on rational choice assumptions with a historical/systemic analysis of the international political economy. My ultimate purpose is to locate the Brazilian case within this analytical framework and to explain the role of path dependence and institutional inertia in producing conflicting policy currents on the trade front.

Section II - The International Political Economy and the Openness Debate

The question of whether integration into the world economy has positive implications for economic development is one of the most recurrent issues in the political

economy field, dating back to the work of Adam Smith and David Ricardo. Economic theory suggests that openness is conducive to growth due to potential efficiency gains derived from the international division of labor and comparative advantages.³⁴ There is an ongoing discussion in the empirical literature, especially with respect to the policy orientation of developing countries, questioning if outward-oriented countries grow faster (Baldwin 2003). This debate assumed ever more relevance after World War II when, under the influence of the Bretton Woods liberal order, multilateral institutions were established to promote free trade, representing a mechanism to encourage economic development via the closer integration of the developing countries in the international economic relations. Among these institutions the World Bank, the International Monetary Fund (IMF) and the GATT (General Agreement on Tariffs and Trade) led this effort. In the same period, any number of developed and developing countries in Western Europe, Latin America and East Asia adopted state intervention and a regulated domestic economic order. In Europe, countries maintained and expanded welfare state policies of social protection. In the developing world, countries adopted import substitution industrialization policies, aimed at shielding national firms from external competition to nurture domestic industrial capacity. Both groups of countries have embraced a regulated domestic political economy, emphasizing the role of state institutions in welfare distribution and in carrying out industrial and infrastructure policies. The regulated

¹ The literature often interprets openness in terms of the share of exports plus imports in a country's GDP ($X+M/GDP$). Here, I consider openness to be not only trade in goods or the level of domestic tariffs, but also the overall outward policy orientation of a country, including the degree of willingness to receive foreign direct investment. I use the term trade liberalization interchangeably with openness, although they may not be the same thing. Winters (2004), in a comprehensive literature review, makes this distinction, positing that countries with high trade openness can also have substantial state intervention.

domestic policy approach has co-existed with the liberal international order since the 1950s.

The rationale for the liberal international order began with the necessity of providing domestic stability to the Western European countries, striving to recover from the economic disruption of World War II. An overriding concern of Bretton Woods was to foster financial and trade co-operation in order to avoid the economic instability that was so ubiquitous during the 1930s. The Post World War II political economic order thus evolved according to two economic models: market capitalism versus social capitalism. The Soviet Union, of course, took the latter to the extreme and triggered the Cold War and an international bipolar order with its insistence on a centrally planned communist strategy. Thus, the Marshall Plan and U.S. support for the creation of the European Economic Community must also be understood within this political-strategic context. Ruggie (1982) affirms that, to provide international stability, embedded liberalism – a system in which liberal international norms co-existed with domestic state interventionism - was necessary to foster welfare states in U.S. allies and to deter the “threat” of communist expansion.

Trade liberalization is considered to be a major milestone of the liberal order and one meant to complement the monetary order. During the 1930s, countries promoted beggar-thy-neighbor policies based on currency devaluations that artificially increased the competitiveness of domestic goods, accumulated trade surpluses (gold reserves) and guaranteed their own balance of payment stability. However, this mercantilist policy promoted a race to the bottom that undermined the international financial order and it is ultimately believed to be one of the causes of sluggish international economic

performance during that decade, even contributing for the scaling up of military tensions prior to World War II. Protectionist trade policies were also at the core of this disruptive model.

After World War II, U.S. and British policymakers argued that free trade would provide stability and prosperity to all the involved countries. Therefore, the GATT's new liberal trade order was defined by two core principles: (1) reciprocity – countries should lower tariffs in return for similar concessions; (2) most-favored nation (MFN) – a principle that granted non-discrimination and equal treatment in trade relations among all GATT members. Thus, in spite of the GATT's technical-juridical language, the ultimate aim of the trade order was to promote political stability (Spero and Hart 2003, chapter 3).

In other parts of the world, although the political-strategic logic was not as apparent as it was in Europe, developing countries used the loopholes of the Bretton Woods order to promote their interests. Brazil, for instance, used the GATT's balance of payment exceptions, i.e. "special and preferential" treatments, as a mechanism to nurture domestic industrial firms (Abreu 1998, 2004a). In Latin America and East Asia during late 1950s and 1960s, government subsidies and incentives sought to foster industrialization in light consumer goods, such as appliances and apparel, and later in durable consumer goods, such as automobiles. In a certain way, these industrial policies were the catalyst for a state capitalist strategy that was embedded in nationalist ideologies, but one that prevented communist threats.³⁵

These exceptions were consolidated in the Generalized System of Preferences (GSP) of the GATT, negotiated during the Tokyo Round (1973-1979), which granted

³⁵ See Schwartz (2000), Kohli (2003), and Wade (1990) for an elaboration of this particular form of state capitalism within late industrializers.

preferential tariff treatment for developing country's exports of manufactured and semi-manufactured goods in order to promote their industrialization. The GSP agreement, however, prompted several complaints from developed countries. It characterized the latent tensions between North and South, as the newly industrializing countries (NICs) started to tap into northern industrial markets, particularly in low-skilled labor intensive industries formerly dominated by the developed countries. This conflicting picture grew even more contentious in agricultural goods, where subsidies and policy incentives to farmers in the developed countries, such as the Common Agricultural Policy (CAP) of the European Economic Community, damaged the competitiveness of developing country agricultural production. These tensions, nonetheless, did not hinder the successful tariff reductions promoted by the GATT in the post World War II era. After the Kennedy round (1962-1967), tariffs on dutiable, nonagricultural goods in the developed world were slashed by about one-third compared to levels before the round. After cuts, tariffs stood at an average of 9.9 percent in the U.S., 8.6 percent in the United Kingdom, and 10.3 percent in Japan. The overall decline in tariffs for the first five trade rounds was 73 percent; for the Kennedy round alone it was 35 percent (Spero and Hart 2003: 72). As a consequence, from 1950 to 1992, merchandise exports as percent of GDP grew from 9.4 to 29.7 in Western Europe; from 3.0 to 8.9 in the U.S.; from 2.3 to 7.2 in Asia, and remained stable in Latin America at 6.2 (Maddison 2000).

Developing countries also took advantage of the booming trade in the post World War era and several of them grew at sizable rates during the post world war period. The graphs below compare the GDP per capita in PPP adjusted U.S. dollars (thousands) of selected Asian and Latin American economies from 1950 to 2000, based on the Penn

World Trade data. While the Asian countries grew monotonically during this period, with a dip but noticeable rebound in income after the 1997 financial crisis, Latin America only maintained this same monotonic pace until 1980. Moreover, although the Latin American countries started at a higher level of GDP per capita, they ended the period with lower per capita income than some Asian countries.³⁶ Regarding China and India (figure 7), even considering that the impressive growth of these countries in world markets is a phenomenon of the last two decades, their relatively lower levels of income per capita compared to other countries stands out in the graph. The vertical straight lines in figure 6 denote the 1980s, the so-called “lost decade” in Latin America, a period also characterized by “structural reforms”. In figure 7, the vertical line depicts the year of the “Asian crisis” (1997).

³⁶ The graphs are based on the real-GDP-per-capita data from *The Penn World Table* (version 6.1), compiled by Summers, Heston and Aten (2002), who adjust national income levels according to purchasing power parity and thus overcome the complications caused by using foreign-currency exchange rates.

Figure 6: Real GDP per capita, selected Latin American economies

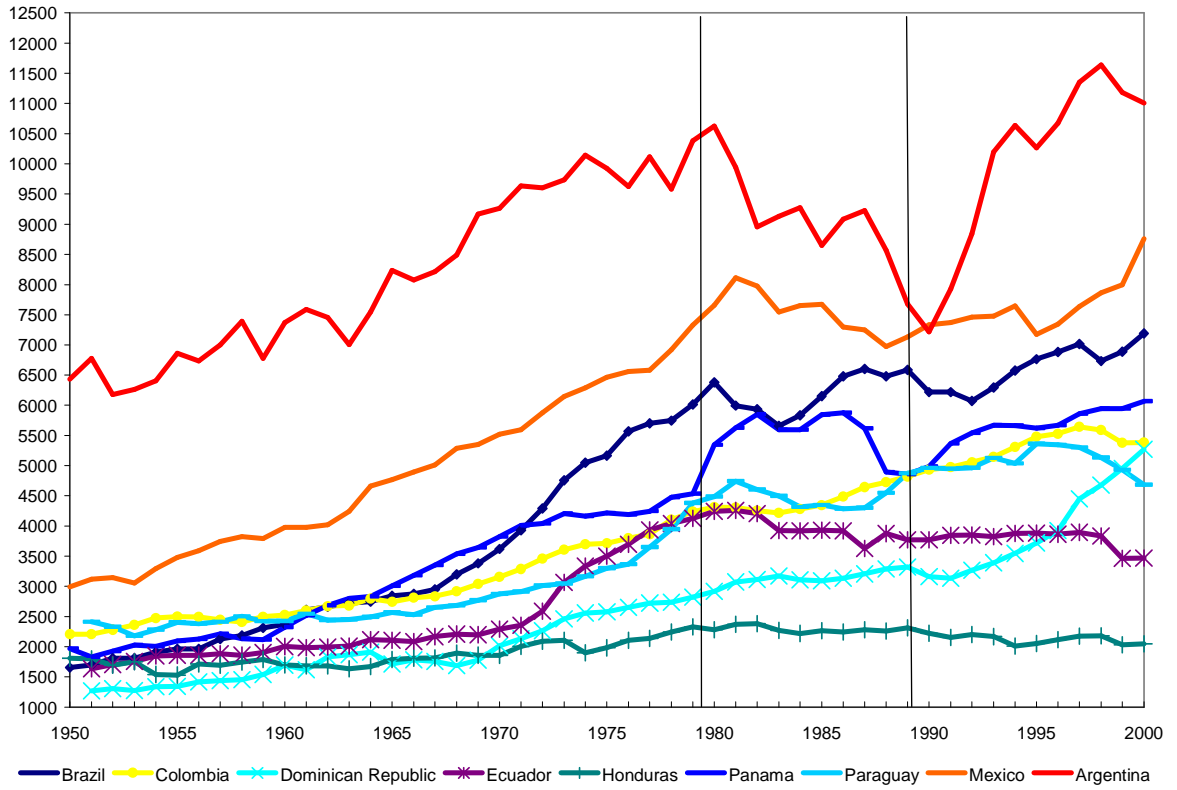


Figure 7: Real GDP per capita, selected Asian economies

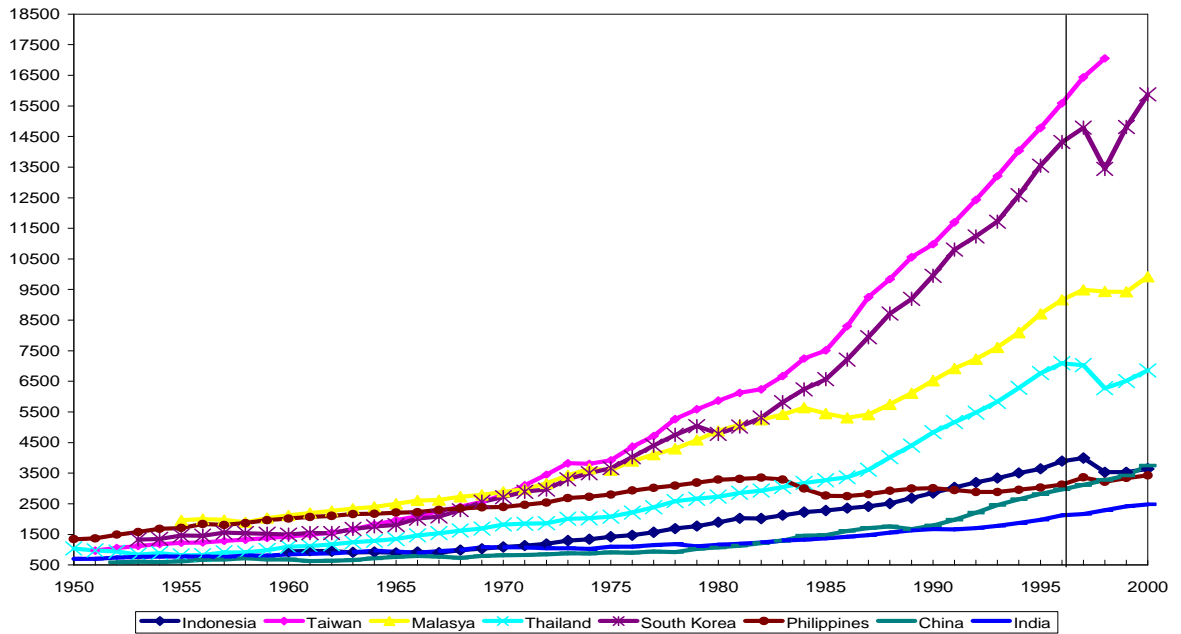


Figure 8: Real GDP per capita, G-7 economies

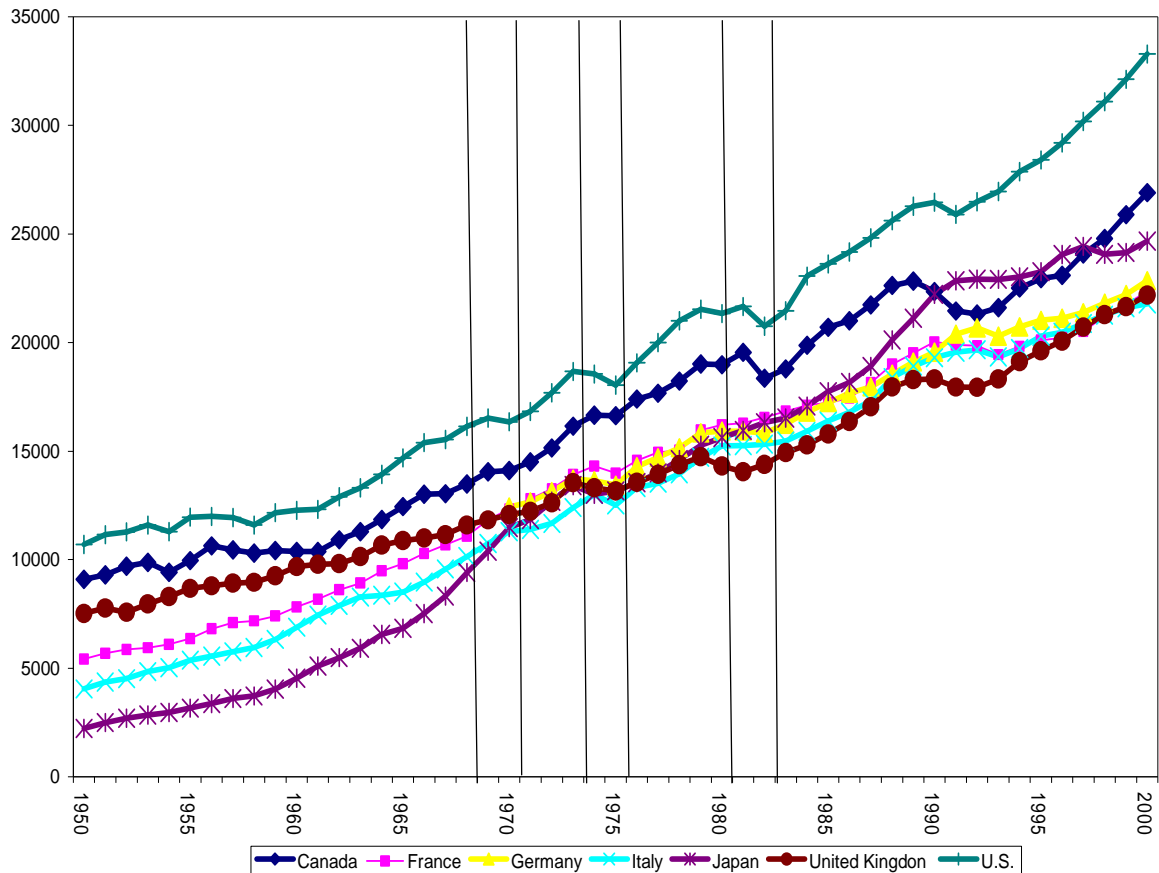


Figure 8 above, also based on the Penn World data, shows the same pattern of income per capita growth in selected OECD countries (G-7). Straight lines indicate periods of recession: in the early and mid-1970s, as well as the early 1980s, they are noticeable. These slumps provoked a turning point in the world economy, and this obviously impacted the developing countries. Latin America, in particular, was severely hit by the drought of international savings, also known as the external debt crisis of the 1980s. These recessions were caused by several world economy imbalances: in late 1960s, the flourishing economic scenario raised inflationary trends; the oil price shocks of the early 1970s, which contributed to price acceleration and the deterioration of the fiscal position of oil-importing countries, also amplified the downturn. Such events

brought about slower rates of income growth, undermining the welfare state model build since World War II in Europe. The Bretton Woods exchange rate system, led by a U.S. dollar that was pegged to gold reserves, also suffered strains and was abandoned in 1971. In the 1980s, orthodox macroeconomic (tight monetary policy, interest rate hikes, floating exchange rates) and microeconomic (de-regulation, privatization, tariff cuts) policies ensued. Increasingly, there was a perception that throughout the Western World the managed/state led economic order had intrinsic flaws that could be only corrected through staunch market discipline. The Reagan-Thatcher orthodox revolution in the early 1980s brought about an acceleration of market forces and unleashed further economic globalization trends, particularly in the financial sector. Finally, the demise of the Soviet Union in the late 1980's and of the communist economic model symbolized the victory of the free-market political economy over the state interventionist/inward oriented model.

The exogenous shocks influenced the policy orientation of many developing countries around the world. In Latin America, structural adjustment, based on market oriented policies and state retrenchment were carried out, as advised by the Washington Consensus, which I discussed in chapter one. Thus, during the 1980s, Latin American countries underwent a series of policy reforms, among them trade liberalization.

Against this backdrop of policy reform in the developing countries, the world trade negotiations within the Uruguay Round (1986-1993) of the GATT continued to promote a considerable drop in non-agricultural tariffs. During the Uruguay round a new trend crystallized: commercial agreements started to address behind the border trade related measures, for example, the liberalization of the domestic institutional framework in which the economies of signatory countries operate. This trend continued with the

establishment of the World Trade Organization (WTO) in 1994. For example, among the new WTO regimes were the agreement on Trade Related Investment Measures (TRIMS), the Agreement on Subsidies and Countervailing Measures (ASCM), an accord on Trade Related Intellectual Property Rights (TRIPS), and the General Agreements on Services (GATS).

In short, these “new” trade disciplines increasingly included not only measures to facilitate the free flow of goods, but also issues pertaining to the institutional/regulatory domestic environment, such as rules on foreign direct investment (FDI) and intellectual property rights protection (IPR). From the standpoint of the South, much of the current debate surrounding trade negotiations evolves around how international trade regimes may limit the ability of developing countries to carry on autonomous domestic policies and regulations. Brazil, along with India, Russia, and China, has been especially vocal in expressing this concern. From the graphs above, there is hardly a trend relating to the income convergence predicted by neoclassical economic growth theory. There are successful growth “accelerations”, such as South Korea, Thailand in Asia, as well as more meager performances in Latin America and linear pattern in developed countries. Yet, the policy responses adopted across the board with varies degrees of depth emphasize the importance of openness– understood in terms of outward orientation of countries. The economic literature has been debating how openness translates in economic growth. In the next sub-section, I explore the recent literature on the trade/growth connection, and seek to bolster the discussion about openness for a country like Brazil.

Openness, Regionalism and Growth

Modern neoclassical economic theory stresses the importance of openness as an explanatory variable for economic growth. Openness increases foreign direct investment (FDI) and improves the productivity of human and physical capital. Neoclassical economics is based on the notion of utility-maximizing rational actors and the market equilibrating forces of supply and demand. Thus, with free trade, rational actors within countries optimize the production of goods with favorable factor endowments to sell to the international market, spurring growth in the long-run. Furthermore, accordingly to economic growth theory, knowledge accumulation – the crucial force for growth - is encouraged by the free flow of goods and services. The principal neoclassical growth model (Solow) also posits that economic development is a consequence of capital accumulation due to high rates of investment and savings. Hence, FDI may contribute to growth by offering an external source of savings and knowledge to a country. However, whereas neoclassical growth models take production technology as exogenous, new economic growth theories believe knowledge accumulation can be enhanced due to proper use of policies, which foster R&D and education. As the rest of this section will discuss, this feature is one of the main differences between neoclassical and new growth theories. This theoretical debate goes to the heart of contemporary discussions about globalization and the role for policy intervention in world trade agreements.

Much of the dispute about globalization and the effects of trade on domestic economies departs from two main tenets within classical political economy (Buchanan and Yoon 1999, 2000).³⁷ Neoclassical models derived from a Ricardian approach are based on constant returns to scale and static considerations about factor endowments, and hold that the distribution of the ownership of factors of production will determine the

³⁷ Buchanan and Yoon (2000: 42-48).

benefits of free trade. Market equilibrium after trade opening is thus based on supply and demand in a scenario of perfectly competitive markets. There are, therefore, losers and winners when a country joins the world economy. Technological improvement, although possible due to spillover effects, occurs as a consequence of factor accumulation (e.g. knowledge capital) and the import of capital goods.

The Smithean perspective is based on imperfect market competition and increasing returns to scale.³⁸ Accordingly market expansion after trade liberalization can bring about potent redistributive effects due to dynamic specialization inside the economies, in a manner that even those initially harmed can adapt and benefit from a new equilibrium driven by new market forces. Besides, market expansion due to openness also allows for greater levels of entry and exit, which may enhance the efficiency of economic actors and allow for a Pareto superior market equilibrium. Finally, as far as technology is concerned, the possibility of increasing returns to scale allows for the adoption of the latest evolving technologies which may create dynamic productivity gains. Proper institutional rules and governmental policies can enhance this market process, contributing to factor accumulation (knowledge, capital), and innovation.

³⁸ The formulation of the Smithean perspective and the possibility of increasing returns are given by Euler's theorem. The theorem asserts that when a function, $Y = F(K, L)$, relating the dependent variable, output (Y) to two independent variables, factors of production capital (K) and labor (L), is homogenous of degree one, the sum of the separate partial derivatives multiplied by the corresponding independent variables is equal to the total value of the function or the dependent variable: e.g. $Y = F_K K + F_L L$. In the case of constant returns, factors of production will marginally pay their shares, exhausting the total value of the product. The exponents of the independent variables sum to unity. Under the Smithean perspective, profit-seeking firms extend their scale of operation in order to take full advantage of increasing returns. When aggregate demand is high, as in the expansion towards foreign markets, firms may reach scale advantages while remaining small relative to the size of the product. In this competitive structure, an increase in the number of efficiently operating firms, combined with non-efficient firms leaving the market, will enhance overall productivity of the economy and will stimulate the adoption of new technologies. Mathematically, the production function where x_1, \dots, x_n are factors of production (input bundles), t is their shares and k is and scalar referring to the sum of their marginal prices:
 $f(tx_1, \dots, tx_n) = t^k f(x_1, \dots, x_n)$ for all x_1, \dots, x_n and all $t > 0$ is homogenous of degree $k > 1$, meaning that when one doubles the factors of production, the output more than doubles and the sum of the exponents of factors of production is more than unity (Buchanan and Yoon 1999; 2000).

The discussion about the economic effects of regional integration agreements (RIAs) relates to both of the abovementioned political economy models: the classical approach clearly follows a Ricardian tradition and focuses on short-term effects about trade creation and diversion; modern trade theory relates to the Smithean perspective, positing that regional integration may trigger dynamic economic effects due to returns to scale, the clustering of economic activities, and technological spillovers. Yet, both traditions emphasize that, while in the short term some actors will lose, in the long run, trade liberalization allows for a more efficient allocation of the factors of production. Integration theory also stresses that these effects tend to be greater in a regional setting because of deeper liberalization commitments, which in turn can foster greater productivity and economic welfare gains. These productivity enhancing effects are also amplified by the imperfect markets aspect of modern international trade, characterized by intra-industry transactions and the vertical integration of firms.³⁹ Bardhan and Udry (1999 chapter 05), for example, describe a model about the market enhancing effects of trade openness: an upstream market characterized by imperfect competition and increasing returns to scale, and a downstream market in which firms are price takers and operate in a constant returns to scale environment. Trade liberalization and integration with more advanced economies in the upstream market enhances domestic efficiency and productivity in both upstream and downstream markets because markup prices for the inputs in the downstream market tend fall after liberalization.

³⁹ Baldwin and Venables (1995) provide a technical explanation of new trade theories and regional economic integration. Krugman (1995) provides a technical review on international trade and imperfect markets. For a brief but comprehensive review of the empirical literature on the economic effects of RIAs see also: OECD (2001).

Despite theoretical justifications from different traditions of political economy, the openness-growth relationship is empirically controversial and may be somewhat unclear because of endogeneity and reverse causality. Historically, trade growth happens in countries already experiencing modern economic growth; and developed countries trade more with each other than with developing countries (Kravis 1970; Easterlin 1998, 41-42). Technological change is the crucial cause of economic growth, which must be combined with institutional arrangements like property rights (e.g., intellectual property rights) and enforcement of legal contracts to create incentives to foster markets. Rational actors will then look for mechanisms to enhance comparative advantage (North 1990, 1993).

There is growing evidence in the empirical literature that the simple removal of tariffs is insufficient to promote economic growth. Rodriguez and Rodrik (1999) categorically dismiss the negative causal relation between trade barriers (tariff or non-tariff) and economic growth. Rebutting a series of empirical works, they state that other factors contribute to growth, including differences in macroeconomic policies and domestic institutions, and suggest that the study of variations in trade policy may prove to be a better avenue of analysis. Frankel and Romer (1999), however, defend the idea that the link between trade and growth is somewhat tenuous, but exists. They argue that the impact of trade on income growth depends on a country's size and geographical characteristics. Controlling for these factors, they affirm that trade has a positive impact on income growth. Their results apply both to developed and developing countries. They also minimize the impact of tariff removal and acknowledge that policies and institutions are important channels influencing growth.

Overall, there have been a variety of empirical methodologies employed in the literature, which may contribute to the divergent results obtained in terms of verifying the trade-growth relationship. In light of this diversity, Greenaway et al (2001) criticize different methodologies and employ lagged dependent variables to account for the income growth effects of trade liberalization on developing countries. They find that the impact of trade liberalization on income is illustrated with a J-shaped curve, with positive but modest impacts on GDP per capita. Finally, a more recent paper by Wacziarg and Welch (2003) follows up this question. First, they update a comprehensive cross-country database on trade indicators, such as tariffs, non tariff barriers, and trade liberalization dates for the 1990s; then, implementing new measurement strategies based on within-country trade policy variation that allows them to correct some of the previous inconsistencies in the literature, their results suggest that the effects of increased trade liberalization within countries through time are positive, economically large and statistically significant.

Conversely, while the literature on trade liberalization under regional integration focuses on the welfare effects and direction of trade, much less attention has been dedicated to the effect of RIAs on growth, especially at the empirical level. The traditional literature usually uses *dummy variables*, which implies that the potential growth effect of an RIA depends merely on a country signing it, and does not reflect agreement or country characteristics. Berthelon (2003) fills this gap by introducing some methodological innovations. He uses two variables: absolute RIA, which captures the size of partners' markets, and relative RIA, which reflects partners' market size relative to the size of the domestic market. The former variable captures the different effect of a

county joining, for example, the NAFTA versus Mercosur or the Andean Community. The latter variable allows one to capture the different effect of, for instance, Czech Republic or Ukraine joining the EU, or Argentina and Colombia signing free trade agreements with the U.S. With these variables, the author finds strong evidence of RIAs fostering growth, and the results are robust to different estimation techniques. The author also considers whether the growth effects of RIAs depend on the country's level of development by differentiating between three kinds of RIAs: North-North (including only developed countries); South-South (including only developing countries) and North-South (including countries in both groups). The author finds sound support for the positive growth effects of N-N agreements, but mixed results for N-S and S-S ones.

Of note, the broad literature discusses the impact of openness on income growth rather than on income levels; therefore the distributional consequences of trade liberalization, which can be severe, are seldom considered. This void is filled by a growing literature on the welfare effects of trade liberalization. Quantitative research - computable general equilibrium (CGE) models - has been estimating economic welfare gains of trade liberalization under unilateral, multilateral and regional frameworks. The Michigan Model of World Production and Trade, for example, which covers eighteen economic sectors in twenty two countries/regions and incorporates aspects of trade with imperfect competition in manufacturing and services, is one of these computational analyses.⁴⁰ According to this research, trade liberalization has positive welfare effects for

⁴⁰ There are several studies that assess the possible quantitative gains of multilateral liberalization and use the Michigan Model data set. See, for example, Drusilla K. Brown, A. V. Deardorff and Robert M. Stern, "Computational Analysis of Multilateral Trade Liberalization in the Uruguay Round and Doha Development Round", RSIE Discussion Paper no. 489, Ann Arbor MI, School of Public Policy, University of Michigan 2002.

See also, Sandra Polaski. *Winners and Losers: The Impact of the Doha Round on Developing Countries*, (Washington: Carnegie Endowment for International Peace 2006). The CGE models also gauge the

the owners of abundant factors of production, which in developing countries such as Brazil, is unskilled labor and land.

Regarding the effects of trade on income inequality, the World Development Report “Equity and Development” (World Bank 2006, Chapter 9 and 10) offers a comprehensive discussion about the effects of trade liberalization. This report emphasizes the deleterious effects of agricultural subsidies/tariffs in the North, and stresses that the phasing out of those protectionist instruments could quickly boost the income of poor citizens in the developing countries. However, the World Bank report also acknowledges that trade liberalization causes several modifications in products and labor markets, and income growth depends on several other factors, such as the level of human capital or the stability of the macroeconomic environment. In fact, the report mentions the possibility of losers emerging from amongst the poorest households in several countries, particularly because their agricultural goods would be displaced by more competitive sellers in both domestic and international markets. Therefore, the report suggests it is worth looking at the micro-level and at case studies to assess the impact of trade liberalization in poorer countries.

Of course, there are plenty of doubters concerning the effects of trade liberalization on poverty alleviation, income distribution and job creation (Oxfam 2002). The Oxfam study just cited also discusses the allegedly negative impact of trade liberalization on the environment, one of the main criticisms leveraged at trade agreements since the negotiation of NAFTA in the early 1990s. In this dissertation I assume trade liberalization is important for economic growth, principally due to the

quantitative effects of multilateral vis-à-vis regional liberalization. When I discuss the FTAA, I will mention one of these studies.

dynamic forces it may trigger, including technological shifts, which can trigger more efficient resource savings and uses of the factors of production. The following review of new growth theories will further clarify the relationship between trade liberalization, technological change and economic growth.

New Growth Theory

New growth theory—known also as endogenous growth theory— posits a causal relationship between openness and growth; however, it acknowledges that the causes of growth are complex, and conditioned by the accumulation of human capital. New growth theory focuses on understanding the economic motivations the trigger technological investments. Thus, in contrast to neoclassical economic models, new growth theory considers technology to be an endogenous variable. R&D activities, carried out both by private and public actors, are believed to increase the stock of ideas available in the economy, some of which may promote innovation and technical progress, as well as increased profits. Hence, R&D stimulates economic growth because it affects total factor productivity (TFP)—new technologies promote more efficient methods of production with a given amount of capital and labor.⁴¹

New growth theory emphasizes the importance of human capital for R&D activities and innovation. The accumulation of human capital stock facilitates not only the creation of new ideas, but also the absorption of knowledge developed elsewhere.

⁴¹ The functional form of these assumptions expressed in the Cobb-Douglas model, which adds human capital to the Solow growth model:

$$Y(t) = K(t)^\alpha H^\beta [A(t)L(t)]^{1-\alpha-\beta}, \quad (1)$$

where K is the stock of capital, L is labor, and A is the stock of ideas (e.g. knowledge); H is human capital, which arises with the interaction between labor and the stock of ideas in a given society (Mankiw et. al. 1992).

Thus, this theory posits that long-run economic development is connected to the growth of the number of people dedicated to research, which positively affects the growth of ideas. The cost of innovation falls as human knowledge improves, due to increasing returns to scale (Romer 1990).⁴² Summing up, improvements in human capital, leading to technical innovation, are responsible for economic growth in the long-run.

Such theoretical findings have policy implications and justify the importance of formal education and labor force training. However, definitive conclusions are still unresolved in the literature. For instance in a textbook on economic growth, Jones (2000), stresses that market forces out of the control of policymakers (e.g., population growth rate) determine technological and long-run economic growth.

Furthermore, new growth theory posits that countries can improve the level of R&D investment and innovation when increasing their degree of integration into the world economy. This occurs because of international knowledge spillovers and positive externalities resulting from trade in goods and foreign direct investment. Coe et al. (1997) observe that the growth of TFP in developing countries is positively related to the stock of R&D capital of industrial countries. Thus, the absorption of technology increases as a

²⁶ The property of increasing returns to scale in a production function refers to the fact that the use of ideas by one economic actor does not preclude their use by others (non-rivalry). However, some may charge others for the use of their ideas (partial excludability). In the previously mentioned Cobb-Douglas functional form, based on the textbook of Romer (2002: 100), the property of increasing returns to scale can be applied to the variation of stock of ideas, thus the production function is given by:

$$\dot{A}(t) = B[a_K K(t)]^\beta [a_L L(t)^\gamma] A(t)^\theta, \quad (2)$$

$$\theta > 0, \beta \geq 0, \gamma \geq 1,$$

where, \dot{A} is variation in the stock of ideas across time, B is a shift parameter, K is the stock of capital, L is the stock of labor, a_K and a_L is a fraction of capital and the labor force associated to the production of ideas (e.g. knowledge intensive goods), β , γ and θ are coefficients (elasticities) associated with capital, labor and knowledge, and A is the current stock of knowledge. This functional form may have constant, decreasing, or increasing returns to scale. The interaction among researchers, fixed set-up costs, and so on may be important enough in R&D that doubling capital and labor more than doubles output. Therefore, there are increasing returns to scale, and the parameter θ is positive.

country imports more sophisticated products—for instance, machinery and equipment used in domestic production processes—or, as FDI increases, local firms enhance their productivity by copying methods of production from foreign companies. Nonetheless, this latter mechanism has drawbacks since foreign firms may limit the transfer of technology in order to preserve a competitive edge. The absence of a qualified work force in the receiving country may be another obstacle. In addition, companies may transfer only a certain level of technology due to license restrictions. Proper institutions can enhance this process: a minimal level of intellectual property rights protection (IPR), for example, must be required, and the lack of it may hinder technology transfers (Narula 2003: 191-192).

Along with the importance of openness, new growth theory acknowledges the crucial role of domestic institutions. For instance, one of the logical linkages between IPR protection and economic growth is that, by constructing an environment conducive to technical innovations and to the accumulation of human knowledge, IPRs will contribute to increased economic growth (Gould and Gruben 1996). Another point of dispute regarding IPRs stems from the presence of both static and dynamic effects. Generally speaking, in a static environment, IPRs are not welfare maximizing because, after an innovation, the economic entrepreneur has a legal monopoly. Once the innovation is made, however, spillover effects might spread over other sectors of the economy. A temporary monopoly is justified because research activity requires large sunken costs, such as building high-level human capital. The incentives for continuing innovation will be greater if the results of new discoveries are protected by an extensive system of IPR. In a dynamic setting, the patent is justifiable because society will be better

off when economic actors undergo risky activities, allowing knowledge to advance and spread into other sectors (Narula 2003; Maskus 2000). IPR protection also has asymmetric distributive effects on a global level: the efficient degree of protection might not maximize every country's welfare. Net importers of knowledge products may be required to pay more royalties. Thus, the creation of domestic IPR systems, by itself, may not guarantee economic growth. On the one hand, developed countries advocate that IPRs should be granted indiscriminately so that market forces would suffice to spur technological innovations. On the other hand, developing countries argue that indiscriminately granting IPRs may hinder domestic R&D, and they are doubtful that private multinational companies will transfer up-to-date technologies and support domestic learning.

Under the assumptions of new growth theory, lower access to external R&D due to inadequate institutional settings is usually associated with lower productivity growth rates (Schiff and Wang 2006). Since externalities and knowledge spillovers are inevitably international, the global economic integration of a developing country may contribute to its economic growth. Diao et al. (1999) verify that trade openness impacts the absorption of foreign R&D stock: the effect is greater if countries are able to process this body of foreign knowledge effectively. This last point relates to the issue of domestic R&D capability. According to this assumption, Lederman and Maloney (2003, 2006) examine patterns of R&D investment and development, verifying that although rates of return for R&D investments are higher for developing countries; other institutional variables count in R&D investment decisions. Albeit returns may be smaller, the evidence implies that developed countries have more investments in R&D. This suggests that countries with

national innovation institutions may be better equipped to integrate into the world economy. In their case study of Mexico, they posit that trade integration in a RIA was not enough to spur domestic R&D performance. Thus, it seems that trade integration/openness is a necessary but not a sufficient condition for technological innovation, which require other policies and adequate institutions.

Summing up, based on new growth theory assumptions, the more policy-oriented literature suggests that trade openness and FDI are important channels to allow spillover and growth in productivity (Schiff and Wang 2006, Schiff et al 2002). The more theoretical literature also supports the technological spillovers hypothesis: Diao et al. (1999) and Coe et al. (1997) verify that more open countries experience an increase in both foreign and domestic stock of R&D.

This theoretical and empirical debate has serious trade policy and trade negotiation implications, as the new trade agenda comprises sectors intensive in technology, such as communication services, and disciplines that may affect domestic R&D policies. Along these lines, the protection of IPRs has been one of the most contentious issues of contemporary trade discussions and involves the debate about policy space and the building up of domestic institutions. As I will expand later, of the main disagreements of Brazilian negotiators concerning the discussion of new trade themes, both at the WTO and within North-South trade negotiations such as the FTAA and the UE-Mercosur, is the difficulty of combining international agreements with domestic policy/regulatory space. The dispute over the use of generic drugs to combat the epidemic of AIDS is an example of how international trade agreements can influence

domestic policies.⁴³ I will discuss some of these issues in the next section on the political economy of world trade negotiations. In order to gauge the possible effects of recent trade liberalization, this next subsection addresses some of the empirical findings regarding Latin America and Total Factor Productivity (TFP).

The Examples of Mexico and Brazil

Considering TFP improvement, the benefits of integration into the world economy can work both via trade and FDI channels. The Inter-American Development Bank (IDB) (2002) compared several manufacturing sectors in Mexico and Brazil: the results are consistent with the hypothesis that trade integration spurs productivity. Lopez-Córdova and Moreira (2004) also examined the effects of trade liberalization and regional integration on productivity gains in the recent experiences of Brazil and Mexico and verified the TFP gains from international economic integration. Albeit somewhat counterintuitive in the Mexican case, their results support the idea that openness spurs productivity gains due to import competition and export orientation. Although these works do not disaggregate in terms of R&D intensive sectors, the results show that Latin American firms may be adopting more up-to-date production methods, thus narrowing the technological gap.

The IDB found a significant increase in the number of domestic firms participating in world markets: from 39 percent in 1996 to 44 percent in 1999 in Brazil, and from 28 percent to 43 percent in Mexico. During the same period, the internationally-

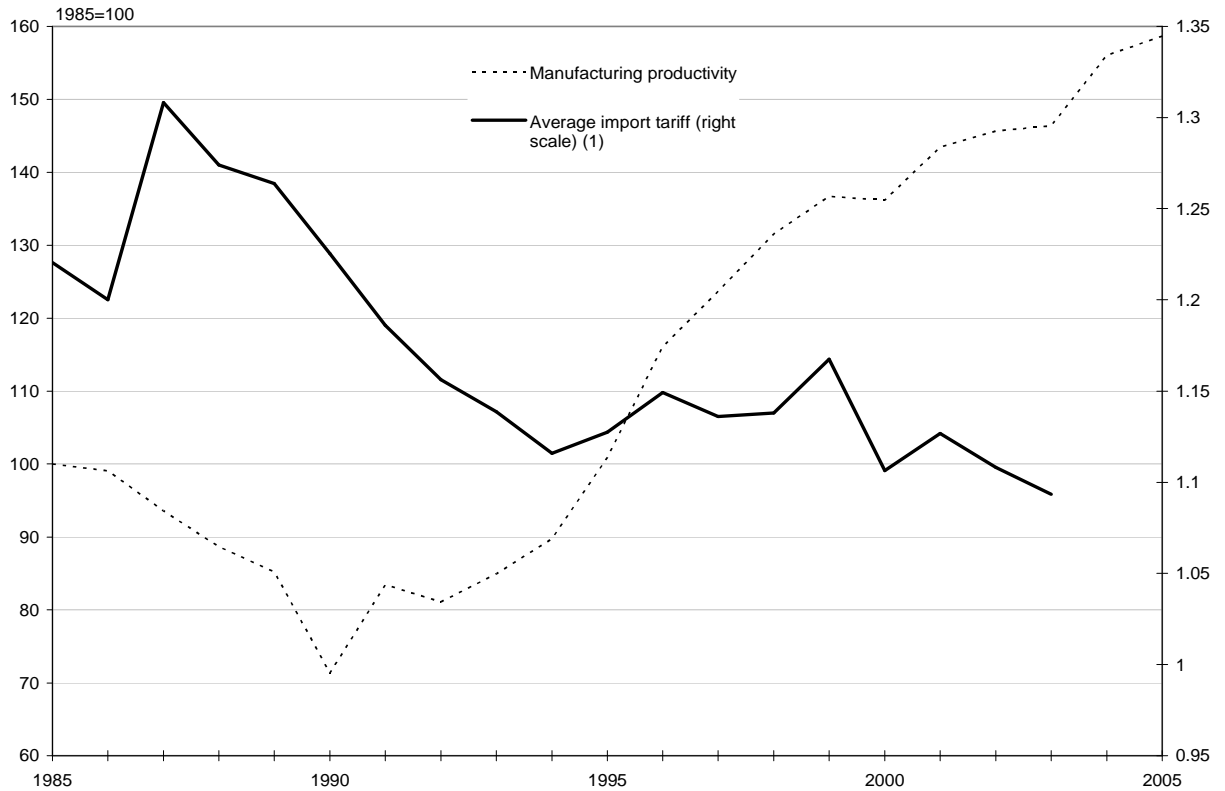
⁴³ Brazil argues before the World Health Organization (WHO) and the WTO that international patents should be violated to allow for the domestic production of HIV medicines at lower costs. Such policy determination is potentially contentious in current trade negotiations, given the importance of intellectual property rights for bilateral trade negotiations. The U.S., for example, is currently negotiating and signing accords, that go beyond the TRIPS/WTO disciplines. See Fink and Reichenmiller (2005).

oriented firms experienced higher productivity gains. Consequently, at least in some outward-oriented sectors, these countries may be catching up and experiencing technological and productivity improvements due to export success. Furthermore, FDI has encouraged these gains, suggesting that there are positive effects caused by competition, knowledge and backward linkages.

The IDB study also shows that the North American Free Trade Agreement (NAFTA) shaped the export drive in the case of Mexico, whereas in Brazil, the destination of exports was more diversified, going both to Mercosur and other regions of the world. In brief, even considering that other economic factors and policy reforms may have contributed to these outcomes, Mexico's and Brazil's unilateral trade liberalization and regional integration through NAFTA and Mercosur, respectively, contributed to TPF gains during the 1990s (IDB 2002, 254-265). López-Córdova and Moreira (2004) indicate similar results. The graph below depicts manufacturing productivity and an index of average tariffs in the Brazilian economy since 1985. Although one must assume several other variables may have influenced productivity gains in Brazil, including the end of hyperinflation since 1994, the negative correlation between the variables tariff protection and productivity are worth noting⁴⁴.

⁴⁴ In chapter four, I look at variables that account for technological intensity in selected industrial sectors in Brazil to gauge how technological content will influence trade policies such as protection (higher tariffs) and state support (more subsidies).

Figure 9: Productivity and trade protection.



Source: OECD (2006)

Section III - Multilateral and Regional Trade Integration

In this section, I will depict the status of current world trade negotiations from a theoretical, but also from a more factual perspective, bearing in mind the contemporary world economic situation. Thus, I emphasize not only *actor-based* political economy, but also the *systemic/structural* features of the international political economy characterized by globalization.⁴⁵ Globalization encompasses several interrelated phenomena that affect

⁴⁵ In this dissertation, I assume globalization to be multifaceted phenomenon with both economic and political underpinnings. Globalization, narrowly understood, could be interpreted as an increase in the flow of goods and capital across nations. Meanwhile, new trends in world affairs, such as the demise of

world economic governance, such as the surge of China in the world economy, the relative weakening of the Bretton Woods institutions and the changing logic of U.S. leadership in world economic affairs.⁴⁶ I also discuss how globalization limits/alters the provision of public goods and how regionalism arises as one response to this trend and to the search for more effective governance of the world economy.

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The Political Economy of Trade and the World Economy

The Bretton Woods institutions of the post Second World War era embodied free trade and monetary cooperation as cornerstones of world economic stability. For the architects of these international economic institutions, namely the International Monetary Fund and the World Bank, liberal economic values have public goods characteristics: free trade and monetary stability are non-rival and non-excludable and create positive spillovers for all countries. In reality, free trade practiced by one nation has positive effects on others to the extent that the opening of markets allows participating countries to sell products in which they specialize. If all countries liberalize, there is a Pareto superior outcome. The same rationale works in monetary affairs in that a cooperative world monetary order allows countries to correct imbalances and to avoid financial crises. Both the neo-realist and the liberal-institutionalist international relations literature highlights the importance of international public goods, which can be provided by

Communism, the end of the Cold War, and more recently, the upsurge of world terrorism, can be also related to globalization, which blurs the borders between national and international affairs, creating a transnational arena.

⁴⁶ Spero and Hart, *The Politics of International*, chapter 11.

regimes backed by a hegemonic country (Krasner 1983), and/or by a set of self-enforcing rules embodied in international institutions (Keohane 1984).⁴⁷

Recent trends in the world economy, namely the deepening of globalization, characterized by the upsurge of trade-oriented countries in the IPE and the financial crises that erupted during the 1990s and 2000s, have been changing and undermining the logic of the international institutions. In spite of the still powerful economic leadership of the U.S., free-market values backed by institutions such as the WTO have been contradicted by countries that have adopted managed and interventionist economic policies and which have been growing in importance in the world economy. Conversely, the flow of (bad) financial assets among countries and the lack of sound regulations, which spanned the recent crisis of mortgage assets (subprime), is evidence that the international economic order has been under strain.

In this context, the mounting interest in new regional integration arrangements can be interpreted as a response to the stalemate at the multilateral level, but also as a response to the deepening of globalization and to the necessity of creating mechanisms of regional economic governance.⁴⁸ The early example of the European Union and the more recent drive toward regionalism, which comprises more than tariff related measures and involves comprehensive rules of economic governance, can be regarded as an attempt to

⁴⁷ A more recent literature, based on the liberal-institutionalist tradition, analyzes the effects of globalization on world economic governance from a rational actor political economy approach (Kahler and Lake 2003). The message here: despite structural constraints, preferences matter in the carrying out of domestic trade and monetary policies.

⁴⁸ For an analysis on the impact of the globalization on state institutions see Cerny (1995). The author argues that globalization, by increasing competition in world markets, undermines the provision of public goods by national states. Thus, he believes the modern welfare state is turning into a competitive state and new forms of governance to regulate the global economy are needed.

foster public goods on the regional scale (Brelvi et al 2002).⁴⁹ As a consequence RIAs involve deeper integration rules (described below) and mechanisms of institutional cooperation, in the realm of fiscal and monetary co-operation and convergence, the prime example being the European Union.⁵⁰

On the other hand, there are different types of regionalism: there is a minimalist sort, market driven, comprising basically trade/investment related rules, called Anglo-Saxon regionalism; and there is a more institutionally oriented regionalism, which comprises rules and norms to mitigate market failures, the prime example, once again, being the European Union (Brelvi et al 2002).

Emerging markets and developing countries, Brazil included, are grappling with these world economic trends including globalization, the difficulties of multilateralism and the upsurge in contrasting trends in regional integration. Therefore, the very question is not if regionalism is a building bloc or a stumbling bloc of the multilateral order, but to what extent regionalism provides a response to the possible disruptive effects of globalization in order to tame the deleterious effects of world imbalances.

There is a burgeoning literature in economics and political science which seeks to understand the apparent contrasting strategies of multilateralism versus regionalism.

Neoclassical economic theory holds that unilateral trade liberalization is the best option

⁴⁹ In the initial chapter of their book, Brelvi et al. present a theoretical debate about the concept of regionalism versus globalization, and cover such contending theoretical traditions as constructivism, realism and liberal-institutionalism. The authors stress the element of governance as a crucial aspect of the shift toward regionalism. Therefore, nation-states commit regional agreements to control market outcomes and to alleviate the possible deleterious effects of globalization.

⁵⁰ For an explanation regarding the upsurge of regionalism and how countries attempt to control market outcomes by moving economic decision-making to the transnational arena see Hülsemeyer (2000). According to this author, European Union-style regionalism offers an alternative to mitigate the deleterious effects of globalization - decreasing information asymmetries and negative externalities - by allowing the building up of transnational institutions and policies. Conversely, Garret and Rodden (2003), while analyzing the phenomenon of fiscal decentralization, argue that globalization shifts the balance of financial institutions and policies not toward the transnational realm but to sub-national arenas.

for countries, but in this debate neoclassical economists also opt for multilateralism, assuming that this strategy is more welfare enhancing than regionalism—which is regarded as a second best option from this perspective. Meanwhile, in a world characterized by lobbies, rarely the best outcome prevails and multilateral negotiations have been plagued by fierce political economic pressures. Therefore, a strand of the literature supports regionalism, not only as the second best option, but as the best way to break out of political economy stalemates. Bouzas (2005), following other authors, such as Haggard (1997),⁵¹ posits that Latin American countries may benefit by committing to an RIA with more advanced countries in order to lock in domestic economic reforms. Even considering industrialized countries, regional integration agreements can lead to domestic institutional change, and trade liberalization can tie the hands of policymakers and decrease the ability to escape from previously agreed rules in international agreements (Rosendorff and Milner 2001). The U.S.-Canada Free Trade Area, for example, can be regarded as an early example of an external commitment signaling Canada’s willingness to reform its domestic economic institutions and tie the hands of domestic policy makers.

According to another strand of this literature, regional integration is a complement rather than substitute for multilateral trade liberalization because it triggers a domino effect and creates a web of complementing and juxtaposing regional integration agreements that may enhance and compel multilateral negotiations to move forward (Baldwin 2006). According to this view, the drive toward regionalism in the Western

⁵¹ Stephan Haggard, “Regionalism in Asia and Americas”, in Edward Mansfield and Helen Milner (eds.), *The Political Economy of Regionalism*, New York: Columbia University Press, 1997.

Hemisphere (NAFTA, Mercosur), in Asia (ASEAN, APEC⁵²) in the early 1990s, and the enlargement of the European Union in the 1980s, provided a catalyst for the stalled multilateral trade negotiations during the GATT's Uruguay round.

Current trade negotiations comprise not only liberalization in goods, but also deeper integration commitments and behind the border measures in areas such as services, investments, intellectual property rights protection (IPR), and government procurement. The "North-South" regional integration initiatives have been bolder at proposing such disciplines, this being the so-called "WTO-plus" approach. The North American Free Trade Agreement (NAFTA) is an early example of this format, as would be the FTAA. For a country like Brazil, joining trade integration agreements raises the fear of losing policy autonomy, particularly in an FTAA sort of agreement which from the start was cast as a WTO-plus endeavor.⁵³ On the other hand, integration into the world economy, especially via a regional integration framework, can unleash powerful dynamic forces with positive effects for economic development: economies of scale, R&D spillovers and externalities, learning-by-doing, and the clustering of economic activities (Venables, 2003). The literature on the political economy of regional economic integration has pointed to the possible productivity gains to be derived from increased trade flows between North and South as a powerful rationale for these trade agreements based largely on the assumptions of new growth theory models (Feenstra 2002, chapter

⁵² The Asia-Pacific Economic Cooperation (APEC) is an economic forum for [Pacific Rim](#) countries to discuss matters on regional economies, cooperation, trade and investment. It has the following members: Australia, Brunei Darussalam, Canada, Chile, and People's Republic of China, Hong Kong, China, Indonesia, Japan, Republic of Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, Philippines, Russia, Singapore, Chinese Taipei, Thailand, United States, and Vietnam.

⁵³ There is an ongoing debate on how joining a trade agreement undermines policy autonomy, which I have mentioned previously. For contrasting views see UNCTAD (2006) and WTO (2004). Curiously, these two international organization linked to the United Nation system have different approaches toward trade and industrial policies; UNCTAD has been historically advocating more state activism. For an academic discussion, see Shadlen (2005).

06 and 10). In addition to productivity gains, there are also potential non-conventional gains of joining RIAs (Fernandez 1997): institutional and regulatory discipline (e.g. business facilitation, investment, services, government procurement, intellectual property rights, etc) have been increasingly discussed at negotiations over these modern trade integration agreements. Apparently, regionalism can produce more profound economic and institutional modernization, which has not been fully considered by the classical literature on preferential trade agreements (Ethier 1998, 2001).

Therefore, an analysis focusing only on the political economy of factors of production ownership may not convey all the dynamic complexities of the new regionalism. Hence, even in a capital scarce country, domestic groups and firms connected to FDI and engage in intra-industry trade with capital endowed countries – for example, the U.S. or Canada - may support North-South agreements in order to gain access to cutting edge technology and to reap economies of scale. Milner (1997) and Chase (2003) apply these theories to the case of U.S. industries lobbying for NAFTA. There is little research, though, regarding the position of firms in less developed countries⁵⁴.

The reality has been harsh on these theoretical findings, nevertheless. Mounting protectionism and political constraints have been hampering current multilateral negotiations, as well as the deepening of current regional integration schemes in the Western Hemisphere. The stalemate in the FTAA, the acrimony related to approval of the

⁵⁴ In chapter four, I will look at variables that measure regional trade participation of selected industrial sectors in Brazil, wishing to find if industries engaging in intra-industry and regional trade will lobby for policies of protection (tariff) or state-support (subsidies). For now, it is worth stating that regional integration initiatives have been a force behind trade reform in developing countries (OECD 2001, IADB 2002, World Bank 2002).

CAFTA by the U.S. Congress at the last minute, and the inability to broaden the trade agenda of NAFTA to include issues such as labor mobility and energy security, are evidence that protectionist trends are on the rise. Within both the multilateral and the regional arena, the stalemate boils down to a straightforward application of neo-classical political economy models (Heckescher-Ohlin): owners of scarce production factors do not gain from trade liberalization and thus they exert protectionist pressures through lobbies directed at the Executive and the Congress. This explains the position of agriculture and labor intensive industries in developed countries. In the Doha Round, the power of agricultural sectors is evident in the high tariffs in Europe and Japan and in the level of subsidies in the U.S. Equally, labor intensive sectors are also protected by higher tariffs, cases in point being imports of textiles, apparel and footwear from developing countries that are penalized (Schott 2006). Conversely, developing countries are wary of accepting further liberalization in capital intensive goods and sectors, such as high-tech industries (e.g. telecommunication materials, IT goods) and services (e.g. software development, public utilities), whereas further liberalization in this field is supported by private sector constituents in developed countries for whom the export of intangible assets or high-tech goods is commercially gainful and/or wish to expand opportunities for investment.

Trade liberalization also involves the skepticism and criticism of public opinion in both developed and developing countries regarding the effects of globalization. In Latin America, the support for neoliberal structural reforms, as shown by a *Latinobarometro* poll of 2005, has been dwindling and it can be interpreted as a response to the recessive macroeconomic situation of the early 2000s and to the allegedly low income generating

results of these structural reforms. In the developed countries, the case for environmental and labor clauses in trade agreements reflects the concern about an excessive market-driven globalization and causes local social tensions. In this context, it is worth asking if countries will commit to deeper trade commitments.

Deeper Integration Issues: the New Trade Agenda

Economic activities are regulated through countless domestic disciplines endorsed and implemented at every level of government. These regulations can be sector specific (agriculture, mining, telecommunications and financial services, for example) or horizontally specific, that is, applying to all firms within an economy (for instance, company law, taxation, environmental, labor and employment, intellectual property rights requirements).⁵⁵ In the two decades since the Uruguay round, the WTO/GATT multilateral framework started to push forward more comprehensive rules to regulate the domestic economies of signatory countries, attempting to create a more level playing field between domestic and foreign firms, based on the premises of national treatment (NT) and most favored nation (MFN). In that direction, the TRIPS, the GATS and the TRIMS created rules for intellectual property rights, trade in services and investments, respectively. The WTO Doha round currently being discussed expanded the agenda to negotiations on government procurement, competition policies and the possible inclusion of labor and environmental trade related rules. All those issues are much contested by developing countries, which are not willing to discuss them in the absence of headway on more traditional trade themes, such as market access and agricultural subsidies. However,

⁵⁵ See Torrent and Molinuevo (2004).

the new regionalism format has embraced and even deepened the commitment to incorporating these “regulatory” disciplines into new trade accords. They are present, for instance, in the FTAA and in the EU-Mercosur negotiations. Trade negotiators both at the multilateral and at the regional level, are increasingly determined to advance regulatory frameworks based on horizontal rules.

Trade in goods also involves domestic regulatory content, such as standards, which according to the degree of requirement, can act as a non tariff barrier (NTB). The WTO also has disciplines on these NTB issues. Finally, deeper integration discussions also open up the possibility for creating supranational institutions within the framework of a trade agreement. In this regard, the European Union is the prime example, having established institutions such as the European Committee and the European Council to oversee the process of integration⁵⁶ as well as a parliament with legislative powers. The example of the Mercosur is much more modest: the establishment of supranational institutions and legislation has been one of the most contested issues within this bloc.⁵⁷ The relative delay in discussing the institutional format within Mercosur certainly contributed to the hesitant position of the bloc in discussing trade agreements with third parties. The recent turmoil in Mercosur can be understood as a consequence of this institutional vacuum, which rendered it incapable of sorting out the particular interests within some sectors from the broader integration aims of the bloc as a whole. This trend is mirrors Brazilian foreign policy characteristics, which favors a piecemeal approach to

⁵⁶ These institutions have distinct missions within the European Union framework: the **European Council** is a meeting of the heads of state or government of the European Union and the President of the European Commission, while the **European Commission** is the executive body of the European Union. These bodies often have different positions regarding the pace of trade liberalization or European policy making.

⁵⁷ For a discussion about the creation of supranational institutions in Mercosur, see Rosenberg (2002). For a recent account of Mercosur developments from the perspective of a Brazilian scholar, see Camargo (2006).

international matters, especially if they may involve the building up of supra-national institutions.

I discussed in the previous chapter, trade policy in Brazil must be understood in a broader context, one where by state intervention, is readily embraced as a way of correcting market failures and providing public goods, even if this has hindered economic freedom and protected inefficient domestic economic actors. To the extent that contemporary trade agreements discuss deeper integration issues which comprise regulatory and institutional rules intended to unleash market forces, reduce state intervention and establish a level playing field between domestic and foreign firms, there has been latent tension between long run characteristics of the Brazilian economic policy model and these trade agreements. The FTAA discussions, for example, were embedded in the assumption that trade, investment and even economic governance rules are intrinsically intertwined, hence, triggering a cautious Brazilian negotiating position.

Despite the so-called priority and precedence of Latin American integration in official Brazilian discourse (Amorim 2005), there are also squabbles regarding deeper integration, such as the strengthening of supranational institutions to correct the asymmetries between partner countries. One example is the current disagreement about the creation of a development bank in Mercosur. Mercosur has been slowly making progress to create a Fund of Convergence (FOCEM) that may address the special interests of smaller countries (Paraguay, Uruguay) (Cepal 2006:96). The 2006 ECLAC report on Latin American international economic integration acknowledge that countries in the region, particularly in South America, have been lagging behind in committing to deeper levels of integration. The report mentions that the several free trade areas in the

sub-continent have been timid at proposing disciplines on services, investment, government procurement, intellectual property rights, competition policy and labor rights. In short, Latin American integration is not addressing key subjects that are essential for the competitive modernization of the regional economy.

The lack of deeper commitments is surprising because in Latin America, intra-regional trade seems to be very much the result of the political will that inspired and continues to inspire the sub-regional integration trends of the post-war era. This trend is also starting to spillover to traditional trade: CEPAL estimates that total Latin American and Caribbean intra-regional trade in 2003 was a meager 16 percent of total regional exports, a lower level than the peak of 21.1 percent registered in 1997. These smaller figures were probably the result of the pro-cyclical nature of intra-regional trade in the region, which presents a declining trend in the combined shares of intra-regional trade and a growing shift in favor of inter-regional trade, including flows to developing Asia (table 11 in the Statistical Annex) (Agatiello 2005, Kumayana 2005). Summing up, despite the existence of treaties and tariff reduction mechanisms inside the continent, the levels of stagnation of intra-regional trade and the absence of deeper integration commitments and disciplines seems to indicate that Latin America integration is hostage to an empty discourse and the inability to further advance an integration agenda. During commodities boom, this is still the main component of export portfolio of the sub-continent, intra-regional trade shares decline.

Ortiz-Mena (2000) points to the difficulties applying political economy theories of economic and institutional convergence in the South-South integration process. He applies the theory developed by Milner (1997) to the case of the G-3 (Colombia, Mexico

and Venezuela; do not mistake with the G-3 of Brazil, India and South Africa), a FTA that was actually extinct, as an example of how the rise of intra-bloc and intra-industrial trade was not able to boost regional institutional deepening. In Mercosur as well, in spite of the impressive growth in intra-bloc and intra-industry trade in the first years of the common market, which spurred an impressive intra-regional flow of goods during the 1990s (e.g. the automotive sector), deeper trade related disciplines have been stalled. Mercosur still has very meager rules regarding investments, services, intellectual property right rules and competition policies, not to mention labor mobility disciplines.

On the other hand, extra-regional integration projects, particularly those with advanced countries, such as at the stalled FTAA and Mercosur-EU, or at the successful CAFTA, or even at bilateral agreements, such as Chile-UE, Chile-Japan and Mexico-UE, deeper trade rules have been proposed, discussed and eventually accepted by the involved parties. The adoption of disciplines of regulatory and institutional convergence can be regarded as a logical step for less developed countries willing to lock in policy reforms and to acquire a competitive edge in the world economy via North-South agreements.

Notwithstanding the meager results of intra-regional integration, Latin America and Brazil are hardly to blame for the stalemate at the hemispheric and multilateral levels. Despite the possible welfare gains described by several CGE models, interest groups in developed countries have fiercely opposed further liberalization in agriculture and textiles—land and labor intensive sectors in which they have fewer comparative advantages. In the multilateral discussions, achieving the Doha Bargain would require political commitment and negotiation positions far superior to the ones currently on the table (Cline 2005; Elliot 2006; Schott 2006). Besides, as the mandate of the WTO

includes a development agenda, such as Aid for Trade and the fulfillment of the Millennium Development Goals, there is a case for conceding to the demands of the poorer countries (World Bank Development Report 2006: 209). Given that the trade policy apparatus and negotiation capacity of the developed countries is far superior to that of poorer countries, the responsibility to continue the multilateral trade negotiations lies in the hands of developed country politicians and in their ability to break political economy stalemates among their constituencies. In the next section I elaborate on the WTO's Doha round and the Brazilian negotiating position within that forum.

The Doha Round: State of the Art and the Brazilian Position

The Doha round has been stalled since the Sixth Ministerial Summit of the WTO, held in Hong Kong in December 2005. The original aim of that conference was the setting up of modalities (in WTO parlance: actions that guide the negotiations) in order to conclude the round in 2006. Meanwhile, the same stiff positions that marked Doha from the start prevailed in Hong Kong, thus rendering the failure of the Ministerial meeting inevitable.

In the last moments of the conference, the WTO Director General was able to approve, with the support of the U.S. and Brazil, some minimal non-quantitative measures. In agriculture, for example, the elimination of export subsidies was agreed according to a timeline ending in 2013, conditional on specific modalities. In cotton production, developed countries conceded to developing countries in two important areas: the immediate elimination of subsidies, and increased market access - free from quotas and other restrictions. Yet, tariffs remain high in some semi-processed goods. In contrast, in the case of non agricultural market access (NAMA) and in services zero

progress was made. Despite the apparent alliance between Brazil and the U.S. to press the EU for greater concessions in agriculture, polarization was the rule. The developing countries, represented by the G-20,⁵⁸ pushed for the liberalization of agricultural markets, whereas the developed countries insisted on greater commitments in services and industrial goods.

The Brazilian stance at the WTO negotiations sought gains in agricultural liberalization, where the country has a clear comparative advantage.⁵⁹ In contrast, Brazil is reticent to further liberalize services and industrial goods, because it is relatively less competitive in both domestic and international markets within those sectors. The Brazilian government is aware of the potential welfare gains of a successful conclusion of the Doha round. Less overtly, it also acknowledges the potential for positive productivity effects on domestic export oriented sectors and on sectors exposed to international competition. Meanwhile, the discourse of Brazilian negotiators is imbued with the rhetoric of policy autonomy and doubts that excessive liberalization in industrial goods and services could hamper domestic development (Amorim 2005).⁶⁰ Moreover, there is still a clear commitment to treat trade negotiations as a vehicle for advancing the more general goals of Brazilian foreign policy (Guimarães 2004).

Brazil, since the election of left wing Labor Party president Luis Ignacio Lula da Silva, has been assuming a more active position in the WTO negotiations. The country

⁵⁸ For a description of the G-20, with a special focus on Brazil's role in that group see Veiga (2006) and Paquin-Boutin (2005).

⁵⁹ Brazil, according to several CGE models, is the country with the most to gain from the liberalization of world agriculture markets. See Polaski (2006).

⁶⁰ In order to illustrate this point, I quote the position of the Brazilian Ministry of Foreign Affairs:

“It is clear for that we can not compromise the ability of the state to carry on industrial, technological and environmental policies. The Brazilian participation experiences in the former rounds of GATT and in the onset of the WTO suggest a cautious position against potentially harmful concessions that will be realized only years later” (author's translation). (Amorim 2005)

believes that multilateral agricultural liberalization will benefit world welfare, particularly those poorer countries that count on basic crops as their main source of export income. Brazil, meanwhile, is less forthcoming on the fact that the liberalization of world agriculture markets can also have a negative impact on the income of non-competitive domestic agricultural sectors in poorest countries, which would see their domestic markets flooded by cheap imports. (World Bank 2006: chapter 05, Paquin-Boutin 2005). Brazil basically supports a negotiated liberalization in Non Agricultural Market Access (NAMA) and services, as this could spur developing countries' welfare and productivity, but it has demanded greater discussion on safeguard measures and more flexibility in pursuing policy goals.

Amidst this debate, Brazil opposes the negotiation of environmental and labor clauses as a part of the Doha round. The country sustains that environmental and labor clauses could be used as disguised protectionism. Though, it recognizes that the liberalization of services could involve migration and labor force mobility, areas that would certainly benefit some developing countries. The current WTO agreement on Services (GATS) – Mode 04⁶¹ - partially addresses labor force mobility in the case of short-term workers. According to studies of the Financial G-20, demographic trends in several developing countries create strains in local labor markets, as an excess of low-skilled labor leads to higher unemployment and social tensions. In contrast, developed countries have a shortage of low-skilled labor force (Koettl et al 2006). Given this situation, the economic incentives compel the developing countries' workers to migrate to developed countries. Temporary labor contracts could thus be proposed in the trade

⁶¹ Mode 4 from the GATS agreements refers to the modality in which the service seller moves to the location of the service buyer. Thus, Mode 4 implies temporary migration.

agreement framework (Rodrik 2001). Additionally, agreements should include remittance rules that allow the transfer of money between recipient and source countries, in order to facilitate the saving of migrant workers and to create positive spillovers for source countries' economies and financial markets.⁶²

Meanwhile, due to the current impasse, Cline (2006) acknowledges that the proposal of such disciplines is not feasible at the WTO Doha round and he argues that only regional integration initiatives can move forward on these issues. The liberalization of labor force/migration discussions also engender political economy concerns in developed countries. There is protectionism from groups which represent less skilled domestic workers (trade unions), because the increasing flow of migrants exerts a depressing influence on local wages. Thus, the inclusion of labor clauses in trade talks is doomed to be a contentious issue for any audience. Temporary labor mobility clauses in trade agreements could reduce the negative pressure from public opinion, but politicians and policymakers in developed countries must also be frank about the fact that trade liberalization creates winners and losers on both sides. Several developed countries' sectors could gain. For instance, workers within capital or knowledge intensive industries could benefit from labor mobility rules and they could exploit open markets in developing countries.

Complicated as labor issues may be, international commitments do have the power to create domestic incentives toward best international practices (Fernandez 1997). Along these lines, further commitments under the WTO could provide a justification to

⁶² The Financial G-20 is an informal group of developing and developed countries, plus the European Union, that discusses international macroeconomic and financial issues, possible modifications on the Bretton Woods international financial architecture and trade related themes. On labor mobility agreements, see Koettl et al (2006).

for lowering agricultural subsidies in the U.S. and for reformulating the Common Agriculture Policy in the European Union. In the end, one of the consequences of committing to trade integration initiatives is to provide a rationale to persuade protected domestic groups to surrender privileges that create domestic economic inefficiencies and penalize tax payers and consumers. Yet, if the traditional trade agenda lags behind in the current WTO Doha round due to collective action stalemates, it may be too premature to commit to a deeper regulatory and institutional agenda at the level of multilateral trade discussions.

Summing up, the meager results of the Sixth WTO Ministerial Summit may be a potential source of tension in the world economy. Whereas a steep protectionist wave in the U.S. and in the EU is not likely yet, with the deepening of “subprime” financial crisis and the fear of global recession, protectionist pressures coming from displaced sectors decrease prospects for a successful conclusion of the multilateral trade agenda. The current stalemates at the WTO and within several regional integration agreements like the FTAA have cast doubt on the extent to which trade liberalization is still desirable. Current global imbalances have further clouded this picture. The world economy is currently characterized by severe macroeconomic problems such as the abovementioned financial crisis, the twin deficits (current account and fiscal) in the U.S and by the impressive growth of China and India in world markets. To what extent are these trends detracting from the commitment to liberalize trade? In the next section, I briefly elaborate on these points.

Global Imbalances: China’s surge as a New Source of Tensions in the World Economy

The extraordinary expansion of China, and to a lesser extent, India, in world markets has been creating positive spillovers for the world economy, but also, new political economic tensions. On the positive side, the IMF report (2006: chapter 3) notes the negative correlation between globalization, narrowly understood as the rising flow of goods and capital among nations, and world prices. China has been a very active global player in the supply of industrial goods. The country has shifted its export profile in the last three decades – from low-tech merchandise (toys, plastics, textiles) to mid and high-tech goods (appliances, machinery, electronics and electronic components). According to the IMF, the impact of China on world prices has been twofold: a) due to an increase in the supply of industrial workers, China has placed downward pressure on prices for labor inputs; b) due to an increase in the supply of industrialized goods in world markets, it contributes to low inflation in importing countries. According to the IMF report, the deflationary effect has been particularly intense in information technology (IT) goods, which are massively produced in China. In fact, China has carved a competitive niche in the IT market. Finally, there are also productivity gains related to the increased competition of Chinese goods in importing countries, which also contributes to lower prices, although in some cases this competition ends up displacing local production (IMF 2006: chapter 3). Regarding India, the same phenomenon is occurring, but to a considerably smaller degree and not as much in industrial goods; India's success is principally related to the outsourcing of services by Western companies and by an increase in the supply of high-skilled Indian labor in IT firms in the U.S.⁶³

⁶³ On current trends in the world economy and global imbalances of the mid-2000s brought about by the escalating importance of India and China in world trade, see “*The New Titans - A Survey of the World Economy*”, The Economist, September 16th 2006.

The upsurge of China and India must be placed in perspective: since the second half of the 2000s growth has resumed, particularly in the emerging markets and commodity exporting countries due to high international demand for oil, minerals, and crops, mainly from the U.S. and China. Although balance of payments disequilibrium is still a source of instability in some countries, current account surpluses and higher levels of dollar reserves provide a cushion against the kinds of financial crises that marked the 1990s and early 2000s.

Yet, sources of tension linger. Among the global imbalances, the twin deficits in the U.S. (current account and fiscal deficits) and the misalignment of the Chinese currency have potentially de-stabilizing effect in the world economy, at least in the short run. The situation of the world economy in the end of the 2000s is affected by the burst of the real state bubble in the U.S., which is likely to create severe recessionary consequences, whose depth and extension are still unknown. This situation turns prospects for trade liberalization on a multilateral and regional scale very improbable. These global imbalances increase the probability of domestic political economic tensions and therefore require concerted action by countries and international institutions. These global macroeconomic imbalances can also provoke additional protectionism on the part of the U.S., which already faces a battle with the renewal of Trade Promotion Authority (TPA) by a Democratic majority in the congress (Fergusson 2006). This same scenario of free-trade backlash is visible in the European Union, which has a more protected economy and is in need of structural reforms. In short, macroeconomic unbalances can provoke protectionist backlash not only due to the raise of tariff and NTB barriers, but

also due to measures to support sectors harmed by the severe downturn: the auto industry (Brunel and Hufbauer 2009).

In relation to Latin America and Brazil, the Chinese appetite for commodities has been contributing to the current trade surpluses and accumulation of dollar reserves in recent years (CEPAL 2006: chapter 2). Yet, the competition from Chinese manufactured goods is also displacing Latin American industrial exports in third markets and even inside Latin America. Mexico is a prime example, as China has bumped Mexico down a notch as a trade partner of the U.S., competing with mid and high technology Mexican exports. Brazil, as well, has been benefiting from China's stiff demand for commodities and suffering from its competition in industrial goods. Chinese hunger for soy contributed to the upsurge of agribusiness in the interior regions of Brazil, displacing traditional crops, such as rice and cotton and even cattle ranching. Conversely, China became one of the main destinations of Brazilian pig iron exports. The Chinese have also been interested in steel production in Northern Brazil. In fact, the South-South flow of foreign direct investment is a current trend in the world economy, and FDI between Brazil and China increased in the first half of the 2000s. These new investment links may enhance the role of both countries in the world economy (UNCTAD 2006).

Meanwhile, within Latin America, the export of Chinese industrial goods, such as electronics, has been substituting Brazilian for exports. Additionally, Brazil is forming a triangular relationship with regard to intra-industrial trade with Chinese components. For example, in the cell phone industry, multinational companies (MNC) have taken advantage of this triangle and Brazil's preferences as a member of Latin American Integration Agreement (LAIA) to sell to the Latin American markets. The CEPAL 2006

report recommends that Latin America firms should aggregate value for MNC's based in China and take advantage of Chinese expertise to penetrate foreign markets, instead of just competing with them in third markets. In short, despite the aforementioned benefits, the impressive growth of China in the world economy raises concerns and hopes in Latin America, as everywhere else.

From the macroeconomic perspective there are problems related to the excess of investment and foreign trade surplus from China and the lack of savings in the United States. Roubini (2006) provides a diagnostic of current world economic trends, acknowledging that mercantilist exchange rate policies in China have provoked macroeconomic disorder. In truth, the misalignment of the Yuan increases the competitive edge of Chinese goods and contributes to the increasing trade deficit of the United States. Yet, the big U.S. consumer market is eager to buy cheap imports coming from many countries in the world. Thus, China cannot bear all the blame for today's global imbalances, and the U.S. is just as responsible for the problems given its macroeconomic mismanagement and the lack of domestic savings. On this point, Roubini cautions that the Chinese appetite for U.S. Treasury bonds, which helps to finance the U.S. fiscal and current account deficits, may become unsustainable in the long run. The excess of Chinese savings, associated with the lack of savings in the U.S., can deepen structural problems in the world economy. Ultimately, in order to curb inflationary trends provoked by the fiscal deficit, the U.S. Federal Reserve (Fed) may need to raise domestic interest rates. The impact of these measures in international financial markets may create strains for several developing countries that still need to finance their current account deficits. Finally, protectionism, not only in goods but also in assets, has been on the rise:

whereas the U.S. is eager to sell bonds to the Chinese and other central banks, the participation of these countries in FDI and the buying of tangible assets in the U.S. has not always been welcome.

The same rationale can be applied to the outsourcing phenomenon: U.S. public opinion believes that this kind of competition hurts U.S. actors and competitiveness. Therefore, there are protests regarding the export of jobs outside of the U.S., especially high-skilled jobs (IT services) for which the U.S. has long had a comparative advantage.⁶⁴ Summing up, these trends have prompted protests from some domestic groups and the U.S. Congress has sought to counter Chinese competition by proposing numerous questionable measures. There is also a quest for reforms in the international financial institutions in order to tackle these imbalances and improve transnational co-operation.

These global macroeconomic imbalances contribute to political economic tensions and to the dwindling of support for a global free trade. The current stalemate on the WTO multilateral agenda is testimony to this point. Regarding trade politics, the U.S. is sending contradictory signals: while still expressing support for free trade, it has shifted its trade strategy from a fierce supporter of the Bretton Woods multilateral order, to a web of regional and bilateral trade agreements, a strategy called competitive trade liberalization (Feinberg, 2005).

Finally, regarding Brazil, these international macroeconomic aspects have been creating strains and opportunities for the country, while also fostering a cautious and

⁶⁴ Bhagwati et al (2004) explain that due to technological shifts, productivity enhancements and innovation, jobs continue to be provided domestically in the U.S. at the same rate or even faster than job dislocation to other countries. Therefore, even with outsourcing, there is net job creation in the U.S., particularly in high-skilled jobs. In fact the demand for these jobs is on the rise.

lukewarm approach to further trade commitments. As mentioned, the sizable trade surpluses can be credited to soaring commodities prices in international markets. The booming world economy helped Brazil to correct current account deficits and to Brazil's mass foreign reserves, which hit to US\$ 150 billion in mid-2007. Yet, the weak dollar and the over-evaluation of the Brazilian real hurt domestic export interests. Despite the trade surpluses, business interests often complaint about the domestic exchange rate. The political economy of exchange rate is one of the most polemic policy issues since the decision to float the real in 1999. For now, the Central Bank is shielded from pressure and is carrying out a strictly technical monetary policy, but there are critics even inside the government that defend faster interest rate cuts and limits to currency appreciation. Against this backdrop of a fairly orthodox financial and macroeconomic policy, trade policy presents a possibility for more heterodox and autonomist positions.

The ongoing "subprime" financial crisis, and its impact on global economy, can have dire consequences for trade surplus of Brazil, which hugely benefit from world demand in the mid-2000s. Meanwhile, as I support in this dissertation, trade-policy in Brazil is characterized by permanent traits favoring cautious and piecemeal liberalization, even in moments of trade upturn. Hence, the global economic downturn is an extra ingredient that removes Brazil from committing toward multilateral and regional integration agreements, especially those that involve North-South formats.

Section IV - Conclusion

This chapter applied political economy theories to multilateral and regional trade negotiations and I discussed the role of deep integration issues in this context. I adopted a

structural approach and I analyzed how trade negotiations are enmeshed in global economic affairs. I also discussed how Latin American countries, Brazil in particular, in responding to the challenges of economic globalization, such as the upsurge of China, and the changing role of multilateral economic institutions. My main assumption is that several exogenous shocks in the world economy described in this chapter have been influencing trade policies in Brazil. However, the trade negotiating position of the country is grounded in world views that guide foreign policymaking, as described in chapter one. In the next chapter, I will expand on this issue, addressing the role of Brazil in two North-South regional trade integration negotiations, the FTAA and the UE-Mercosur.

The political economy theories presented in Section II will also be retrieved in chapter four, when I test the political economy cleavages that will influence trade policies - liberalization (decreasing tariffs) and state support (more subsidies). As I have discussed in that section, industrial sectors engaging in intra-industry and regional trade may be subject to positive technological spillovers, according to empirical works applying “new growth theories”. My task will be to test if these industrial sectors will be able to influence domestic policies, to the same extent that of “factor endowment” content (Labor x Land x Capital) and trade participation (export orientation and importing competition) of industrial sectors may influence policies, according to “endogenous trade policy” theories.

Section V – Statistical Annex

Table 11: Export destination, Latin America and Caribbean 2003, percentage of total exports.

All countries to	Including Mexico	Excluding Mexico
North	74.1	51.5
North America	56.8	30.8
European Union	11.1	20.4
Japan	6.2	0.3
South	25.9	48.5
Intra-regional	14.3	27.3
Inter-regional	11.6	21.2
From	To U.S., Canada, EU and Japan	Intra-regional plus Developing Asia, Africa and Middle East
Mercosur	46.1	53.9
Argentina	32.6	67.4
Brazil	52.4	47.6
Paraguay	11.2	88.8
Uruguay	38.5	61.5
Chile	53.8	46.2
Andean Community	61.3	38.7
Bolivia	24.3	75.7
Colombia	60.8	39.2
Ecuador	59.1	40.9
Peru	59.5	40.5
Venezuela	64.8	35.2
Mexico	93.9	6.1
CACM	67.9	32.1
Costa Rica	68.0	32.0
El Salvador	65.0	35.0
Guatemala	64.2	35.8
Honduras	73.7	26.3
Nicaragua	67.1	32.9
Regions - subregions	Intra-regional trade	Export share in world exports
Latin America and the Caribbean	16.0	5.2
Andean Community	9.0	0.8
Mercosur	11.9	1.5
CACM	20.7	0.2
Caricom	21.3	0.1

Source: Kuwayama 2005, ECLAC 2006.

Chapter 3 - Brazilian Trade Policy and Asymmetrical Integration: The EU-Mercosur Stalemate and a FTAA Thwarted.

Introduction:

Brazilian Trade Options in the Face of Global Challenges

This chapter discusses how the international scenario and new world trends (e.g. deep integration issues) discussed in the last chapter have affected Brazilian trade policy and strategy in the context of North-South negotiations. Recent exogenous shocks, both economic and political, clearly affected Brazilian foreign economic policies, and a main task in this chapter is to assess their impact on Brazil's trade policy. These external phenomena stopped policymakers from breaking entirely with Brazil's traditional path because trade policy is influenced by broader economic and political variables, including institutional inertia and ideological biases, as described in chapter one. The contradiction between domestically determined economic policy models and the dynamic and changing international environment partly explains the country's failure to adhere to multilateral and regional trade negotiations, each of which entails a North-South, such as the FTAA and the Mercosur-EU, that involves deeper liberalization rules,.

In this chapter I discuss the external trade options facing Brazil, with a focus on the North-South projects within the Western Hemisphere (FTAA) and beyond (Mercosur-EU and the WTO's Doha round negotiations). I will examine in more detail the stalemate that beset the FTAA, particularly Brazil's disagreements with its main trading partner, the United States, as this is the core example of the difficulty of the country to surrender its managed trade/industrial policy tradition and to commit to a North-South integration agenda. I evaluate why these integration projects have been at odds with Brazilian foreign

economic policy and vice versa. My goal in this chapter is to critically assess the contrasting views on trade strategy in the literature and to verify how they apply to Brazil's position within the North-South trade negotiations.

As I discussed in the first chapter, Brazilian trade policy is carried out with a great degree of bureaucratic insulation by “technocrats” and professional diplomats. As an instrument to promote economic development, Brazil's trade policy is part of a broader foreign policy strategy. Within this context, trade policy is conditioned by a particular world view based on the preferences of policymakers. Those diplomats that shape Brazilian foreign policy remain committed to an autonomous position in the world economy, a characteristic that has been reinforced by the incumbent Labor Party government. Deep integration issues intrinsic to North-South integration are at odds, not only with the developmentalist economic policy that prevails in Brazil, but also with this autonomous foreign policy tradition. Primarily for these reasons, the Brazilian foreign policymaking establishment is cautious about economic integration with Northern markets, a stance that has been even more pronounced in negotiations with the U.S.⁶⁵

Different types of regionalism reflect varieties in forms of capitalism and trade policy models. Brazil, as a country which attempted to build a “developmentalist” state and promoted active export promotion during its recent history, is struggling to adapt its domestic political economy institutions and public policymaking to new international realities. For example, North-South integration places pressure on policymakers to reduce state economic interventionism and concede more power to supranational bodies.⁶⁶ As

⁶⁵ For a summary of the continuity and rupture in Brazilian foreign policy under the Labor Party government, see Almeida (2006). Oliveira (2003) analyzes these same trends in Brazilian foreign policy from the standpoint of the FTAA negotiations.

⁶⁶For a detailed analysis of Brazil's participation in the international system, see Viola (2005).

the country is challenged by the possibility of integration with the EU or the U.S., it has simultaneously sought alternative integration projects in Latin America, including an expansion of Mercosur.

But Brazil is not the only state to experience problems with North-South trade negotiations. Other interested Northern parties, such as the EU and the U.S., also failed to commit wholeheartedly to integration with the South, and they were intransigent on some key issues, because of similar domestic political economy pressures. Thus, I also analyze the position of these other actors at the negotiating table so as to better understand the Brazilian position. These trends are reinforced by global macroeconomic problems.

The chapter is divided into the following parts: section II consists of a methodological foreword; section III analyzes the EU-Mercosur negotiations; section IV discusses the FTAA project; finally, in section V I conclude with an overview of the debate on how the politics of domestic structural reforms, as discussed in chapter one, have interacted with and become enmeshed with the recent external scenario.

Section I - Methodological Foreword

The upsurge of regional integration agreements can also be interpreted as a response to the expansion of globalization and the necessity to provide public goods on a global scale (Cerny, 1995). The expansion in intra-industry trade and the clustering of economic activities across borders requires supra-national regulations and institutions to provide a level playing field for enhanced investment and trade in goods and services. According to the integration literature, the mounting interest in regionalism is due to the fact that the deeper rules of institutional and regulatory convergence are easily achieved

on a regional rather than a multilateral scale. In short, the move toward supranational institutions expresses the concern about economic *governance* and about taming the market failure effects of globalization, the idea being that regional arrangements can better facilitate economic adjustment (Breslin et al, 2002).

Yet, the literature also emphasizes that the regionalism pursued by the U.S., the EU and Japan, is not the same (Wise 2007; Phillips 2001; 2002). The so-called Anglo-Saxon regionalism is oriented toward market facilitation, rather than the EU model of building up political institutions that help to mediate market relations and mitigate market failures. Though the EU is currently at a more advanced level of economic integration, in its initial years, there was a concern with the correction of market failures within that project. Thus, institutional mechanisms that address regional imbalances and implemented fiscal transferences were created in order to diminish regional income disparities among member countries. Over time, this has been a constant policy priority for the EU.

Despite differences in the models of regionalism, trade agreements of Anglo-Saxon inspiration, i.e., those pursued by the U.S., have been criticized by economic actors and civil society groups even within the U.S. Domestic constituents have been asking for more comprehensive rules that address the imbalances allegedly caused by trade integration. Though the motivation may be market driven (e.g. in order to curb the competitive edge of developing countries because of lax environmental and labor standards), this debate is also part of civil society's desire to regulate the effects of globalization. In other words, pluralistic interests, and not just the big corporations, have

a stake in trade agreements. The position of the 109th U.S. Congress on trade negotiations has clearly manifested concern over these issues (Fergusson, 2006).

For developing and emerging market countries the challenges of the world economy require agile responses, the risk being the loss of market share and governance capacity. In particular, Latin America and Brazil are now caught between different regional integration models (Grugel, 2004), both of which include demands for deeper integration, and beyond border measures (services, investments, intellectual property rights, government procurement, etc.), and the regulation of deleterious trade effects, in the areas of labor rights and environmental preservation. The Latin American countries are further pressed by fierce competition coming from Asia, especially from China, as I discussed in the last chapter.

In this dissertation, I assume three clusters of analytical tools to analyze trends in the world political economy:

1. Multilateral and regional trade integration, with a focus on the latter;
2. Trade liberalization, domestic reforms and the role that domestic actors play in this process;
3. Economic and institutional development, including trade, technology and innovation.

My working hypothesis is twofold:

1) International economic shocks/trends and the demise of domestic economic models change policymakers' and interest groups' preferences, hence, opening up the opportunity for (trade) policy reforms; however, 2) entrenched domestic institutional/bureaucratic characteristics, as well as the ideological biases

embedded therein, are able to block further liberalization and therefore preserve some features of an old development model in a new economic era.

In this chapter I draw on the literature on multilateral and regional integration, on endogenous trade policy formation and on new growth theory to analyze the participation of Brazil in recent North-South integration negotiations and agreements. In discussing the EU-Mercosur negotiations, I focus on endogenous policy formation and arguments based on bureaucratic politics. While analyzing the FTAA, I rely on endogenous policy formation and new growth theories. Underscoring both discussions, I apply the structural integration theory reviewed in this methodological foreword, and analyze how the different types of regionalism can shape distinct foreign policy choices. The underlying questions in this chapter are:

- 1) The structural aspects of regional integration: Brazil has a managed/interventionist trade policy and an embryonic welfare state that attempts to tame globalization/market failures, yet it has experienced similar hurdles while discussing regional integration with the EU and the FTAA, which allegedly represent different types of regional integration.
- 2) Factor ownership and ideas determining policymaking and negotiating positions in multilateral and regional fronts: Are domestic protectionist interests and bureaucratic-institutional determinants to blame for Brazil's reluctance to sign North-South regional agreements?
- 3) New growth models and regional integration: Do intra-industry trade flows and the interest of foreign investors help to determine policy choices within those North-South integration projects where Brazil was involved?

Section II. Brazil and the EU-Mercosur Negotiations

The EU-Mercosur agreement has important features of the new wave of regionalism, two of which are worth emphasizing. First, this is an initiative that aggregates countries at different levels of development within a North-South format. Second, it goes beyond border measures, tariffs and the simple trade of goods, meaning this initiative includes disciplines on domestic rules and regulations and a possible institutional convergence among the signatories. The EU-Mercosur negotiations constitute an important case study for discerning if the “new regionalism” offers some real trade liberalization prospects. To date the position of the EU, though proposing a deeper integration agenda, is still very protectionist on the agricultural side of the agreement. Similarly, the Mercosur countries have taken a defensive approach with regard to disciplines that may be excessively intrusive on the domestic regulatory framework and that involve further tariff slashes on industrial goods in their market.

In order to interpret the Brazilian and the Mercosur position at the negotiating table, theories of international political economy are useful. Overall, while the global economy is based on dynamic industries characterized by technological intensity and increasing returns to scale, the domestic politics of trade policy is still characterized by a tight bargain between protectionist and free-trade groups which strive to influence bureaucracies, all of which have their own agenda. The debate within the EU-Mercosur reproduces this format: those sectors in Europe pushing for trade liberalization are the owners of abundant factors of production in the developed North. Conversely, the owners of the scarce factor –land– fear further trade liberalization, particularly in agriculture

where Mercosur countries are extremely competitive due to resource endowments. The inverse picture could be applied to Mercosur.

This endogenous trade policy explanation, however, overlooks the level of bureaucratic autonomy in setting up the trade negotiation agenda. Bureaucratic autonomy is a prominent feature of the EU and to a lesser extent in Mercosur, as the foreign affairs and trade ministries in the latter countries do have considerable leeway to decide on policy stances and negotiating positions. In comparative terms, the deeper integration agenda involving regulatory and institutional issues affects domestic political economy dynamics in both regions. The Mercosur countries possess some political economic characteristics that resemble those of the EU (Breslin et al, 2002; Phillips, 2001), and in some respects the integration project of Mercosur emulates the European trajectory in that Mercosur is a common market that strives toward policy convergence and the creation of supranational institutions (e.g. Parliament). Thus, the discussion of deeper integration issues in the EU-Mercosur talks is also embedded in logic of economic governance, which defends a more regulated economic order, an approach that both the Latin American and the European countries seem to prefer in contrast to the market-driven approach that characterized the FTAA. Therefore, co-operation and trade capacity building are also part of the broad negotiation agenda in the EU-Mercosur talks.

Yet despite this apparent convergence of interests and the mutual recognition that regionalism involves more than trade-related affairs and requires supranational institutions, the EU-Mercosur negotiations have been stalled since late 2004. What went wrong?

The Heart of the Matter

In October 2004, after intense negotiations in Lisbon, the EU-Mercosur trade talks ended with mutual objections and vague statements about re-launching the negotiations in early 2005. Both sides were reluctant to make key concessions. From the Mercosur vantage point, complaints about agricultural subsidies and market access dominated, whereas the EU demanded greater access to industrial goods and services markets, as well as the ability of European firms to compete for public procurement contracts in the Mercosur countries. The Mercosur proposal on investment and services, based on a positive list and utilizing the classification of the World Trade Organization was considered to be too timid by the EU. However, in June 2004, the Brazilian Foreign Minister at the time, Celso Amorim, had already argued that the EU proposal was approaching a “technical limit for it includes disciplines that would require modifications on Brazilian domestic legislation” (Novo, 2004).

In September 2004, Mercosur presented its final offer, comprising disciplines in services, investments and government procurement. The services proposal encompassed all the relevant fields of concern to the EU, including the financial sector (insurance and banking); telecommunications (access of European companies to the Brazilian market long distance, provided it is interconnected with a company already operating in the country); maritime transportation, professional services (ranging from architecture and engineering to IT services); environmental services (water and sanitation, pollution control); postal services (with full access to the express mail market); construction; tourism and distribution. The investment offer covered most of the primary and

secondary sectors. Just a few exceptions were maintained, and these derived from clauses in the Brazilian Constitution, such as the prohibition on acquiring land in border areas, and the requirement to register foreign investment in the Brazilian Central Bank. The national treatment principle was applied in almost all sectors. Finally, regarding government procurement, the Mercosur countries offered a mechanism of consultation which opened up the possibility of special treatment for European firms, provided that the Mercosur national governments could retain the capacity to use procurement as a tool for social and industrial policies (Ministry of Foreign Relations, 2004). The Mercosur offer, however, did not include disciplines on competition policy or intellectual property rights, the latter which are covered by the WTO/TRIPS agreements.

Although the offer included some of the new trade themes, Mercosur negotiators argued that the proposed regulatory framework for several sectors went beyond the agreement, meaning that the inclusion of such disciplines would require additional conformity with domestic legislation. According to the expression used by Torrent and Mollinuevo (2004), the framework of the agreement would be just the “hook” that would indicate the commitment of the participating governments to further adapt their domestic legal and policy structures.

Most noticeable in the Mercosur proposal was the interest in maintaining active industrial policies in the realm of government procurement. In the Mercosur countries, particularly in Brazil, state-owned companies historically carried out industrial operations and fostered domestic industrial and R&D capacity. For example, state-owned

telecommunications firms used procurement policy to boost local supplier inputs.⁶⁷ With the privatization of several utilities during the 1990s, prominent among them the telecoms, the European companies emerged as main buyers of Brazilian and Argentinean state-owned companies. Simultaneously, industrial and R&D policymaking shifted to other governmental actors. Brazil, in fact, has recently launched instruments to encourage private R&D. The current legal mechanisms for industrial and R&D policies in Brazil were addressed by the PINCTE (Industrial, Technological, and Foreign Trade Policy), which includes instruments such as the Innovation Bill (Law No. 10973, 12/02/2004), launched by the federal government. Thus, as far as the EU-Mercosur trade negotiations are concerned, the institutional framework for industrial policy already has been addressed by other governmental institutions and bills within Mercosur.

With regard to investments, despite the current lack of common ground within the EU-Mercosur agreement, European firms are already important investors in Latin America in utilities and infrastructure. This is due mainly to the aforementioned privatization programs undertaken during the 1990s. The degree of European FDI in the Mercosur bloc is considerable. For example, according to IABD data, the flow of European FDI to Mercosur grew from 0.73% of Latin American GDP in 1985-1990 to 1.37% in 1995-2000. Mercosur as a whole received more than US\$200 billion of FDI between 1990 and 2000, of which 98% went to Argentina and Brazil, mainly from extra-regional sources (Inter-American Development Bank, *"Beyond"*, 2002). European companies, particularly from Spain and Portugal, were the main investors in Argentina and Brazil in this period (Chudnovsky and López, 2000). After 2001, however,

⁶⁷ As I have been discussing in this dissertation, new trade themes apparently limit policy capacity. On this point see WTO (2002) and UNCTAD (2006). For a case study of government procurement in telecommunications, domestic regulations and trade agreements, see Bastos Tigre (2003).

investment flows to LAC entered a period of decline and FDI inflows from the EU countries were also negatively affected. From a record level of €46.2 billion in 2000, flows receded to €5.0 billion in 2003. In just three years, Latin America's share of total extra-EU FDI fell from 10.6 percent to 3.6 percent. Although a worldwide phenomenon, FDI to Latin America was particularly hit by financial turbulence of early 2000s. As the region's economic environment improved in 2004, European investment rebounded strongly, more than doubling the level of the previous year. Latin America posted the highest increase in European FDI flows among developing regions, and its share in extra-EU FDI again rose to over 10 percent (IADB, 2006). In view of this situation, in which economic turbulence affects the level of FDI, it is worth asking to what extent integration commitments might act as an insurance against severe crises. Though such commitments may not completely shield the Southern Cone economies from world economy cycles, this possibility was not seriously considered in the EU-Mercosur negotiations.

The point constantly raised by Mercosur and the Brazilian negotiators concerned EU pressure to commit more advanced trade disciplines in the absence of the proper regulatory capacity, thus jeopardizing domestic policy capacity. Trade liberalization may increase efficiency and productivity, but it is not a sufficient condition for growth and development, particularly in a global economic order that requires other policies and institutions, such as educational and technological capabilities (Bouzas, 2005). As the "new trade issues" require a greater degree of domestic policy and institutional capacity, a possible solution for this problem would be to devise, within the framework of the EU-Mercosur agreement, trade-related capacity building and technical cooperation mechanisms. In fact, these concerns were expressed at the outset of the EU-Mercosur

conversations. For instance, the EU offered cooperation in the field of enforcement of IPR legislation, expressing this in the text of the thirteenth meeting of the EU-Mercosur committee.⁶⁸

The scope of cooperation and trade capacity building goes beyond narrow trade issues and requires solid political commitment on the part of all involved. However, such initiatives are often slated too broadly and are cloaked in diplomatic rhetoric about the benefits of external relations and free trade. Mercosur and the EU, for instance, have an Interregional Framework Cooperation Agreement, dating back to 1995 and in force since 1999. This, however, proved to be just a fair statement of interests (Devlin et al. 2005). Recent FTA agreements between the EU and other Latin American countries, such as Mexico and Chile, offer more concrete examples of policies to support trade-cooperation and trade capacity building—measures that would also be beneficial for Mercosur. Such initiatives have amounted to more serious political commitments and have been coupled with concrete steps, such as the preparation of reports “Country Strategic Papers” establishing a work schedule and the assignment of financial funds. In the case of Mexico, € 8 million was contributed to support co-operation and trade facilitation in several areas, including the regulatory, service and investment disciplines. In Chile, € 5 million have been earmarked for trade-related technical assistance (Devlin and Vodusek, 2003). Although these are not sizable amounts, the examples of Chile and Mexico show that it is possible to generate concrete measures and incentives within these free trade agreements, which offer possibilities for policy support and adjustment.

⁶⁸ Thirteenth Meeting of the Mercosur-European Union Bi-Regional Negotiations Committee, May 3–7, 2004. Brussels, Belgium.

Explanations for the EU-Mercosur Stalemate – The Bureaucratic Underpinnings of Brazilian Trade Policy

The high degree of insulation and bureaucratic divergence within the negotiation process may be one explanation for lack the ability to reach agreement over the deeper trade rules within the EU-Mercosur negotiations. On the EU side to date, there has been an apparent conflict between the European Commission and the European Council, the first being more free-trade oriented than the latter.⁶⁹ As suggested by integration theory, the European Commission uses the EU external agenda to appease European economic and social sectors and emphasize the benefits of increased trade. Meanwhile, despite the Commission's effort to push forward structural reforms in domestic policies, such as the Common Agricultural Policy (CAP), it has failed to change the position of the European Council on several key issues, including trade liberalization in agriculture (Faust, 2002). An additional motivation of the Commission has been to establish trans-regional relations that can advance the strategic interests of the EU in order to counter the U.S. influence in the Western hemisphere (Derisbourg, 2002). Yet, these motivations were insufficient to break the fierce domestic political economic deadlock that favored protectionist interests in agriculture over the greater goals of trade opening and diversification of commercial ties.

On the Mercosur side, there has been as undeniable delay in forging what currently constitutes an incomplete customs union. The already mentioned inability to move toward a stronger institutional framework and policy convergence in macroeconomic, industrial, and regulatory matters, poses problems when negotiating

⁶⁹ The European Council is comprised of the heads of states of European countries, which are more sensitive to political-electoral pressures and may oppose trade liberalization. The European Commission, conversely, is backed by EU bureaucrats, with more technical and neutral positions on trade policy.

integration agreements with third parties (Rosemberg, 2000). A possible solution would be to go beyond the diplomatic circuit of negotiation; by this, mean that as the trade agenda expands in width and depth, other bureaucratic and social actors in Mercosur should be brought into the trade negotiation process. For instance, the inclusion of competition rules, a matter that was not even part of the EU-Mercosur proposal, would require closer participation of several Brazilian ministries (Economy, Justice, External Affairs) and social society representatives (groups for consumers rights, for example). Similarly, an agreement that covers investment rules should be coordinated with the policy directives of the responsible federal bureaucracies. Regarding governmental bureaucracies, and as I discussed in chapter one, there is a lack of cooperation and an informal segmentation regarding trade and financial affairs within the Brazilian government, which undermines any negotiation strategy. As contemporary trade agreements include disciplines on investment rules or financial services, for instance, this separation has clearly become anachronistic. Conversely, regarding the participation of civil society and business groups, Bonomo (2006) notes the lack of mobilization of the business sector in trade negotiations within the EU, which did not become clear until the very end of the negotiating process. This same pattern was observed in the case of the FTAA negotiations.

Another possible explanation for the deadlock is the current Brazilian strategy of participating proactively in the world trade system, which is not recent but has received a new boost under the Lula administration (2003-now). Brazil has been seeking an active leader within the G-20 and the G-3 (Motta Veiga, 2006; Paquin-Boutin, 2005), its goal being to counter the protectionism of the Northern countries in multilateral and regional

trade negotiations. In the case of the G-20, Brazil's coalition-building is specifically targeted toward leveling the playing field in agricultural negotiations at the WTO. Here Brazilian diplomacy has joined with that of other emerging markets that share a similar position in the world trade system, such as India and South Africa (the other members of the G3). In doing so, Brazil has adopted a "South-South" discourse that has stiffened positions against the developed countries, not only within the EU-Mercosur negotiations, but also the FTAA, and the WTO Doha round. It is worth noting that these Brazilian trade rapprochement projects with similar countries do not include deeper integration, not even more concrete measures in the realm of tariff cuts. Thus, Brazil's trade activism within these various groupings still amounts to little more than diplomatic declarations of mutual interest (Almeida, 2006). Finally, as Mercosur is a common market and thus requires a joint foreign economic policy, it is worth asking, to what extent has the overall position in the negotiating table been damaged by the recent disagreements between the two main partners Brazil and Argentina? The very same hurdles experienced in negotiating deeper liberalization of industrial goods with the EU and the U.S. would arise in reaching an agreement with India and China, for example (Carranza, 2004).

In short, there should be no inherent conflict in committing toward more comprehensive trade rules with the EU and in the FTAA, while at the same time seeking deeper ties with the emerging market countries. However, Brazil's ambiguous position in trade negotiations stems from Lula's need to appeal to a domestic audience which, due to protectionist interests and/or ideological points of view, refutes closer ties with developed markets.

Summing up, if there has been any continuity to Brazilian foreign policy, it lies historically in the search for autonomy in world affairs. Even considering common historical ties and domestic political economies that are more akin to those of the European countries, Mercosur's negotiators were not able to cut a deal with the EU, or significantly to involve other sectors of civil society in the debate. In Brazil's particular situation, where the main stakeholders are bureaucratic actors and the country's protectionist tradition was the driving force for the negotiating process, this thwarted outcome was inevitable. Finally, though the foreign economic policy position within the government shows some sign of conceding to certain orthodox macroeconomic requirements, when it comes to trade issues, the autonomist/left view still prevails. The current shift toward left wing politics in Latin America has not necessarily harmed external commitments. In the case of Brazil, however, this trend has made the process of negotiating deals with third parties more complex --- the probable enlargement of Mercosur with Venezuela being a prime example. In the case of the FTAA, these political and economic tensions are even more pronounced, as we will see in the following section.

Section III. The FTAA: Brazil, the U.S., and the Political Economic Hurdles to North-South Negotiations

The failure to meet the deadline to establish a Free Trade Area of the Americas (FTAA) by January 2005 confirms the lack of common objectives and unresolved rivalries between Brazil and the United States---the two main players at the regional negotiating table. At the heart of this standoff lies the determination of the U.S. to

negotiate over new trade themes such as services, investment rules, government procurement, and intellectual property rights, versus Brazil's concern with facilitating market access for traded goods, including agriculture, and trade remedy measures (anti-dumping).

Apart from these important substantive differences, there was also considerable divergence on the possible format for the FTAA, a point related to the disagreement regarding economic governance within the RIA. At the November 2003 Miami Summit, Brazil and Argentina proposed a model in which different topics would be discussed on separate tracks, instead of the initial single undertaking approach proposed all along by the U.S. This alternative framework was meant to tackle the liberalization of trade in goods on track one, whereas a second track would allow countries the option of joining deeper integration arrangements involving the above-mentioned new trade themes. Because these new trade themes were also being discussed at the multilateral level within the Doha Round of the WTO, the South American countries argued that this second track would gather momentum within the multilateral venue.

This FTAA *à la carte* was met with skepticism by U.S. and Canadian negotiators, and even some analysts in Brazil complained that the plan would be counterproductive and would fail to gather traction (Guilhon de Albuquerque, 2006)⁷⁰. Sensing a possible stalemate, and in line with its increasingly bilateral approach to foreign economic policy, the United States then proceeded to complete free trade agreements (FTAs) with other Latin America countries (U.S.-Chile) and sub-regions (U.S.-Central America) while still going through the motions of negotiating the FTAA. Brazil countered by attempting to

⁷⁰Gary Hufbauer and Sherry Stephenson (2003) posited that this strategy would turn out to be a pyrrhic victory for Brazil because it would make further liberalization discussions more difficult in exchange for an incomplete agreement.

negotiate an FTA between the United States and Mercosur, the so-called four-plus-one approach, which fell into the same void as the FTAA (Masi and Wise, 2005). Additionally, Brazil reinforced its autonomist foreign policy tradition and emphasized Latin American integration, with the possible enlargement of Mercosur with Venezuela, the proposal of a South America Community, and “South-South” talks, for example, the G-3. Yet, these initiatives faced distant negotiation hurdles, particularly within Mercosur, and stalled at the level of diplomatic rhetoric.

This section analyzes the political and economic issues that divided Brazil and the U.S. at the FTAA. The stalemate surrounding the FTAA negotiations is related to the high levels of asymmetry between the countries involved and hence the differing goals that sunk the negotiations. Whereas in Brazil the FTAA discussion was contentious and highly politicized, especially concerning the country’s ability to commit quickly to the new trade themes, in the U.S. a general apathy and lack of interest in the FTAA rendered it a low policy priority. My main hypothesis concerns the inability of Brazilian policymakers to surrender a managed trade policy and to commit toward challenges posed by the new regionalism and by globalization.

In the bigger scheme of things, Brazilian negotiators would need to take a more objective stance with regard to the costs and benefits of signing on to a project such as the FTAA. In other words, although a market opening for trade in goods is important, the achievement of this goal would inevitably require inclusion of the deep integration issues favored by the United States. After all, the original justification for pursuing the FTAA was the prospect it held for achieving WTO-plus outcomes within the new trade issues areas; in the absence of these outcomes, the FTAA has become a moot point

In analyzing the position adopted by Brazilian and U.S. actors at the FTAA negotiations, I rely on political economy explanations proposed at the outset of this dissertation and previous chapters: endogenous trade policy, new growth theories and political science models of bureaucratic politics. This section emphasizes the former two. Concerning the latter, I have already discussed the Brazilian case in more detail in the first chapter, and thus, in this section I focus on the U.S. case. The following sub-section reviews these theories as they apply to the varying trade stances of Brazil and the U.S. A next sub-section relates Brazilian and U.S. negotiating positions and demands to the broader international trade strategies of the two countries.

Brazilian and U.S. Domestic Political Interests in the FTAA

Endogenous Trade Policy Models

Endogenous trade theories seek to explain domestic trade policy and politics by applying economic models to political scenarios. The domestic political economy is treated as a market in which there is supply and demand for protectionist or liberal trade policies. Ronald Rogowski (1989), for example, was one of the first to use a neoclassical model like Heckscher-Ohlin (H-O) to explore how trade impacts the political behavior of domestic actors, and in doing so showed how endogenous trade theory can serve as a useful explanatory tool. According to the H-O model, those political actors who own the less abundant factors of production (e.g. some combination of capital, labor, or land) will lobby against openness and regional integration. At the same time, those political actors who own the abundant factors will support trade liberalization and will lobby in favor of

negotiating an FTA. The H-O theorem asserts that openness will decrease the welfare of the owners of scarce factors and increase that of the owners of the abundant factors.

Endogenous trade policy models thus allow for variations in domestic political responses. Another such model by Stolper-Samuelson recognizes, for example, that lobbying activity may occur along factor lines (e.g. capital versus labor) while the Ricardo-Viner-Carnes model holds that lobbying can also fall along industry lines (e.g. importing-competing versus export-oriented sectors). Magee et al (1989) interpret trade policy outcomes within the context of a democratic regime, whereby competing parties declare their respective positions, industries then lobby and make party donations that will advance their own welfare gains, and the parties then use this campaign financing to influence misinformed voters. In another variation, Grossman and Helpman (1994) explain protectionism as a function of the structure of industrial organization, trade dependency and the elasticity of import demand or export supply. The Magee et al approach suggests that trade policy may vary markedly with a change in government, while the Grossman-Helpman model implies that political capture by vested interests perpetuates a stable or more slowly changing equilibrium for trade policy (Noland, 1997).

Endogenous trade policy offers potentially important insights for analyzing the U.S. and Brazilian cases. Although most often applied to political behavior within sectors involving traded industrial goods, endogenous trade policy models can also shed light on political positions assumed within the new trade issues such as services and intellectual property rights. In the case of Brazil, where capital and knowledge-based factors are scarce, the owners of these scarce factors have resisted all but a gradual liberalization in these sectors. Canuto et al (2003) have analyzed the possible impact of the liberalization

of services within the FTAA on selected Brazilian sectors (Health Insurance, Credit Export Insurance, Land Transportation, Engineering, Accounting and Legal Services), all of which are characterized by low levels of foreign investment.

Their study suggests that the liberalization of these service lines would bolster the ability of Brazilian companies to operate in hemispheric markets, but that the adjustment costs would also be steep. This is because U.S. and Canadian companies would be fully positioned to dominate the national market and the majority of Brazilian firms are still not prepared to meet the competition. The study concluded that the kinds of regulatory harmonization intrinsic to an agreement in services under the FTAA would benefit those companies already adhering to international regulatory standards and offers them competitive advantage vis-à-vis Brazilian companies. Political behavior was not considered in this study, although one could infer that the highly complex domestic regulatory framework that governs Brazil's services sector, including constitutional clauses against foreign participation (e.g. in the case of health services), presents high barriers to entry and strong protection of Brazilian interests.

The electoral hypotheses of Magee et al are less compelling in terms of the Brazilian case, as foreign trade policy still does not hold much appeal for the political parties and a large share of the electorate. Most often, trade discussions are confined to specialized groups. The Grossman-Helpman assumptions about political capture seem more apropos for Brazil, as trade policy debates are basically limited to those with ready access to small pockets of the Brazilian bureaucracy that deal with trade and industrial policy. Broadly speaking, the agencies and ministries responsible for trade and, particularly, industrial policy have been historically stacked with political rather than

technical appointees, though this picture has changed recently. The world view from a diplomatic corps that wishes to avoid or delay further integration with the U.S. also prevails (Viola, 2005; Albuquerque, 2003). The bias toward protection is reflected in higher tariffs for value-added sectors such as electronics in Brazil, and exceptions for the automotive sector under Mercosur (Leipziger et al, 1997; Costa Vaz, 2004). As the costs of protectionism increase for those producers with a comparative advantage for exports, such as agriculture and select industries, some pushed for a more ambitious and realistic approach to the FTAA, including the willingness to concede in negotiating over the new trade themes (Albuquerque, 2004-05).

In terms of the U.S. case, Noland (1997) applies endogenous trade theory to the behavior of the USTR during the administrations of Reagan, Bush (1988-1992) and Clinton. Overall, he finds that there is no policy variation between these different administrations: all used retaliatory actions against other countries according to the size of the trade deficit a given country was running with the U.S. Despite the fact that the stakes are lower than those involving big markets such as the EU and Japan, the same pattern of behavior held in the U.S. commercial relationship with developing countries. That is, it engaged in similarly protectionist legislation, for example, against Brazil in the late 1980s with regard to disputes over intellectual property rights.

Within the FTAA process, this easy resort to protectionism was also apparent. U.S. apparel and textiles led the charge, as has steel and agriculture (Schott, 2003). The endogenous trade policy logic does seem to hold for the U.S., the agricultural sector being a case in point. Technological advances have rendered some products competitive (soy and corn) against Brazil, but not others (orange juice concentrate, sugar, cotton).

U.S. producers of these latter crops would be worse off under the FTAA and therefore pushed for further protectionism under the rubric of the U.S. Farm Bill. In the Western Hemisphere, Argentina and Brazil have been especially harmed by U.S. agricultural measures and this caused Latin American negotiators to be wary of U.S. at the FTAA negotiating table. Despite the fact that the Bush administration bears high fiscal costs for its agricultural policy, the executive branch has only committed to a slow phase-out of agricultural subsidies through negotiations at the WTO.

Ultimately, the impulse for further trade opening in the U.S. will come from representatives of the services and knowledge-intensive sectors. As the owners of abundant factors---knowledge and capital---these groups will largely benefit from the liberalization of trade in services, including telecommunication, banking, insurance and investment. A coalition of these groups helped secure the Trade Promotion Authority (TPA) bill for the George W. Bush administration, although their pro-trade lobbying for the FTAA failed to keep this initiative alive in the U.S.⁷¹ Yet, as I discussed in the previous chapter, the upsurge of India and China in world markets with the outsourcing of IT jobs may create protectionist demands even in the capital intensive sectors, though the companies may still favor liberalization. In the next chapter, I discuss how factor coalitions may change due to globalization phenomena (Rogowski 2004).

Summing up, endogenous trade policy models provide convincing explanations for the respective Brazilian and U.S. stances in the FTAA. This is especially true for the differing attitudes of Brazilian industrial and technological sectors, which fear integration

⁷¹ For more on the pro-trade position of these groups see the websites for: the Coalition of Service Industries (www.uscsi.org), the National Council for Foreign Trade (www.nftc.org), and the National Association of Manufacturers (www.nam.org). The latter organization published a memorandum of understanding with the Federation of Industries of Sao Paulo, Fiesp, the most powerful business association in Brazil, in January 2005 supporting the resumption of the FTAA negotiations.

because they are less competitive compared to their U.S. counterparts, whereas those same groups in the U.S. welcome a stronger hemispheric trade/regulatory environment as a favorable change. The same logic applies to U.S. sectors that are labor intensive, which stand to lose by liberalizing trade with those labor abundant sectors in Latin America. A main oversight of endogenous trade policy analysis is that it does not consider the importance of intra-industry trade and spillover effects in knowledge intensive sectors, which can provide much of the rationale for trade integration. In the following section, I discuss this literature and apply it to the cases of Brazil and the U.S. in the context of the FTAA.

New Growth Theories: Economic Dynamics and Political Cleavages

Despite the asymmetries between the United States and Brazil, and with proper preparation and reform of the sectors at hand, new growth theory explanations suggest that with a combined increase in research and development (R&D), technology adaptation, and competition policies, Brazil could achieve higher levels of sustainable growth by completing the FTAA. This is partially because of the high levels of intra-industry trade between Brazil and the United States. The international political economy literature convincingly portrays the role of intra-industry trade as an impetus for liberalization, and for productivity growth, as discussed in chapter two.. However, few political economy analyses focus on the role of intra-industry dynamics in shaping trade policy in Brazil. A considerable literature, for example, assesses the influence of intra-industry trade in the U.S. decision to pursue NAFTA, as transnational companies sought

to access markets and lower their input costs.⁷² Regarding the competitive aspects of trade liberalization under regional agreements, North-South regionalism does not always enhance competition. In rules pertaining to FDI participation, for example, Chase (2004) posits that regionalism can be a mechanism used by incumbent firms to protect themselves from pressures coming from increased global competition or to delay the entry of new participants in a given market. Olerreaga and Soloaga (1998) also discuss these non-competitive aspects of RIAs, in the case of the relatively protected automotive industry in the Mercosur. Yet, in North-South integration, along the lines of the FTAA, econometric models point to the welfare enhancing effects, as I discuss below.

In the FTAA discussions, those sectors and industries that pushed for a more comprehensive liberalization of services, investment and intellectual property rights mainly belonged to the most dynamic/knowledge intensive sectors of the U.S. economy. Ostensibly, these same sectors should be lobbied for the FTAA in Brazil, since they are dominated by multinational companies that similarly favor trade integration as a way to maximize on technology, productivity and specialization. While political constraints overshadowed the enthusiasm of an FTAA in both the U.S. and Brazil, the latter has begun to take some concrete steps in these areas.

Recently, the Brazilian government launched a new industrial policy (PITCE) to stimulate the linkage between R&D and the private sector. Also, a new innovation bill was approved before the Brazilian Congress and a debate on how to better foster R&D

⁷² On intra-industry trade, see Pastor and Wise (1994); Milner, (1997); and Chase (2003). On NAFTA see Orme, (1996); Mansfield and Milner, (1997); Haggard, (1997); and Cameron and Tomlin, (2000).

investment by the private sector is underway.⁷³ By the same token, the government has encouraged new investments in infrastructure through partnerships between private and public agents (The Economist, May 2004). Partly due to these efforts, Albuquerque (2004-05) notes that those sectors most exposed to international competition since the first phase of trade liberalization (agriculture, shoes, and textiles) perceived the advantages to be had by Brazil's membership in the FTAA, such as cheaper access to capital goods, production inputs and technology.

Yet, there is still not enough debate that connects issues of economic competitiveness and the new trade themes with Brazil's broader trade strategy. On the contrary, some within the Brazilian diplomatic corps continue to argue that the inclusion of new trade themes in the hemispheric integration agenda would only "put the future of the country in jeopardy" (Rossi, 2003: B02). Despite the fact that intra-industry trade is an important part of Brazil's bilateral exchange with the U.S., or that the Mexican market is an increasing destination for automotive exports from Mercosur, closer ties with the NAFTA countries in the FTAA was not regarded by many in the Brazilian diplomatic or business community as important for the country's competitive upgrading.

In the U.S., the issues intrinsic to new growth theories are part and parcel of the integration debate. Business sectors in the U.S. perceive that the outsourcing of low-wage production and value-added services, such as software and call centers, are welfare maximizing and resource saving. As trade liberalization and intra-industry production have placed a premium on increased economies of scale and the clustering of factor inputs, U.S. policy preferences have changed (Schiff and Winters, 2003). The case of

⁷³ In line with these directives, the Brazilian government created an Agency for Industrial Development (ABDI) in January 2005 in order to co-ordinate industrial and technological policies, including input from domestic actors.

NAFTA shows that U.S. companies in leading North American sectors like autos and electronics moved their operations to Mexico in search of more cost effective production curves. The upsurge of China and India increases such trends and poses new challenges and opportunities to firms and consumers in the United States.

In the FTAA, the same incentives were present, as reflected by the lead role that knowledge-based and service-oriented industries in the U.S. took in lobbying for it. For the U.S. business sector, the liberalization of regulatory frameworks in Latin America would make it possible to invest in several sectors currently characterized by high barriers to entry, such as energy, mining and communications. The main incentive for U.S. sectors is that the FTAA would have allowed for the design of more comprehensive rules and would involve considerably fewer actors than in Doha-WTO negotiations.

Despite the fact that the potential gains from an FTAA would outweigh the losses, there is little ground for optimism, as political-ideological interests in both the U.S and Brazil superseded the discussions. Quantitative research - computable general equilibrium (CGE) models – has estimated the economic welfare gains of trade liberalization under unilateral, multilateral and regional scenarios. The aforementioned Michigan Model of World Production and Trade shows that an FTAA would increase economic welfare of member countries by \$118.8 billion, with the largest increases ensuing to the United States (\$67.6 billion) and to South America (\$27.6 billion) (Brown, Kiyota and Stern, 2005). Non-trade costs and benefits are difficult to gauge, though. For example, trade liberalization inevitably entails FDI flows and institutional reform, but also comprises domestic adjustments, such as bankruptcies and labor-market displacement. RIAs are often trade-diverting in terms of their impact on non-members.

Ultimately, economic theory holds that trade liberalization under RIAs may spur dynamic growth and enhance productivity, but it would take a few years following the implementation of an FTAA before such an evaluation would be possible. For now, it is apparent that Brazilian negotiators did not fully consider these numbers and instead surrendered to protectionism.

On the other hand, quantitative research that estimates the static effects of an FTAA clearly show welfare gains for Brazil (World Bank, 2004)⁷⁴. These gains will be greater for those poorest households, where the most abundant factor, unskilled labor, is concentrated. Protection in Brazil favors capital intensive manufacturing relative to unskilled labor intensive agriculture and manufacturing, therefore, trade liberalization raises the return of unskilled labor relative to capital, thereby helping the poor.

Based on recent global trends and due to the untapped dynamic possibilities, capital intensive industries may also be able to accrue gains. For example, figures from the U.S. State Department show that technology-intensive goods are now the largest export sector of the middle-income developing countries (Hasset and Glassman, 2003).⁷⁵ According to this same data, information and communication technologies represent US\$450 billion in exports from the developing nations, compared with US\$235 billion for raw materials and US\$405 billion for low-tech goods. Latin America fits into this

⁷⁴ For a shorter version of this World Bank study, see Harrison, Rutherford, Tarr and Gurgel, (2004). These papers are based on a static CGE model using the GTAP 5.0 database. According to the results, liberalization under an FTAA would provide net welfare gains for the Brazilian economy. Results are also positive in other scenarios such as a Mercosur-EU agreement, multilateral tariff liberalization, a WTO Doha agreement, and even with a Mercosur unilateral tariff cut of 50%. These studies find that the poorest households in Brazil would experience percentage gains of between 1.0 to 5.5 percent of their consumption, about three to five times the average for the country.

⁷⁵ See also National Science Foundation Division of Science Resources Studies, "Latin America: High-Tech Manufacturing on the Rise but Outpaced by East Asia," 2002.

mold, as data from the National Science Foundation show an increase in higher-tech exports from this region, with the U.S. as the main importer.⁷⁶

The National Science Foundation report also notes that there has been an increase in private R&D expenditures in the region, as the subsidiaries of U.S. companies increased their share of investment four-fold from 1990 to 1996. In Brazil, for instance, such investments grew from US\$113 million to US\$489 million during this same time span. With regard to the particular relationship between the U.S. and Brazil, manufactured products and intra-industry trade now account for 70 percent of U.S. exports to Brazil and almost 75 percent of Brazilian exports to the U.S. (Fishlow, 2004). Although numerous factors help shape a given investment decision, the fact that countries in the region would be trading higher value-added goods and operating according to the same rules within an arrangement like the FTAA indicates a better probability that FDI will increase. Overall, these data show that the forces of economic dynamism, driven by intra-industry trade and technological spillover effects, are already at work in the relationship between the U.S. and Brazil. In turn, this structural logic provides at least some incentive for U.S. actors to engage in closer trade and investment ties with Brazil. To the extent that these sectors failed to mobilize in actually launching the FTAA reflects their inability to exert influence over entrenched bureaucracies in Brasilia and Washington, which is the focus of my analysis in the following section.

Brazil and U.S. Trade Strategies

Clashes between the United States and Brazil in multilateral trade talks are not new, nor did they start with the advent of the Doha Round in 2001 or with the election of

⁷⁶ National Science Foundation Division of Science Resources Studies, "Latin America: R&D Spending Jumps in Brazil, Mexico, and Costa Rica" 2002.

the left-leaning Lula administration in 2002. As Albuquerque (2003, 2006) points out, even during the more market-oriented administration of President Fernando Henrique Cardoso (1994--2002), the initial years of the FTAA negotiations were characterized by a defensive position on the part of the Foreign Affairs Ministry. This trend has increased under Lula, because the leading senior diplomats appointed from his Labor Party are now formulating Brazilian foreign policy and remain biased in favor of an import substitution industrialization strategy (Viola and Pio, 2003). This said Brazilian international relations in recent years, and the position of the Foreign Affairs Ministry and parts of civil society as well, have been characterized by a considerable degree of dogmatism and even anti-Americanism on certain issues, trade being one of them. Given that the Ministry of Foreign Affairs has had the higher profile in FTAA negotiations, it is no wonder that the trade talks have faltered.

Regarding U.S. trade policymaking, there are some similarities with Brazil but also some important differences. The U.S. trade bureaucracy is also spread across several departments, such as Commerce, Treasury, Agriculture, Labor, State, and the USTR. Executive-level advisers in the cabinet also play an important role in foreign economic policymaking. But at the end of the day, the executive office is instrumental in bringing trade policy to center stage (Destler, 2007). Along with the institutional landscape, the economic ideology of a given administration can therefore be crucial for the importance that trade will assume on the national agenda. The early Clinton years proved, for example, that an administration's commitment to the idea of free trade can transcend opposition within the president's own party.

The U.S. Congress is certainly more powerful in influencing trade policy outcomes than is the Brazilian legislature. This is evident in U.S. protectionist legislation that has had considerable impact on the regional trade negotiation process and that confirms that parochial interests are never far from the surface of U.S. congressional politics. As noted in a March, 2005 issue of the *Economist*, U.S. trade policy has suffered at the hands of the George W. Bush administration, despite its rhetorical commitment to liberal economic principles. This appears to be due, first, to the USTR's lack of leverage within the administration and to the turnover of two trade representatives between 2005 and 2006; and second, to the low levels of international economic expertise within the Bush cabinet---until, that is, the 2006 appointment of Wall Street's Henry Paulson as secretary of the U.S. Treasury. The commitment and leadership of the USTR seems important in influencing the U.S. Congress on trade issues, the FTAA and Doha included. During the brief stint of the very capable Rob Portman as the U.S. trade representative, Congress ratified the Central American Free Trade Agreement (CAFTA).

Whether the U.S. bureaucratic process and ideological commitment toward free trade could maintain momentum under Portman's replacement at the USTR (Susan Schwab) was a source of doubt even before the 2006 U.S. midterm elections. Now, with the Democratic Party in control of both houses of Congress and the appointment of some avowed protectionists to key trade-related congressional committees, the prospects for reviving the FTAA and the Doha negotiations have become all the more remote (Fergusson, 2006). The election of Democrat President Barack Obama and the deepening of macroeconomic unbalances derived from the financial market crisis add complexity to

trade policymaking and to the historically contentious relations between the Legislative and the Executive on the issue.

Brazil's External Ambitions and Strategy

Apart from the FTAA, Brazil has recently sought to deepen trade integration arrangements with a number of commercial partners, including the EU countries, the enlargement of Mercosur with other Latin American countries (Venezuela), and the Andean Community. In addition, Brazil has been active on the multilateral front at the WTO. Historically, Brazil's trade strategy has been to promote the multilateral forum of the General Agreement on Tariffs and Trade (GATT) and the WTO as the best option for developing countries to challenge the economic hegemony of the developed countries. The current Labor Party government (2003-now) has been forthright in pushing this line of Brazilian economic foreign policy, which has been especially apparent since the launching of the Doha Development Round in 2001 (Masi and Wise, 2005).

At the Doha WTO meetings, Brazil and other countries that share similarities as large developing economies moved to form the G20 group, its purpose being to present a joint proposal for the liberalization of crucial markets (agriculture) and to protest the distorting consequences of subsidies upheld by the developed countries. Within the G20, Lula's government has pursued the goal of expanding bilateral trade among big emerging market economies like China, India, Russia, and South Africa, which have now become a priority in Brazilian commercial policy.⁷⁷ This is so despite the fact that these markets accounted for only 3.4 percent, 0.5 percent, 1.9 percent, and 0.6 percent, respectively, of

⁷⁷ See "The Americas: Looking South, North, or Both? Brazil's Trade Diplomacy," *Economist*, February 7, 2004, p. 51. For a more sympathetic interpretation of Brazil's trade policy, see William Greider and Kenneth Rapoza, "Lula Raises the Stakes," *Nation*, December 1, 2003, p. 11.

Brazilian exports in 2001 (Paiva Abreu, 2001). But Brazil's emphasis on a multilateral and autonomous strategy is understandable since its exports to large trade partners now render the country a truly global trader. Brazil's exports in 2005 were 22.4 percent to the EU, 19.2 percent to the United States, 8.4 percent to Argentina, and 3.4 percent to Mexico. Non-traditional markets accounted for 37 percent of Brazilian exports in that year.

Table 12: Brazilian Exports by Main Markets, 1997, 2004 and 2005.

Items	1997		2004		2005	
	US\$ billions	% of total	US\$ billions	% of total	US\$ billions	% of total
Total Exports	53	100	96.5	100	118.3	100
European Union	14.5	27.4	24.6	25.5	26.5	22.4
USA ¹	9.4	17.8	21.3	22.1	22.7	19.2
Argentina	6.8	12.8	7.4	7.6	9.9	8.4
China	1.1	2.1	5.4	5.6	6.8	5.8
Mexico	0.8	1.6	3.9	4.1	4.1	3.4
Japan	3.1	5.8	2.8	2.9	3.5	2.9
Others	17.3	32.7	31	32.1	44.8	37.9
Russia	0.8	1.4	1.7	1.7	2.9	2.5
South Africa	0.3	0.6	1	1.1	1.4	1.2
Iran	0.2	0.5	1.1	1.2	1	0.8
Uruguay	0.9	1.6	0.7	0.7	0.8	0.7
Paraguay	1.4	2.7	0.9	0.9	1	0.8

Sources: Central Bank of Brazil and Brazilian Ministry of Development, Industry and Foreign Trade.

¹.Includes Puerto Rico.

The biggest challenges for Brazil to overcome regarding either a regional (FTAA) or multilateral (Doha Round) deal are the political and economic obstacles to integration with the more advanced economies. Obviously, for many small Latin American nations with non-diversified economies the stakes for achieving WTO-plus outcomes are very high. In Brazil the prospect of joining an FTA with the biggest and most advanced

economy in the world creates economic opportunities, but also complex problems. These challenges coincide with Brazil's need to undertake deeper market reforms to complement and sustain the rules around the new trade issues (Pastor and Wise, 1998; Navia and Velasco, 2003) Modernizing reforms are needed, for example, to improve economic institutional structures, to enforce property rights, and to encourage more flexible rules for investment and to foster innovation. Broadly, Brazil will require a much-upgraded institutional and regulatory environment to succeed in a technology-driven world economy.⁷⁸ Brazil's cautious and piecemeal approach to foreign economic policymaking hinders this process.

The connection and complementarities between deeper reforms and further trade integration has yet to be fully appreciated by Brazilian economic actors and policymakers. Although the Lula administration has committed to pursuing the new trade issues at the WTO, with the breakdown of the Doha negotiations the FTAA would have ostensibly been a viable fallback strategy. But the reluctance of political and economic elites to broach the discussion of deeper integration within Doha, the FTAA, and even the EU-Mercosur talks, has foreclosed all of these options for the time being. This political intransigence defies the economic realities. First, sectors damaged by U.S. competition could surely be won over with the promise of some transitional support from the government (Mesquita Machado and Ferraz, 2005). And second, the long-term benefits of conceding on the new trade issues could mean a sizable increase in Brazil's international economic standing. While the habit of sitting on the fence politically in the

⁷⁸ For instance, a sound regulatory environment creates incentives for foreign investment in knowledge-intensive sectors such as telecommunications and services. Similarly, a modern and enforceable intellectual property rights regime is more likely to stimulate investment in R & D and to foster human capital development.

face of badly needed economic reforms is common to the Latin American region, by continuing to do so Brazil risked an incredible opportunity to break out of this mold.

U.S. Reactions and Reticence

Since comparative advantage for the United States has come to rely primarily on trade in services and high-technology products, the prompt liberalization of Latin America's barriers in these areas would pave the way for a major incursion of U.S. service-based companies into the region. Hence U.S. interests in gaining deeper access to Latin American markets, especially in South America, have been concentrated on these sectors at the WTO. Since the outset of the FTAA proposal in 1994, the U.S. position has been that the FTAA would be meaningful only if it reached beyond what the WTO had accomplished with regard to these new trade issues: steeper liberalization in traded services and investment, the opening up of government procurement, the quick and comprehensive enforcement of intellectual property rights, and even the inclusion of labor and environmental issues on the trade negotiating agenda.

U.S. objectives in the hemisphere must also be considered in light of the difficulties that have surrounded efforts to complete the Doha Development Round at the WTO. For some, the gradualist and piecemeal nature of hemispheric integration under the auspices of the FTAA seemed a more promising option for the United States (Weintraub, 2001). Just as NAFTA enabled its members to advance in areas that had eluded agreement at the Uruguay Round (dispute settlement, services, investment, intellectual property rights), the FTAA could have provided incentives for negotiating breakthroughs at the multilateral level. This appeared to be happening in 2004, when the United States

and the EU expressed a willingness to negotiate the reduction of agricultural barriers at the WTO (Narlikar and Tussie, 2004)⁷⁹.

Yet it was also the intransigence of both on this front that led to the 2006 breakdown of the WTO negotiations. Faced now with the collapse of both the WTO and FTAA negotiations and the recent election of a U.S. Congress even more suspicious of trade deals than its predecessor, and the global downturn, the U.S. ability to provide the necessary leadership seems greatly diminished. Concerning U.S. interests in hemispheric integration, two additional points should be emphasized. First, the FTAA was originally viewed by the United States as a means of strengthening its own bargaining position with regard to Europe and East Asia. This is so in a direct sense, as the United States continues to seek greater access to European and Asian markets and as it has pursued these same goals within the WTO's multilateral framework. Second, the FTAA is the only regional process that promised to promote Latin America's global ties while retaining the United States as the main hub.

Relegating Latin American countries to be spokes to the U.S. hub would allow for the elimination of the patchwork of sub-regional preferences that has evolved since the early 1990s. However, whereas Latin American countries deemed the hub-and-spoke model acceptable and even desirable a decade ago, many have now rethought its value to them. The persistence of intraregional asymmetries and the disappointing returns on trade liberalization and market reforms are behind this change of heart, and nowhere this is more apparent than in Brazil. Ironically, this is so despite the country's impressive trade advances.

Conclusion and Prospects and Retrospect

⁷⁹ See also Sing (2004).

While Brazilian negotiators insist that the FTAA is only one of several options for the country's trade strategy, this specific integration project had important consequences for the economic advancement of the country. With the usual delays in the multilateral trade arena and with increasing competition from Chinese goods in world markets, the FTAA could constitute the logical next step for sustaining the external trade boom that has seen a doubling of Brazil's share of exports in recent years: from 9 percent of GDP in 1990 to 16 percent in 2003. The trick would be to finesse the antitrade bias on the domestic political front and to tilt responsibility for the reactivation of hemispheric and/or multilateral talks toward the economic ministries and export-oriented interests.

As Brazil is a pluralistic and complex society, the challenge is to further broaden the trade policy debate to include not only the official and business positions but also opinions from the media, academia, and labor. Some of these civil society sectors have already embraced the notion that integration is an important instrument for the modernization of the country within today's highly competitive global context. These sectors have also gradually accepted the inevitability of incorporating environmental and labor standards into trade agreements, as well as the imperative to address related social issues.

Again, quantitative assessments so far show that the poorest households and the most unskilled laborers will benefit the most from further trade liberalization. These findings may lead some sectors to support trade agreements, particularly with the United States. The 2006 reelection of President Lula and his pragmatism concerning economic affairs may also give extra impetus to trade talks and help diminish the influence of stiff ideological positions. Yet as the Mexican experience with NAFTA has shown, trade

liberalization under a North-South FTA is no panacea: concurrent institutional modernization is crucial for realizing the projected gains.⁸⁰

For the United States, where the stakes in an FTAA have always been low, the challenge for incumbent administrations is to publicize the economic and political benefits of trade agreements, such as the FTAA. The acrimony that surrounded the U.S. domestic debate over the passage of the trade promotion authority legislation and then the CAFTA agreement revealed that the completion of the FTAA from the U.S. vantage point would require executive leadership and statecraft. With the collapse of the FTAA and Doha negotiations, the Bush administration simply failed to rise to this occasion. As the U.S. Congress continues to oppose even small initiatives involving trade policy (for example, bilateral deals recently negotiated by the USTR with Vietnam and Colombia), it seems likely that U.S. trade policy will remain on hold until after the 2008 presidential election. Thereafter, a main task will be to work to convince domestic import-competing sectors and labor and environmental groups that the benefits of further trade agreements will outweigh their costs. The fast approval of the US-South Korea bilateral trade agreement, just days before TPA expiration, indicates that when the stakes are higher, executive leadership can overcome legislative anti-trade biases.

With regard to the FTAA, the quantitative evidence to date shows its potential to spur economic growth, foreign direct investment, and the transfer of technology (Brown, Kiyota and Stern, 2005). But the onus was on U.S. politicians and policymakers to publicly convey these findings and to use them to forge the kind of coalition that came

⁸⁰ Tornell, Westermann, and Martinez (2004) discuss the case of Mexico under NAFTA. According to these authors, the lack of a proper regulatory framework, a domestic credit crunch, and lax judiciary enforcement created strains and bottlenecks within the domestic economy that impeded the realization of NAFTA's full benefits. See also Wise (2007).

together to support the NAFTA agreement. Granted, Mexico's struggles to succeed under NAFTA may have had a negative demonstration effect on Congress and the U.S. public, but rather than shun future trade deals with developing countries, the parties should directly address the adverse aspects of NAFTA and negotiate within those areas, like market access and agriculture, that directly address the asymmetries. In this respect, Brazil's insistence on gradualism---on holding out for agricultural and market access concessions from the United States before signing on to a new trade agreement---represents an important departure from Mexico's strategy in negotiating NAFTA.

This chapter's main objective was to assess the North-South regional negotiations in which Brazil has been involved. Regional trade integration with developed countries would require steep domestic adjustments – particularly in the Western Hemisphere where the U.S. economy dwarfs other countries. Brazilian policymakers still regard globalization cautiously, rather than as an opportunity and they propose, on the external front, an alliance with similar countries (BRICS, G-3) as a mechanism to correct the asymmetries in the world system and to deter the deleterious consequences of the market driven global order. Conversely, on the domestic realm, they propose an economic model based on state regulation of market forces, through public-private partnerships in infrastructure investments, for example. The recent governments have crystallized the historical trend of managed trade and industrial policies.

However, complexities of economic and political ties with more advanced countries indicate that Brazil would have a lot to gain from integration with developed democracies that foster liberal political and economic reform. Brazil could seek this rapprochement and still maintain its independent foreign economic policy. Instead, the

North-South trade negotiations of the mid-2000s were poisoned by the lack of pragmatism – an expression that senior diplomats and commentators like to use, but not apply.

Section IV - Conclusion

Domestic Obstacles, International Crises and Brazil's Place in the World Economy

By the late 1980s, the failure of the ISI model in Brazil was reflected in the conspicuous levels of state economic intervention and the favoring of special interest groups; the effectiveness of public policies had dwindled and large segments of the population were economically bereft. Because countries such as Argentina, Brazil and Mexico benefited from a favorable world economy in the early post Second World War period and from cheap international bank loans in the 1960s and 1970s, the ISI strategy endured long past its efficacy. From 1950 to 1980, for instance, Latin American GDP grew at an average of 5.5 percent a year (2.7 percent per capita), and high domestic investment ratios sustained these vigorous rates (French-Davis and Ocampo, 2002). When the initial high rates of investment waned, protected social groups, such as industrialists, continued to demand favors. The intrinsic inability of Latin American states to perform basic tasks, while public spending and special privileges soared, explains the resilience of several domestic sectors in pushing for protection, despite the financial strains and lack of economic competitiveness. Market reforms since the late 1980s have attempted to re-establish the fading credibility of Latin American states in the eyes of the international community.

Yet, as I discussed in chapter one, there has been a failure in Brazil and in other Latin American countries to credibly commit to further trade liberalization and the enactment of deeper institutional reforms during the 2000s. Long lasting characteristics of the Brazilian domestic policymaking apparatus explain this reform delay. The financial crisis of the mid-1990s and 2000s, with deleterious domestic macroeconomic consequences, also created a backlash against further economic reform, including trade liberalization (Panizza and Yañes, 2006). The severe financial crisis experienced by countries that adhere to strict free-market rules turn the task of free-trades to convince domestic audiences about the benefits of liberalization very difficult. Though this debate goes beyond this dissertation, the downturn in world markets provide impetus for policymakers that wish to shield the country from the vagaries of the world economy through protectionist measures that protect special interests. As I will discuss in the next chapter, protection and support to special interest groups (industries) have endured economic reforms in the 1990s, and several financial crises.

In the case of Brazil, the international financial community did not falter in providing credit during the 1999 financial crisis, when the U.S. Treasury Department backed a US\$42 billion bailout package. U.S. and international support was also fundamental at the onset of the 2002 presidential elections to tame wary financial markets about the possibility of the election of a left wing President (Sachs 2000; Eichengreen 2002). Confidence then was regained when Lula's incoming economic team reinforced its allegiance to orthodox economic policies. These actions were important to help the country re-assure investors about its commitment toward macroeconomic soundness and contributed to a favorable end of the crisis. Currently, macroeconomic stability is a

reality in Brazil, up of the point that the country began repayment of its IMF loans in early 2006.

There has been backlash of domestic politics concerning further market reform, leading to a credibility gap. The state cannot credibly commit to these reforms because of their asymmetrical distributive consequences among constituents, most prominently the favored business groups. Entrenched interests refuse to cooperate, adding pressure to curb deeper reforms. Brazil's difficulty in further advancing a regulatory and institutional agenda in trade agreements can be explained by this lack of consensus concerning increased competition in the economy, which will clearly produce winners and losers. Party and legislative politics have been an additional setback in advancing these reforms. There has been a shift in executive-ruling party relations, which obliges the executive to use pork in order to advance structural reforms. This trend has been reinforced by Lula's team, which has weakened regulatory agencies and filled technical appointments with party members. It is no coincidence that the Regulatory Agencies Law and the Competition (Antitrust) System reforms have remained stuck in at the Congress since Lula's first presidential term. The rise of *technopols*, which overshoot reforms as a symbolic instrument to gain the confidence of international markets, and as expressed in the high qualifications of officials at the Finance Ministries and Central Bank, does not disguise the fact that the executive is entangled in a precarious political coalition that impedes public policy management capacity in key areas. The Federal executive has to offer targeted favors to compensate both the potential winners and actual losers, as well as find ways to entice foreign investors, i.e. offering concessions of exclusivity, weak regulatory mechanisms, lax enforcement of anti-trust laws, and license guarantees.

The current trade strategy of the Labor Party government favors the overseas expansion of Brazilian conglomerates, which has been facilitated by the world economic situation characterized by high demand and by the overvaluation of the Brazilian Real, making it easy for Brazilian companies to sell commodities or to purchase assets abroad. This trend, meanwhile, is occurring at the expense of a relatively non-competitive domestic environment. Failure to inject competition in several de-regulated markets characterized in the Brazilian and other Latin American privatization experiences. Taming dinosaurs and offering special benefits to economic groups, such as tax exemptions on exports and subsidies on production, may prompt economic activity on a short term-basis but also fuels the country's fiscal problems. Schneider (2008) depicts how states in Latin American countries nurture domestic special interest groups (business) as a reaction to globalization forces, even before market reforms⁸¹.

Brazil's macroeconomic inroads are underscored by the sound performance of exports, which have been steadily increasing for a decade. Export performance has benefited from the positive international scenario, particularly the high demand for commodities from China (Cepal, 2006: Ch. 2). Yet, despite the importance of external trade for the country's recent economic recovery, Brazil has taken stiff negotiation stances at the WTO Doha round, the FTAA and the EU-Mercosur discussions. Although international financial organizations, like the IMF and the World Bank continue to advise market-enhancing reforms, Brazil's stronger macroeconomic situation reinforces its autonomist position in areas other than macroeconomic and fiscal policy. Even though

⁸¹ Drawing on the literature of "varieties of capitalism" (Soskice and Hall 2002), he coins the term "hierarchical market economy", that is, typified by a large MNC sector, weakly intermediated labor relations, high labor turnover, and low skills) that characterize many countries of Latin America and other developing countries

macroeconomic populism seems a thing of the past, trade and industrial policies are increasingly active and the government caters to an internal audience when it blares the importance of an independent foreign economic policy. In short, the difference in Brazil's macroeconomic/financial and microeconomic/trade discourse baffles political economic analysts. The danger is that today's interventionist approaches in the realm of trade policies could spillover to macroeconomic management.

Chapter 04 - The Political Economy of Brazilian Trade Policy: Domestic and International Determinants - Empirical Testing and Data Investigation

Section I - Introduction

In the previous chapters, I analyzed the domestic and foreign determinants of Brazilian trade policy, focusing on the debate regarding Brazil's refusal to surrender its trade policy tradition and to commit toward deeper trade liberalization with advanced markets, both in regional and in multilateral integration negotiations. I discussed as well the hurdles surrounding the conclusion of world trade negotiations, which are a consequence of both developing and developed countries' domestic cleavages and the changing world economy, which brought about protectionist forces. Certainly, neither Brazil nor other developing countries can be exclusively blamed for the world trade stalemate. Yet, in the first half of the 2000s, Brazil shirked from North-South regional (FTAA) and trans-regional (EU-Mercosur) integration agreements and contributed to the faltering WTO Doha round of multilateral trade liberalization.

Notwithstanding neoclassical trade theory that typically suggests that the benefits of trade would be greater among countries with different resource endowments, Brazilian policymakers have consistently refused to engage in and implement North-South integration and have opted instead for managed trade policy. On the domestic front, following a *Gershenkronian* approach, Brazil has adopted higher tariffs and state support, aimed at promoting and protecting industrial sectors. Activist industrial policy has been a constant in the economic policy of the country, even after the *neoliberal* reforms of the 1990s. Conversely, on the external front, Brazil's strategy has been linked to the building up of a regional integration block, *Mercosur*, a customs union that aims to eventually

become a common market. Mercosur is a political project and a vehicle for Brazil's economic leadership in South America. As I discussed in chapter 03, the bloc is characterized by a certain level of economic dirigisme and by protection of industrial sectors.

A logical strategy for a country trying to implement trade and structural reforms in the face of occasional setbacks in public sentiment toward greater immersion into the globalizing world is to lock them in through free trade agreements. The model of “open regionalism”, which welcomes FDI and creates a competitive environment within the bloc, was part of the initial motivation for Mercosur in the early 1990s. In the 2000s, however, Brazil refused to surrender its managed policy tradition, avoiding having to make free trade agreements with advanced markets in order to protect its industrial sectors.

After some years of considerable trade opening and structural reforms, which have decreased not only tariffs, but also the state's role in the economy, it is worth asking: are there differences between economic groups regarding further trade liberalization with advanced markets? Is it feasible to suppose that some industrial sectors in Brazil would benefit from integrating with advanced markets? Is Mercosur the right strategy for the insertion of Brazil into the world economy? What are, ultimately, the explanations for such extremely cautious trade liberalization in Brazil?

I draw on political economy theories to address these questions. This quantitatively oriented chapter uses econometrics, descriptive data and stylized facts to address the questions posed in this introduction⁸². The underlying hypothesis is that Brazilian trade

⁸² In [social sciences](#), especially [economics](#), a **stylized fact** is a simplified presentation of an empirical finding. While results in [statistics](#) can only be shown to be highly probable, a stylized fact can be presented as true. Stylized facts are a means to

policy targets special industrial interests. Despite various shocks⁸³ that Brazil has had to face during the last two decades, trade policies remained quite stable and were dictated by these special interests.

Neoclassical international trade theory suggests that according to comparative advantage, the sectors characterized by factor-intensity in the factors that are most abundant in Brazil and Mercosur, such as those based on natural resources, would be most likely to benefit from integration with advanced markets and would lobby for liberalization. Accordingly, more recent non-neoclassical international trade theory suggests that export-oriented sectors may benefit from trade integration, even when comparative advantage is not apparent, because they may benefit from larger markets and technological externalities. To what extent is regional trade already an intervening variable influencing the position of productive sectors regarding trade policies? The creation of Mercosur in the early 1990s changed the organization of industrial sectors and their strategies within the Southern Cone. Intra-industry and intra-firm interests are now part of the picture. Could the same political economy forces operating in Mercosur be present in a Western Hemisphere regional agreement, such as the FTAA?

The first aim of this chapter is to undertake an empirical analysis of political economy differences among 10 different industrial sectors. With data from the Brazilian Industrial Survey (PIA) of the Brazilian Institute of Geography and Statistics (IBGE), I use three clusters of explanatory variables – trade shares; factor endowments and

represent complicated statistical findings in an easy way. A stylized fact is often a broad generalization, which, although essentially true, may have inaccuracies in the detail (http://en.wikipedia.org/wiki/Stylized_facts)

⁸³ These shocks are events such as the debt crisis of the late 1980s, the structural reforms prompted by the Washington consensus, the creation of Mercosur itself, the financial crisis of late 1990s and early 2000s, and the multilateral negotiations of the WTO, either exogenous or endogenous to the Brazilian economy, which have impacted it, hence, domestic economic policymaking as well. These events were examined in other chapters

industrial organization/competition - to explain the dependent variable: trade policy, expressed in terms of either protection (tariffs) or subsidies (state support). I claim that, despite shocks, state policies toward these special interests have remained relatively constant over the period 1988-2005.

Regression results show that Brazilian trade policies are characterized by a Heckscher-Ohlin pattern of trade policy, that is, that factor use by industries determines their policy position. Hence, the scarce factor in Brazil (capital) receives relatively more protection and support. However, there are some qualifications. Capital exerts more pressure over subsidies rather than tariffs; and it is noticeable an increasingly protection of labor intensive industries. Additionally, industrial concentration and scale (collective action measures) are significant intervening variables, explaining differences in protection and support across sectors but, while the latter acts upon tariffs the former influences only subsidies. Non-traditional variables, however, those proposed by recent “new trade theories”, such as technological intensity by sectors, do improve the power of our model. Trade oriented variables, such as export orientation and import penetration, on the other hand; do not exert strong statistically significant effects on the dependent variables, though regional intra-industry trade seems to play a role influencing state support policies. Adding time trends and dummies to the specifications change some variable’s significance, but it is noticeable the importance of globalization trends and mounting intra-regional trade flows in shaping the policy outcome.

The second objective of this chapter is to discuss the link between domestic trade/ industrial policy measures and Brazil’s external trade strategy. I claim that this policy stance was ultimately responsible for the failure of trade talks with developed countries in

the first half of the 2000s. Based on descriptive data, I discuss trends in Brazilian foreign trade balances and the destination of export flows and relate them to political economy implications of our empirical results. According to data from the Economic Commission of Latin America (CEPAL 2006) and Lall *et al* (2007), Brazil sells more high value added goods to the Western Hemisphere (Mercosur/Latin American countries, and also to the U.S.), whereas its transactions with new emerging counties and non-traditional markets (e.g. Russia, China, and other East Asian countries) are concentrated on natural resource manufactures. I examine why Brazil protects and supports its capital intensive sectors domestically, but does not advance trade agreements with markets that buy these goods

Following this introduction, section II discusses methodological issues relating to the theories and the underlying assumptions thereof for use in empirical testing. These theories were also discussed in other chapters of this dissertation. This section specifies the hypotheses to be tested and expected signs of variables, it briefly comments on the estimation techniques and, finally, it discusses the statistical results. Section III analyzes the geographic as well as commodity content of Brazilian trade flows (1990-2005), and explains how it relates to the debate regarding openness and industrial policy as well as the overall macroeconomic situation of the country. I draw inferences from the econometric results with which to evaluate the trade strategy of the country. Section IV concludes. The annex to the chapter presents data sources, methods used to construct the variables and tables and graphs.

Section II - Methodological section.

In the next paragraphs, I review the literature on endogenous trade policy, political economy of industrial policy/export promotion and economic integration. This literature was addressed in other parts of the dissertation, but here I systematically explain the various theories relate to my particular hypotheses. Then, I explain my choice of dependent variables (tariffs and state support) and I provide a detailed account of the three clusters of explanatory variables (factor endowments, industrial concentration/competitions and trade shares). I elaborate on the possible effects (expected signs) of the effects of the explanatory variables (table 13). I examine the industrial and trade related characteristics of ten manufacturing sectors (table 20) and I perform an empirical analysis in which I regress these three clusters of explanatory variables on trade policies. Finally, I discuss methodological strategies dealing with the empirical tests and model specifications and present the results.

I treat protection (tariffs) and state support (subsidies) as the measures of trade policy, the basic variables to be explained. The literature on endogenous trade policy emphasizes mechanisms of *protection* (tariffs, non tariff barriers, quotas, voluntary export restraints). However, trade policies in Brazil, as well as in other large emerging economy countries, must be also addressed in terms of industrial policy to bolster exporting capacity. Brazil has upheld these mechanisms of industrial promotion during the second half of the twentieth century and retained them even after the structural reforms of the 1990s and the agreements of the GATT/WTO framework⁸⁴.

⁸⁴Industrial state support mechanisms, such as subsidies and tax breaks, aim both at domestic and foreign markets. Therefore, any attempt to discuss the political economy of trade policy should also look at industrial policy measures. For a discussion of the Brazilian export promotion policies, see Shapiro (1997) and Veiga (1998); for a more recent account, in Portuguese, Veiga and Iglesias (2002). For a general discussion of role of government policy in building industrial competitiveness, see Lall (2003) and Kohli (2005).

Theory

This section discusses how the theories mentioned in this dissertation provide tools with which to analyze the political economy of Brazilian trade policy. Following the broad premises of endogenous trade policy theory, Brazil should be expected to protect/support its capital intensive sectors, vis-à-vis labor- or land- intensive sectors. Conversely, according to alternative propositions of this literature, which emphasize lobbying along sector lines – governmental policies are likely to financially support exporting interests and protect import competing sectors. The level of market power and concentration is also an important intervening variable such that economically powerful and concentrated sectors – such as oligopolies, monopolies and conglomerates – should be able to exert pressure and capture governments; resulting in higher tariffs or state subsidies. Finally, recent literature on the political economy of trade asserts that industrial sectors characterized by increasing returns to scale and dependent on foreign inputs may lobby for trade liberalization, particularly, under regional agreements.

Considerable political economic literature has been assessing the impact of factor ownership and the trade orientation of industries as determinants of trade policies. Hence, tariffs (or subsidies), set by policymakers can be understood as prices that clear political markets. Coalitions of industries are formed to influence the redistribution of protection/support. Endogenous protection theories address both the “demand side” - how interest groups organize to influence policy; and the “supply side” – how policymakers choose to grant (or not grant) the benefits (Rodrik 1995). According to Magee et al (1989), the Heckscher-Ohlin (H-O)/ Stolper-Samuelson (S-S) (henceforth H-O/S-S)

hypothesis suggests that lobbying activity will occur along factor lines (e. g. capital vs. labor vs. land); whereas the Ricardo-Viner (henceforth R-V) hypothesis suggests that they will occur along industry lines (import-competing vs. export oriented). Factor mobility also influences outcomes: the H-O/S-S model asserts that, in a two-factor world with complete mobility within domestic industries, liberalization of international trade will lower the real income of the scarce factor and increase the real income of the abundant factor. Conversely, the R-V model suggests that factors of production are industry-specific (thus R-V is also referred as *factor specific*) even in the long run, so that trade liberalization would benefit all factors in the exporting industry but hurt all factors in the import competing industry.

Magee et al (1989) have advanced these highly stylized theoretical models drawing on the contributions of Olson (1967). They formalize Olson's intuition about how the free-rider problem makes lobbying difficult and arrive at predictions regarding the relationship between industry lobby spending and government benefits to industry. According to those authors, since protection has a "public goods" property; it tends to be underprovided. Concentrated industries may be better able to overcome the free-riding problems, facilitating inner co-operation to influence trade policies more effectively.

As an alternative to "interest group" theories, the median voter or direct democracy approach assumes that government adopts policies (trade policy included) in a manner that reflects the majority opinion on the issues. In the two-sector, two-factor, Heckscher-Ohlin model, trade policies are expected to be along these lines: if the median voter's ownership of capital is lower than that of the average owner (as is the case in about all countries), trade policy is biased in favor of labor (as opposed to capital). As stated by the

Stolper-Samuelson theorem, in the two-sector Heckscher-Ohlin model, a change in tariffs raises the return to one factor and lowers that to the other. If the median capital-labor ratio in the economy is low, the median voter will vote for a tariff policy that favors labor over capital (Gawande and Krishna 2003).

Grossman and Helpman (1994) (henceforth G-H) refine the assumptions in the literature explaining protectionism as a function of the structure of the industrial organization/competition, trade dependency and the elasticity of import demand or export supply in industrial sectors. In the “protection for sale” model, protection is “bought” by industries through contributions to the political process; by politicians, who in turn, weigh the aggregate welfare loss of constituents vis-à-vis their rent-extraction gains and decide whether or not to protect/support the special interests. Conversely, certain industries weigh the deadweight loss of tariffs arising from the consumption of imported inputs while deciding to “buy” protection. Therefore, G-H model is applied in an imperfect competition setting in which industries may be price-setters in downstream markets, selling goods to final consumers, but may be price-takers in upstream markets for inputs. In the G-H model, industries depending on imported inputs may lobby for liberalization, or may ask for state support to finance the purchase of those inputs⁸⁵. Thus, the degree of intra-industry trade may also be an important intervening variable. Rodrik (1995) affirms that neither the R-V nor the H-O/S-S models can account for the large and growing share of world trade that is intra-industry. In the presence of increasing returns to scale (IRS), intra-industry trade will make everyone better off: it will increase the number of varieties available for consumption of intermediate inputs without

⁸⁵ The same industries that favour protection in final goods, for example, automobiles, may lobby for lower tariffs in inputs, for example, steel. Of note, the second generation of political economy of trade literature draws on industrial organization theory. See, for example, Krugman (1995), Rodrik (1995)

reducing any sector's real income. Considerations of increasing returns to scale (IRS) and imperfect markets can have important consequences for the analysis of the political economy of regional integration.

There are potential complications to those theories brought about by world economy phenomena – often called *globalization* -, which have facilitated international mobility of factors of production⁸⁶. These trends can also be enhanced by regional integration agreements. Factor-specificity models (R-V) can transcend the conventional cleavages: in that developed countries can have both low-skilled labor and high-skilled labor opposing trade, while in developing countries their capital-intensive sectors might benefit from liberalization, due to the increasing variety of inputs and economies of scale that trade offers. Rogowski (2006) reviews these complex distributive effects. According to his review, there are *anomalous factor* coalitions that arise as a consequence of globalization. For example, there is the possibility that skilled labor in a developed economy, despite being the abundant factor, may advocate protection (e.g. high-tech industries leaving the U.S. and outsourcing IT jobs in India); or scarce skilled labor and capital-intensive sectors in a developing country favoring free trade (e.g. engineering firms benefiting from subcontracting and technology transfers with developed country firms). Low skilled labor in developed countries, despite being scarce, might oppose trade and feel threatened by immigration and its downward pressure on wages. Scheve and Slaughter (2001) discuss these trends indicating that even capital – the abundant factor in the U.S. economy - can be badly affected by declining economic activity in

⁸⁶ Globalization is a far-reaching concept in social science. Rogowski (2006) discusses globalization as an equivalent of trade liberalization; that is the free flow of factors of production (labor and capital), which can be understood as well in terms of increasing immigration and foreign investment. Lall (2003) also discusses the concept of globalization as an equivalent of trade liberalization and foreign investment facilitation and how it may constrain policy latitude of national states.

regions affected by import competition (e.g. the Rust Belt). These authors model the attitudes of owners of financial asset values (mortgages) in regions affected by slumping economic activity because of foreign competition and perceive that these owners of mortgages are opposed to trade liberalization.

It is worth quoting these theories in order to grasp the complexity of contemporary international economic relations, as they address the role of immigration, foreign investments and trade in services. However, for this dissertation, I focus only on trade in manufactures and industrial sectors.

The upsurge of regional integration agreements (RIAs) - also referred to in the literature as preferential trade agreements (PTAs) - increases the complexity of forces in the world economy. Neoclassical trade theory, based on the Vinerian tradition, such as Bhagwati and Panagariya (1996), suggests that PTAs are often welfare-reducing because politically motivated governments set up higher tariffs in order to protect special interests within the bloc from rest of the world competition, causing trade diversion. Grossman and Helpman (1995) and Krishna (1998), similarly, argue that PTAs reduce national welfare as a result of pervasive rent-creating trade diversion. The incentives for lobbying/protection are different when the PTA is a free trade area (FTAs) or a customs union (CUs). In the case of CUs, when external tariffs are jointly set by country members, lobbying activity shifts from the domestic to the regional arena. Therefore, there are increases in co-ordination and transaction costs among members of an economic sector, which may hamper lobbying and tariff escalating. Meanwhile, as Ferreira and Fachini (2005) point out, free-riding tends to be overcome by repeated interactions of economic actors. Thus, the protection of special interests is also pervasive in RIAs, be

they FTAs or CUs and even common markets, such as in the case of the European Union (Francois, Nelson and Pelkmans-Balaoing 2008, Tavares 2006).

By contrast, there is a recent line of research that defends regionalism as a building bloc for liberalization and argues that it can actually encourage trade. According to it, regional integration can have a negative effect not only on internal tariffs among the members but also on tariffs toward third-countries, due to a process known as the domino effect (Baldwin 2006). Ornellas (2005), for example, argues that preferential trade agreements are in fact “rent-destructing” because of tariff-elimination among members, thereby, enhancing exports within the bloc and giving exports from partner countries greater access to the domestic markets. By sharing the benefits of higher tariffs with the producers from partner countries in the bloc, domestic producers become less willing to compensate their government for raising external tariffs on excluded countries. The PTA, in that case, can spawn lower external tariffs and less lobbying. Increasing trade within the bloc will, therefore, lower external tariffs.

Ornellas (2005) argues that his model holds in imperfect competition settings as well, but the application to other instruments of trade policy is not straightforward. On one hand, export subsidies may undermine the very logic of PTAs, on the other hand, countries often engage in regional integration to get around stricter rules for industrial incentives set up in the WTO framework. Subsidies and state support to economic sectors and regions are part of RIAs. For example, the European Union has fiscal transference policies to help the poorer regions in Europe (Hulsmayer 2000; Grugel 2004). In

Mercosur, incentives to industrial sectors are ubiquitous in Brazil and industrial sectors lobby for special treatment within the bloc⁸⁷.

Explanations for the political economy of exporting interests in regional agreements are found in other branches of international trade theory. To Baldwin and Venables (1995), Venables (1999), Venables (2003), and Venables (2006) proximity tends to boost trade flows of neighboring countries, particularly in products which are vertically integrated with respect to different phases of production. Clustering of economic activities is resource-saving and hence regional strategies of transnational companies can contribute to growing commercial flows within the bloc, along intra-firm and intra-industry lines (flows of inputs, components and parts). With integration, firms will operate in larger regional markets, which may enhance their possibility of economic gains. Therefore, industries with regional interests will lobby for /demand state support, and invest in large scale of operation of plants. Scale effects may generate positive spillovers, enhancing export capacity not only inside the bloc, but toward external markets as well. Special treatment of the automobile industry in Mercosur is often justified by policymakers and industry representatives on the grounds of gaining regional and external competitiveness of this industry.

Literature coming from Political Science also discusses the political economy rationale of exporting interests in regional integration initiatives (Milner 1997; Chase 2003). According to these authors, political economy pressures are particularly intense in increasing returns to scale and technology intensive industries. This literature, in line with *factor specificity anomalies*, suggests that skilled-labor and technology intensive sectors

⁸⁷ Often, members design escape clauses within international agreement to allow for these exceptions (Rosendorff and Milner, 2001).

in developing countries may support trade integration with advanced markets. FDI and transnational companies' interests provide further incentive for the RIA agreements in North-South (e.g. NAFTA) and South-South (e.g. Mercosur) (see, for instance, Grether et al 2001; Pastor and Wise 1994). Productivity gains are behind this interest of industries to join RIAs (Lopez-Córdova and Mesquita Moreira 2005). Summing up, domestic groups may lobby governments to join or to establish a RIA. When the RIA is created, domestic sectors will continue to press policymakers to set tariffs and to provide state support accordingly. My task will attempt to find such political economy evidence in the Brazilian case.

In addition to integration theory, are there other theoretical sources explaining political economy motivations for exporting activities, especially, non-traditional manufacturing exports?

The economics literature, since mercantilism, tends to justify the importance of exports for balance of payments and accumulation of capital. Theoretical (Bhagwati and Srinivasan 1978) and policy oriented literature (World Bank 1987) maintains that exports growth can change the pattern of *comparative advantage* and asserts that developing countries should attempt to shift exports from low-tech natural resource-based exports toward low-tech manufacturing. More recently, economic research coming from “new growth theories” discusses how openness to trade and FDI can improve the productivity of the domestic economy, among other reasons because industries benefit from technological spillovers due to increasing access to foreign inputs⁸⁸. This literature discusses the impact of exports in the technological upgrading of emerging economies -

⁸⁸ See, for example, two books from the World Bank, edited by Hoekman and Javorcik (2006) and by Schiff and Winters (2003), which assess trade openness, in general and in a regional integration context. A theoretical perspective about technology transfer and trade is found in Grossman and Helpman (1995).

presumed benefits coming from “learning by exporting” and “foreign markets discipline” - which can enhance not only productivity, but also total factor productivity. Hausman, Hwang and Rodrik (2007) associate export diversification with economic growth. They empirically test a measure of export sophistication to examine the extent and how this measure can predict future growth.⁸⁹ “New growth theory” explanations are also applied in a regional integration framework: industries consuming foreign R&D benefit from technological spillovers and market expansion in RIAs. According to Schiff, Wang and Olarreaga (2002) and Schiff and Wang (2006), North-South integration allows technological spillovers between high-tech and low-tech industries of developed and developing countries, while South-South integration promotes spillover only in low-tech industries⁹⁰.

From a *structuralist* approach, exporting activities are also growth enhancing; however, developing countries will be plagued by underinvestment of risk-averse private agents, who may not tap into exports of manufacturing goods because of fear of low return. This rationale justifies government intervention in promoting value added exports. The book edited by Kim and Nelson (2000) provides a review of theories and case studies about the experience of new industrializing economies in fostering the technological and manufacturing content of their exports. This literature considers political economy aspects as it recognizes the importance of state policies to improve

⁸⁹ Tybott (2006), in the book edited by Hoekman and Javorcik (2006), provide firm level empirical evidence about the impact of exports in productivity. His findings do not support “new growth theories” and there are several unexplained factors that may account for productivity growth besides export orientation.

⁹⁰ These authors examine the impact on TFP of North-South and South-South trade related R&D spillovers. To measure that at the industry level for developing countries, they construct North-South and South-South R&D flows based on industry-specific R&D in the North, North-South and South-South trade patterns, and input-output relations in the South. The main findings are: i) North-South and South-South R&D flows have a positive impact on TFP, though the former is larger; and ii) R&D-intensive industries benefit mainly from North-South R&D flows while low R&D intensity industries benefit mainly from South-South R&D flows.

industrial and export capacity in selected sectors. Exporting interests and state industrial policies have been enmeshed, thereby cross-influencing each other. Focusing on East Asian case studies, Haggard (1990) and Wade (2004), for instance, emphasize policy and bureaucratic autonomy explanations in amassing resources and crafting policies for the technological upgrading of exports; but they also look at the behavior of business groups - conglomerates - that lobbied governments for special favors. The policy instruments used by East Asian countries to bolster industrial capacity and foreign competitiveness included tariffs and subsidies, but also training of personnel and incentives for R&D investments. Climbing the value chain of exports and shoring up emerging sectors, such as electronics, was a common project of entrepreneurs and governments in the East Asian experience.

Ocampo and Martin (2004, chapter 04) examine how Latin American countries perform in terms of export diversification. Their findings show that, despite having adopted policies of import substitution and export promotion during the 1960s and 1970s, Latin American countries have been experiencing difficulties in climbing the value-chain of exports after the structural reforms in the 1990s. Argentina, Brazil and Mexico, for instance, adopted strategies for promoting value-added exports with different degrees of success during the 1970s but severe fiscal and macroeconomic imbalances of the 1980s broke the sequence of public policies and delayed this process (Katz 2000). Ocampo (2004) also highlights how productivity has been stalled in the region since the late 1980s, despite industrial policies that attempted to foster technological capacity during the ISI years and the reforms of the 1990s that scaled back state intervention.

This heterodox literature suggests that export interests in Latin America, particularly in industrial goods, are pretty much intermediated by governments, in granting subsidies, tax breaks and selected protection. In industries in which there is no comparative advantage, the role of governments in gathering resources, pushing for technological upgrading and promoting exports is crucial (Lall 2003). To this literature, private actors are tied to governmental initiatives. From a methodological point of view, this is a complication. In particular, in trying to determine how the export intensity of industries is likely to influence their propensity to lobby governments for tariff protection and state support, one has to confront the possibility of reverse causality. I will address this issue in the section about model specification.

These questions are particularly important for a case such as Brazil, which has a sizable share of exports in high value-added manufacturing industries since late 1980s (aircraft, electronics, and machinery) and has adopted somewhat successful export-diversification policies. It is worth asking if after liberalization in the 1990s, these export interests have acquired an autonomous stance – independent of governments – to lobby for trade liberalization. As I described in former chapters, due to institutional characteristics of foreign policymaking, business interests did not take active role in the recent trade negotiations with advanced markets (EU-Mercosur; FTAA). Is there by now an “*exporting coalition*” in Brazil? My purpose in this chapter is to determine whether or not there exists such a coalition among industrial sectors: I want to test if the export share influences the position of a sector regarding trade policy. At this level of aggregation, it is difficult to make such inferences, but I believe that an econometric exercise can provide some clues about the behavior of industrial sectors.

It is worth reminding exporting business interests may differ between sectors that are more oriented toward Mercosur countries or toward other Western hemisphere countries. This is also influenced by differences in patterns of intra-industry trade with the regions. For example, the three sectors more intra-industry oriented toward Mercosur are “Transport equipments”, “Chemicals and pharmaceuticals” and “Textiles and Clothing”, while for the Western Hemisphere those are “Food Products”, “Machinery” and “Electrical and Electronic Equipment”. Given these differences, “the automobile sector” in Mercosur – albeit exported oriented - would oppose more integration with the U.S. Canada or Mexico. Yet, there is a considerable degree of correlation between exporting interests in both Mercosur and the Western Hemisphere. “Paper, Publishing and Printing” is an example of a sector with high participation of trade along intra-industry lines with both regions. Case studies could be the appropriate methodological alternative to evaluate how sectors behave regarding trade liberalization. Baumann and Carneiro (2002) present findings regarding potential differences in options of trade liberalization influenced by the geographical origin of firms.⁹¹ .

A final piece of literature that could provide hypotheses to be tested in my empirical exercise relates to institutions. Trade policies are a function of the interaction between politicians, policymakers and constituents, which are shaped by domestic institutions. As a result, domestic institutional characteristics can explain not only the level of protection and state support toward economic sectors, but also the mechanisms to correct eventual disruptive effects caused by *globalization*. For example, “welfare states”

91 Those authors analyze the geographical orientation of the leading Brazilian export firms and, on that basis; they infer the potential impact of the effects of the Free Trade Area of the Americas (FTAA). The hypothesis is that, by taking into account the significance of subsidiary firms in the country’s foreign trade and the geographical concentration of these firms’ external commercial transactions, the results derived from the creation of FTAA may differ from those obtained through simulations based on the simple reduction or elimination of trade barriers.

have not only different attitudes regarding state interventionism and trade liberalization, but also different policy responses toward the effects of openness. As Hall and Soskice (2000) explain, “varieties of capitalism” among developed nations will influence policies used to compensate the factor or industry harmed by trade liberalization and economic restructuring. For instance, mechanisms for job protection in declining industries tend to be a greater policy priority in the European Union than in the U.S., where there is belief in the self adjusting properties of unregulated labor markets (Grugel 2004; Breslin et al 2002; Wren 2006).

As I describe in chapter 01, domestic institutions and ideas shape attitudes toward trade policy. In the case of Brazil, trade policies are characterized by patterns of bureaucratic autonomy in economic policymaking by the members of the Executive and their interaction with industrial/economic lobbies is insulated and rarely intermediated by legislative or electoral politics. Policy makers choose “strategic industrial sectors” supporting and protecting national champions and capital intensive sectors⁹². Labor politics, likewise, has a left-wing orientation and a protectionist attitude, and favors, at most, piecemeal liberalization. These conflicts to a large extent with the H-O/S-S model, which suggests that the factor abundant sectors (Labor) would support trade liberalization. The Brazilian Constitution of 1988 consolidated this *corporatist* undertone, with an anti-trade and anti-FDI bias, preserving both capital and labor interests. The Constitution attempted to create welfare state policies, particularly, in public health and social insurance to appease labor interests, while it protects domestic capital in certain economic activities (e.g. mining) from foreign competition (Alston et al 2005). Hence,

⁹² Haggard (1990), Schneider (1995) and Evans (1995) have developed models analyzing how bureaucratic autonomy and “developmental state” bear these special industrial interests.

the Brazilian case would seem to corroborate R-V/factor specificity assumptions wherein both labor and capital in importing-competing industries would oppose trade liberalization, while they would support it in export oriented industries. However, preferences and attitudes, even in export-oriented sectors, will be intermediated by an anti-trade bias in the labor movement and by a nationalistic orientation of business groups.

Structural reforms in the mid-1990s, which prompted privatizations of state-owned companies and economic de-regulation, despite the piecemeal approach, did modify considerably the economy of the country (Pinheiro et al 2004). However, my assumption is that the main traits of the political economy of trade policy have remained stable. Reforms were not able to steer the attention of the public toward trade liberalization in general, and trade integration with developed countries in particular. Broad interest groups and citizens were absent from the negotiations with advanced markets in the first half of the 2000s, whereas diplomats and economic bureaucrats maintained the high level of insulation in discussing the FTAA and the EU-Mercosur agreements. This situation benefited domestic industrial interest groups because, as the negotiation process was abandoned due to divergence in modalities of liberalization, the relative level of protection toward several industrial sectors was maintained (Albuquerque 2003, Bonomo 2005). Attitudes toward state subsidies became less controversial: in general workers, businessmen and the public as a whole have come to support industrial policies to improve manufacturing exports. But this issue is also characterized by a lack of general knowledge of the public, since BNDES funds are financed by worker payroll taxes and its interest rates on loans to economic groups are below market interest rates set

by the Central Bank. Recently, some groups inside academia and specialized circles have been questioning the costs and benefits of industrial policies for the economy as a whole. I expand on this debate in Section III. In short, domestic institutions, be they the organization of economic policymaking, the patterns of relations between the Executive, the Legislative, the private sector and the public, and the Constitution itself, all contribute to a cautious approach to integrating the Brazilian economy in the world economy. Trade policy reflects this characteristic.

Having mentioned these theories, I do not intend to model institutions or ideas in the econometric exercise. My interest here in mentioning them is to show the complexity of political economy cleavages⁹³. My purpose in this chapter is to grasp policy positions of industrial sectors, based on very specific industrial indicators - the level of factor intensity, trade flows and concentration/market power.

How do the various above-mentioned theories perform in empirical tests?

To Gawande and Krishna (2003), early political economy models of trade policy were highly stylized and were tested with different degrees of success. Overall tests were subject to empirical shortcomings, mainly derived from regressor endogeneity and lack of rigorous sensitivity analysis. Those authors acknowledge the headway that such theory has made in establishing increasingly strong microeconomic foundations, contributing to more robust empirical results. Several variables are proposed as determinants of trade policy: industry size, employment, concentration ratios, volumes of imports and exports, changes in imports and exports, elasticity in the use of factors of production, campaign contributions, the level of unionization in industry, the levels of low and high skilled labor, and intra-region/intra-industry trade. Trying to grasp the political economy of

⁹³ I have discussed these domestic institutional characteristics with more detail in chapter one.

trade policies in a developing country framework using quantitative evidence can be problematic due to data constraints and problems of model specification. I hope to advance this debate in the next sub-section describing my variables.

This section presented the theories for my hypothesis testing. However, I did not limit myself to the assumptions of endogenous trade policy theory. I have mingled in contributions coming from other branches international political economy and international economics. To show how this will be translated into empirical tests will be my next task.

Hypotheses and expected signals of variables.

Applying endogenous protection models to analyze trade policies of developing countries is relatively uncommon. The modeling of policy process and lobby influence is not as straightforward as in developed countries because data on campaign contribution/legislative decision – variables that would capture the position of sectors and politicians toward policy issues - is limited. Therefore, the analysis of the “demand side” is complex. Conversely, the “supply side” of policies is influenced by institutional determinants that shape policymakers’ choices, as explained by the theories that emphasize bureaucratic autonomy. This void has been filled by recent research. Olarreaga and Soloaga (1998), Chen and Feng (2000), Grether et al (2001) and Ferreira and Fachini (2005) tested variations of the theory, respectively, on Mercosur, China, Mexico, and Brazil.⁹⁴ Overall, their works confirm that factor endowments and industrial organization/concentration influence the level of protection/support of industrial interests.

⁹⁴ Applied to the Brazilian context, Arruda de Almeida (2004) and Ferreira (2004) have also analyzed the role of special interests in setting domestic tariffs. The latter also comments on the negative impact of protection on labor productivity and Total Factor Productivity (TFP).

But variables not particularly addressed by endogenous trade policy theory, such as FDI (Grether et al 2001) and technological content of industries also influence policies (Chen and Feng 2000).

Furthermore, one of the complications of testing the applicability of these theories to developing economies is that the political economy of trade policy in countries such as Brazil, China and Mexico is expressed not only in terms tariff protection but also in industrial promotion (subsidies), as I discussed in the previous sections. My choice of dependent variables attempts to get around this methodological shortcoming. Tariff protection and state subsidies are both instruments of trade policy. Whereas, tariffs are the traditional variable used by endogenous trade policy models, I also deem it important to include the level of state subsidies received by special interests in the analysis.

Brazilian MFN nominal tariffs are my first dependent variable. As Brazil is part of Mercosur, an exercise to explain the protection of industries in the bloc could use Mercosur nominal tariffs instead, just like Olarreaga and Soloaga (1998). However, it is worth noticing that Brazilian consolidated nominal tariffs are subject to several exceptions under the Mercosur Common External Tariff (CET). Therefore, Brazilian nominal tariffs and Mercosur CET tariffs differ in several lines, such as heavy manufactured products, machinery and equipment (Flores Jr and Watanuki 2008)⁹⁵. Furthermore, the Mercosur legal framework for tariffs was established in 1994 by the Asunción Treaty, and one of my interests is to gauge the effect of this RIA on Brazilian trade policy. Finally, my series begins in 1988, and Mercosur was created only in 1990.

⁹⁵ Not only Brazilian nominal tariffs differ from Mercosur CET nominal tariffs. The legal framework of Mercosur allows temporary exceptions to the CET applied to each country individually on an *ad-hoc* basis and subject to the approval of other members. Hence, even at this level of aggregation (two-digit Standard International Classification - SIC), differences in consolidated tariffs among Mercosur partners exist.

Yet, there is a high degree of correlation between Brazilian and Mercosur nominal tariffs (0.94). Both series come from the same source (TRAINS-UNCTAD) and, certainly, I could use the Mercosur/Brazilian tariffs interchangeably. The annex to this chapter elaborates on the variable construction⁹⁶.

My other dependent variable “State support share” measures the proportion of the National Development Bank (BNDES) loans received by each industrial sector relative to its output. Though Brazilian subsidies are not targeted exclusively at the export market, subsidizing domestic industry can be viewed as a deviation from a situation of free trade, with welfare-reducing effects from the perspective of the world economy. In an open economy, factor endowments would be the only determinant of industry international competitiveness. Therefore, from the perspective of theory, tariffs and subsidies are equivalent (Krugman and Obstfeld 2004, chapter 09). The annex to this chapter explains the methodology for constructing this variable.

Though I do not model bureaucratic or institutional characteristics, my choice of dependent variables captures policymaker’s discretion in “picking winners” and the interaction between government officials and industry representatives. Trade policies are endogenously defined by policymakers in their interaction with industrial representatives. The period of analysis (1988-2005) allows me to make inferences about trade policy setting in Brazil, during a period of important policy reforms aimed broadly at scaling back state intervention and opening up the economy. Furthermore, there have been exogenous financial shocks in this period and the creation of Mercosur itself. My main

⁹⁶ At this level of aggregation, *effective tariffs* would gauge each sector’s political economy differences more efficiently, also because they differ considerably inside the bloc due to each country’s exceptions to the CET. Since my data for Brazilian effective tariffs’ series is shorter, however, I opted for nominal tariffs. (See annex for explanations).

purpose is to track how these changes have affected policies toward different industrial sectors over time.

My general hypothesis in this chapter is that Brazil still maintains a level of protection and support to special industrial interests. My main purpose is to compare the policy treatments received by the ten industrial sectors and to relate these to differences in factor intensity, foreign trade shares and levels of competition (the sectors are described in table 20 in the Annex). Though my level of aggregation is high, it allows us to determine the extent to which the fundamentally different characteristics of these different sectors influence the policies directed at them. Finally, it is worth acknowledging that these two policies – tariffs and subsidies - are closely related: both are mechanisms of industrial policy to address economic sectors' and domestic constituent's interests, hence, they can be regarded more as complements than as substitutes.

Table 13 below explains and summarizes the effects of three clusters of explanatory variables – coming from the different theoretical alternatives and authors identified in the previous sub-section - on the two dependent variables. Table 21 in the Annex presents summary statistics for all the variables. Next, I discuss the possible influence of each of these independent variables on the dependent variables (trade policies). Because I am using the same set of regressors to explain two different dependent variables, estimation problems may arise, which will be addressed in the next sections. These regressors, however, do not necessarily have opposing effects on the explanatory variables, for the reasons explained in the next paragraphs.

Table 13: Effects of Explanatory Variables on Brazilian Trade Policies

Independent Variables (theories; authors):	Dependent Variables (Trade Policies)	
	Tariffs (Effective/Nominal)	State Support Share
Factor intensity variables (Heckesher-Ohlin/Stolper-Samuelson)		
Capital Labor ratio (fixed assets/employment)	(+)	(+)
Capital Intensity (fixed assets/industrial output)	(+)	(+)
Labor Intensity (wages/value added)	(-)	(-)
Skill Intensity (share of wages/employment) (<i>Factor Specificity</i>)	(+/-)	(+)
Trade related variables (Ricardo-Viner; Increasing Returns to Scale)		
Share of Exports (exports/output)	(-)	(+)
Share of Imports (imports/domestic demand)	(+)	(+)
Share of Imported inputs (imported inputs/ output)	(-)	(+)
Index of Intra industry trade (Mercosur)	(-)	(+)
Index of Intra-industry trade (Western Hemisphere)	(-)	(+)
Industrial organization/competition variables (Magee et al; Grossman-Helpman)		
Scale (employment/number of firms)	(+)	(+)
Competition (number of firms in sector/ total firms)	(-)	(+)
Herfindhal Index	(+)	(+)

*Variable's construction methodologies and data sources are detailed in the annex.

The first set of explanatory variables is related to **factor intensity**. At the sectoral level, factor use may reflect technology use more than endowments. Assuming sectors use different technologies, these variables gauge the relative content of “labor” and “capital” used in production. Brazil is a middle-income emerging market economy more

well-endowed with the factor of production “labor” relative to “capital”⁹⁷. According to H-O/S-S theorems, in a country such as Brazil, capital intensive industries should receive higher protection than labor intensive industries. Similarly, subsidies should be directed more to those capital intensive industries. Regarding “labor” intensive industries, because these sectors employ many workers and because of electoral concerns, for instance, Brazilian policymakers will also attempt to create mechanisms to support industries that use this factor intensively. But due to “relative” differences between sectors, according to the H-O/S-S assumptions, it is expected that the labor intensive industries will receive relatively less protection/subsidies than capital intensive ones.

I measure “Capital Intensity” by the ratio between fixed assets and industrial output. Numerator and denominator are in constant 2005 U.S. dollars, thus, the number is a ratio in units. This variable is expected to exert a positive effect on tariffs and on subsidies: the higher the ratio, the more capital has the sector and the higher are tariffs and support. Conversely, I measure “Labor Intensity” using the wage bill to value added ratio; in this case, numerator and denominator are in the current Brazilian currency⁹⁸. The number is a ratio in units. This variable is expected to exert a negative effect on both tariffs and support: the higher the ratio, the higher the content of labor and the smaller are tariffs and subsidies. Meanwhile, there is also rationale to support a median voter model of democracy: as a result, Brazilian policymakers could be expected to grant benefits to labor intensive industries to appease constituents. Thus, in this case, labor intensive industries will receive benefits, expressed either in higher tariffs or subsidies. Therefore,

⁹⁷ Comparatively, Brazil is even more endowed with the factor of production “land”. Though, I do not include this factor as explanatory variable, certain industrial sectors considered (food products, metallurgical products, and non-metallic minerals) include this factor in their production function. Harisson et al 2004 and World Bank 2004 present an estimation of factor shares use by sectors in Brazil.

⁹⁸ Notice that Brazil has experienced three different currencies in the period 1988-2005. Values from 1994 on are in BR reais.

there is a degree of uncertainty related to the expected sign of this variable. But since Brazil is a labor-abundant country, I believe that labor intensity should exert a negative effect on tariffs and on state support.

The “Capital-Labor Ratio” is the ratio of fixed assets (stock of capital at the end of the year) to employment, end of year. It measures the proportion of capital to labor use in each industry. I have this data for the U.S. and for Brazil. Due to variations over time in methodologies of gathering data in the Brazilian statistical service and to avoid endogeneity, I choose not to use the Brazilian time series in the econometric exercises. Instead, I use the U.S. ratio⁹⁹. The higher the number, the more capital relative to labor in the sector, hence, this variable will have positive effect on tariffs and positive effect on state subsidies. This variable is expected to have the same sign to “Capital Intensity” and the opposite sign of “Labor Intensity. Again, there is an issue of technology adoption by different sectors: industries such as electronic and electrical equipment or transport equipment are more capital intensive than food products or textiles and clothing, because they tend to embody more advanced technologies in production. Differences in the use of “labor” and “capital” should be also understood in terms of “asset specificity”. For example, capital intensive sectors may have more immobile assets – such as larger plants with specialized machinery, while labor is a more mobile factor¹⁰⁰. Hence, capital intensive industries will have higher incentives to influence policy, in the case of Brazil, against trade liberalization, favoring higher tariffs.

⁹⁹ Factor use by industry is similar regardless the country of activity. Factor share use by U.S. industries can be considered exogenous to policy choice in Brazil.

¹⁰⁰ Capital intensive industries have higher “asset-specificity” and tend to rely on government policies because they are characterized by high sunk costs, increasing returns to scale and their assets tend to be immobile. For instance, “metallic products” are more capital intensive than “textile and clothing”, thus, the former will apply more resources to influence governments, especially tariffs. (Routledge Encyclopedia of International Political Economy 2002)

In order to get around these technological characteristics of the sectors, I include a variable to measure the content of skilled labor (wages relative to employment), which can be interpreted as a proxy for “human capital”. “Skilled labor” attempts to capture the possible political economy interests of technology advanced industries. Sectors that have the higher skilled labor content are *Transport equipment, Electronics and electronic equipment, Chemicals and pharmaceuticals*, industries considered high-tech by international standards. The methodology of Lall (1999) also includes these sectors in either middle or high technology manufactures¹⁰¹. In order to capture the effects of technology, I also use a dummy variable (Tech), assigning 1 to those high-tech industries and 0 otherwise. “Skill intensity” and “Tech” measure the same thing and they are expected to have the same signals and effect on policies. Brazil is a country more endowed with low-skill labor relative to high-skilled labor (Harrison et al 2004), hence, consistent with H-O/S-S assumptions, human capital intensive sectors in Brazil would receive more tariff protection and more state support. Nonetheless, in line with *factor anomalies* and *increasing returns to scale (IRS)* explanations, high tech industries could lobby for smaller tariffs in order access foreign inputs and to acquire newer technologies. Hence, regarding tariffs, the expected sign of the coefficient is ambiguous. But, regarding state support, the treatment of technology intensive sectors is similar to capital intensive sectors. Indeed, since technology is in even scarcer supply they could be expected to receive even more state support relative to abundant factor sectors. Hence, “Skill intensity” and “Tech” should definitely exert a positive effect on the “State support

101 “Skill intensity”, however, present a relatively high level of colinearity with the variable “competition”, for that reason; I suppress this variable in several regressions.

share". The high level of aggregation in my data turns the interpretation of these assumptions into something of a stylized facts exercise.

Trade share variables attempt to capture the effects of the international exposure of these industrial sectors to foreign competition in demanding compensation/benefits to policymakers, who will decide, based on their incentives and cost-benefit analysis, to grant or not grant such special treatment. Basically, as supported by the R-V assumptions, put forward by Magee et al, and by the G-H model, export orientation and importing competition interests can endogenously influence trade policies. Export-oriented sectors will be pro-liberalization and thus favor further multilateral or preferential trade liberalization, seeking reciprocity. By being able to export, they are competitive, they do not fear tariff reductions. Indeed, even unilateral liberalization would benefit them. On the other hand, domestic sectors competing with imports will prefer to keep tariff barriers.

But here, there is a problem of reverse causality. One could argue that the causation goes in a direction that is opposite to what is hypothesized: higher tariffs could produce less competition, less import penetration and, consequently, an anti-liberalization bias. Similarly, export incentives in the past spurred export orientation of sectors in the present. Brazil has adopted policies in the late phase of the ISI years (late 1960s-1970s) to improve the export orientation of industrial sectors, especially in high value added industries, often involving direct subsidies and state-intervention in production (Kholi 2004, Haggard 2000:181-183). These policies are also known as Export Oriented Industrialization (EOI). In theory, these policies influence the international orientation of

the sectors rather than the contrary. Hence, import and export shares at time t could be a consequence of previous policies that have slashed tariffs and/or granted subsidies.

In order to sustain my hypothesis, in which the causality goes from exports interests to lobbying activity and policy treatment, there is a time lag requirement. Policies in time t are influenced by trade shares characteristics in time $t-1$ or $t-2$. For that matter, in my model specifications, all trade oriented variables are lagged one period. Similarly, the literature addresses this problem by assuming that trade shares of sectors of each country (level of export orientation or import penetration) are the consequence of comparative advantage *in the long run*, which are unconditionally exogenous to policies (Magee et al 1989). For instance, Brazil is land abundant, thus, agricultural goods will naturally have high export orientation, despite, policies that improve (or damage) the international competitiveness of the sector.

Industries that are heavily oriented toward exports, indicated by a large share of output going to exports, are likely to take part in trade liberalization lobbies. Since they are competitive, they do not require protection, but since they also benefit from greater integration with world markets, they may demand subsidies to help them compete in foreign markets. Hence, the variable “Export Share” is expected to exert a negative effect on tariffs and positive one on subsidies. Conversely, industries experiencing foreign competition and import penetration – the share of domestic demand that is supplied by imports - are likely to participate in protectionist coalitions and attempt to deter further trade liberalization but may seek compensation for any losses that they might eventually experience. As a result, a higher “Import share” should exert positive effects on both Tariffs and State Support. The literature also uses “change in import penetration” as an

explanatory variable: positive change in import penetration increase tariffs (Gawande and Krishna 2003). I include this last variable in several regressions.

Having said that, the variables “Export share” and “Import share” are candidates to be instrumented, due to problems of reverse causality and endogenous regressors¹⁰². Due to difficulties in finding strictly exogenous regressors to be used as instrumental variables for the trade shares, I use an estimation technique (Seemingly Unrelated Regression – SUR) that partially addresses the issue of simultaneity of regressors, particularly the problem of contemporaneous correlations between residuals. Trefler (1993), for instance, analyzing endogenous protection in the U.S., in a very rigorous work, tests several specifications and performs sensitivity analysis to address the simultaneous determination of dependent variables and regressors. He uses imports (import penetration) and non-tariff barriers (NTBs) interchangeably as dependent and independent variables. The import equation captures the negative impact of NTBs on imports, and the NTB equation captures the positive impacts of imports on NTBs. His findings are consistent with endogenous protection theory, that is, when trade policy is treated *endogenously*; high levels of import penetration will lead to greater protection. Conversely, he finds that

¹⁰² Reverse causality and *endogeneity* can be understood in econometric terms. More technically, given the cross section regression:

$$y_i = \alpha_i + x'_{1i} \beta_1 + x_{2i} \beta_2 + \varepsilon_i, \quad (\text{A})$$

Where y_i is a dependent variable, x'_{1i} is a vector of explanatory variables, x_{2i} is another explanatory variable, and ε_i the error term, that includes unobservable factors that affect y_i . The most common interpretation is that (1) describe the best linear approximation of y given x_{1i} and x_{2i} . This requires us to impose that:

$$E\{\varepsilon_i x'_{1i}\} = 0 \quad (\text{B})$$

$$E\{\varepsilon_i x_{2i}\} = 0, \quad (\text{C})$$

Coefficients in a regression model are interpreted as measuring causal effects. In such cases, it makes sense to discuss the validity of conditions like (B) and (C). If $E\{\varepsilon_i x_{2i}\} \neq 0$, we say that x_{2i} is endogenous (with respect of the causal effect β_2). We must identify an instrumental variable, say z_{2i} , a variable that can be assumed to be uncorrelated with the model error ε_i but correlated with the endogenous variable x_{2i} (Verbeek 2000)

business interest is more relevant than labor interests to define the character and orientation of U.S. trade policy¹⁰³.

Testing these models is basically therefore a static exercise, since traditional endogenous protection (R-V) models do not address the possibility that trade opening may enhance or diminish sector competitiveness in a future period. Hence, sectors are just preoccupied with short term losses/gains based on their long run comparative advantage characteristics. But, as assumed by IRS theories, some industries may benefit from trade integration, even when they do not have comparative advantage in the short run, due to increasing returns to scale effects caused by market expansion and access to better inputs. I test this hypothesis with the intra-industry variables. I wish to investigate the political economy of industries that trade more with Mercosur and the Western Hemisphere regions. I use the Grubel-Lloyd index of intra-industry trade to create two variables, respectively, “Intra-industry trade Mercosur” and “Intra-industry trade Western Hemisphere”, which measure the levels of exports and imports in the sector that are regional¹⁰⁴ for each such region. While being comparative static in nature, the testing of such variables introduces some elements of “new trade theory”, encompassing increasing returns, imperfect competition and technology transfers. In sectors with intra-industry trade, regional trade liberalization allows firms to differentiate their products and specialize for niche markets. As a result, these sectors tend to be more favorable to open trade and to decreasing tariffs. (Chase 2003). According to the theories advanced by

103 This result is probably being the same in Brazil, as in other parts of the world, meaning greater capacity of business to exert lobby on policymakers. Yet, this exercise will allow looking at the labor oriented variables.

¹⁰⁴ The formula for this index is: $1 - [| \text{exports} - \text{imports} | / (\text{exports} + \text{imports})]$. Annex to this chapter explain methodology of construction of these variables.

Baldwin (2006) and Ornelas (2005), increased regional transactions may also cause downward pressure on tariffs toward third markets.

The same rationale present in Mercosur can be applied to those sectors that trade more intensively within the Western Hemisphere. Since there is no Western Hemisphere FTA though, my assumption is that sectors that trade comparatively more within the continent will favor a future FTA in the region, and they will prefer to decrease third party tariffs. Hence, this variable will exert a downward pressure on tariffs. On the other hand, these same sectors that have geographically concentrated interests may be able to exert protectionist pressures because they tend to be more concentrated. Therefore, the effect of intra-industry trade on lobbying for regional trade liberalization may be uncertain (Chase 2003). However, espousing Ornelas and Baldwin theories, I assume that downward effects on tariffs should predominate. In this econometric exercise, I also examine measures of industrial concentration to find out how they might influence tariffs. In any case, I expect that the regional intra-industry trade variables would have the effect of lowering tariffs.

The effect of such regional intra-industry trade variables on state support is not as clear-cut because subsidies, i.e., export subsidies, often undermine the logic of preferential trade liberalization. Subsidies to domestic industries in RIAs create strains between countries because the companies or sectors recipients of such benefits take advantage of them to artificially increase their participation in partners' markets, causing not only unfair competition within the bloc, but also the possibility of trade balance disequilibrium. Countervailing duties, such as antidumping, have been used to tackle the problems of unfair subsidies within Mercosur, for example. Antidumping measures,

however, have been accused of constituting disguised protectionism, being a questionable remedy for the allegedly trade-distorting effects of domestic subsidies. In theory, the appropriate policy is to draft common rules in the framework agreement that restrict the ability of RIA members to use industrial policies in ways that are detrimental to the welfare of other member countries. In practice, this may be difficult to achieve; only a limited number of RIAs have done much to discipline the ability of members to grant industrial support. The Mercosur legal framework does not prevent the use of industrial incentive policies in Brazil (BNDES loans), but this issue gives rise to frictions and the need for mutual consultation among members.

My hypothesis is that Brazilian industrial sectors with regional interests will increase their demand for state support in order to improve their participation not only in regional but also in extra-regional markets. The same rationale applies to sectors with higher Western Hemisphere orientation, with the difference that, since there is no Western Hemisphere FTA, there is no institutional constraint on asking for state support. WTO agreements, however, limit the latitude of national government in granting subsidies, as established in the Agreements on Subsidies and Countervailing Measures (ASCM) of the WTO Marrakech Treaty. But to get around WTO rules, loopholes have been used by the Brazilian government, which often are related to the complex domestic tax legislation of the country (Shadlen 2003, WTO 2004)¹⁰⁵. In case there was a Western Trade Agreement, such policies would probably be restrained. One of the reasons for the

¹⁰⁵ Brazil has been subject to investigations at the WTO, initiated by Canada, referring to incentives received by the aircraft industry. The incentives comprised the equalization of domestic and international interest rates and were offered by the BNDES (Proex equalization). A panel found that payments on exports of regional aircraft under the PROEX equalization scheme were export subsidies inconsistent with Article 3 of the Agreement on Subsidies and Countervailing Measures (SCM Agreement). The Panel recommended that subsidies should be withdrawn, but Brazil appealed certain issues of law and certain legal interpretations. The Appellate Body upheld the Panel's recommendation. Modifications were made in the domestic legislation, in order that subsidies received by the aircraft industry do not conflict with the WTO legislation. These new modalities often come under the rubric of R&D investments (WTO 2004).

failed FTAA negotiations was the difficulty to even start a discussion on how domestic/regulatory trade measures for industrial incentives should be addressed: U.S. proposing a WTO-plus framework; while Mercosur – especially Brazil - countries preferring industrial policy mechanisms.

Finally, industries engaged in intra-industry trade in regional markets are generally characterized by increasing returns to scale (IRS) technologies. In these industries, clustering and vertical integration of production lines have competitiveness enhancing effects. Thus, it is feasible to suppose that these industries will lobby for state support in order to improve their competitive edge and their participation in regional and external markets. Summing up, sectors engaging in regional intra-industry trade can be expected to receive comparatively more state support. In my specifications, I test interaction terms between these intra-industry and regional trade shares and time trends in order to track their effects over time.

Another trade related variable is the share of imported inputs - how much the domestic sector uses foreign inputs in proportion to its output. Based on the theories discussed above, sectors that require large inputs of foreign goods in their downstream production chains may prefer lower tariffs. The example of steel – an important input in the car industry - is one that comes to mind. Tefler (1993), for example, uses a variable “buyer concentration” to measure the ability of input consumers to lobby for smaller NTBs. But, domestic producers of inputs to other industrial sectors which compete with imported industrial inputs may oppose tariff cuts. Hence the sign of “Input share” on tariffs is undecided. Regarding state support, I would expect a positive sign, because sectors that use inputs intensively demand more state subsidies, compared with those that

do not use them¹⁰⁶. Unfortunately, my data on the share of imported inputs in the consumption of inputs by Brazilian industrial sectors begins only in 1990. By this time, trade liberalization had already started and would not be able to capture the important policy differences between the late 1980s and 1990s. For this reason, I do not include this in regressions variable.

Finally, I look at a third set of explanatory variables in order to assess the impact of **industrial concentration/competition** on domestic policies. According to theory, more concentrated sectors will be able to co-ordinate and to lobby more easily. Therefore, they have the ability to influence policies more effectively by overcoming free-riding problems (Magee et al 1989). The G-H model, using insights of new trade theory, looks at the structure of the industrial organization as an explanatory variable for protection. Industrial organization theory also employs the degree of concentration of the market as a more effective means of measuring economic power and the capacity to influence policies. Therefore, market power will lead to higher tariffs and subsidies

My indicator of industrial concentration is *scale* – total employment in the sector divided by the number of firms. Generally, industries with larger scale are comprised of larger companies, which have more employees, are more concentrated and have the ability to exert pressure on policymakers more effectively. Hence, the higher the scale, the more concentrated is the sector and the larger the capacity to influence policies. Scale is expected to exert positive effects on both tariffs and state support. Alternatively, this can be considered a proxy for “labor unionization”, because more concentrated sectors,

¹⁰⁶ Theoretical as these arguments may be, in the case of Brazil, one of the landmarks of industrial policy has been loans from the government (BNDES) targeted at industries that use intensively foreign inputs (petrochemicals) or willing to enhance production capacity with foreign technologies (machinery). These loans often involve sectors characterized by increasing returns to scale, requiring high machinery content (chemicals, metallurgical, mining, non metallic minerals) (Batista 2002).

with fewer companies, tend to have more powerful unions. Following Olarreaga and Soloaga (1998), I also use another variable to measure “concentration”, namely, the ratio of the number of firms in each sector to the total number of firms in the ten industrial sectors. Sectors with smaller ratios have fewer firms; sectors with higher ratios have more firms. More concentrated sectors will receive more protection and subsidies. This variable will exert negative effects on tariffs but positive effects on state support. For example, the *Transportation Equipment* sector is more concentrated than *Textiles and Clothing*, thus, the ratio of the former is smaller. Again, concentrated sectors have higher capacity to influence policymakers effectively, through lobbying, because they are able to overcome free-riding problems. It is worth stressing that the effects of concentration are related to the level of competition in a given market. It is the best interest of firms in concentrated sectors (oligopolies) to limit the contestability of markets¹⁰⁷. Oligopolies and cartels have incentives to exert direct leverage over governmental bureaucracies to deter free entry, for example, because they have higher profit margins than non-concentrated sectors. Tariff drops lowers barriers to entry, improve competition, hence, harming profits. Moreover, concentrated sectors, due to political organization, may be also able to overcome co-operation problems and influence industrial policies more effectively. From the part of the government is rational to appease sectoral demands for protection and support due to employment, investments and revenue concerns¹⁰⁸.

¹⁰⁷ Earlier literature of industrial organization asserts that free entry and low barriers, making markets contestable, are the best incentive to foster competition. The fact that an industrial sector is concentrated creates incentives among the incumbent firms to restrain entry and keep barriers high (Baumol, Panzar and Willig 1982).

¹⁰⁸ For example, automakers – an oligopoly in the Brazilian economy, as in other parts of the world - are gathered around the powerful business associations ANFAVEA, which has an important seat at FIESP - the Industrial Federation of the state of São Paulo. FIESP has direct leverage over governmental ranks. Its directors and advisors are frequently appointed to governmental jobs – even as Ministry of Industry and Commerce. Similarly, former governmental authorities assume jobs in the private sector and business associations. Conversely, sectors such as *Textiles and Clothing* or *Rubber and Plastic* have thousands of small /middle companies which much less ability to have a seat at FIESP and organize and influence policy.

A more precise indicator to assess market concentration is the *Herfindhal* index, which measures the market share of firms in terms of sales and it is usually considered good proxy of “*market power*”. I have data from Resende and Lima (2005) calculated upon sales data of the main industries in each sector, covering 1986-1998. Sectors with higher market power are able to influence policies more effectively, avoiding competition from imports by raising tariffs and/or state subsidies. I use “Herfindhal” only in alternative specifications, since the availability of this measure is insufficient to cover all the years for my data on nominal tariffs and state support. Following Ferreira and Facchini (2005), who affirm that causation goes from market power to tariff, I lag the Herfindhal index variable by two periods. For the same reason, the variables “scale” and “concentration” are lagged in the regressions. Ferreira and Facchini lagged their concentration variables only for two years, but a wider time span – say five years or ten years- would provide a robust indicative that the causation goes from concentrated sectors to high tariffs. It is well known that oligopolies often arise because of artificial policies, which keep their markets captive. This business pattern is ubiquitous in the *crony capitalist* model that has evolved in several Latin America countries (Kruger 2002). My hypothesis is that, given a previous situation of lack of competition, concentrated sectors will exert lobbying power to keep high both tariffs and industrial subsidies.

In the next section, I consider the empirical strategy and model specification to test the assumptions put forward here.

Empirical strategy and model specification

Based on Tavares (2006), which adopts a similar empirical strategy, I treat policy preferences for each sector - industry tariff rates (or subsidies) - as if they were the result of a politically optimal deviation from free trade. From the perspective of international trade theory, an export subsidy is equivalent to a tariff because it distorts free trade. Thus, I treat them equally in the base model. Letting p_{it} be the relative price of the product of industry $i = 1, \dots, n$ at time t ; p_{it}^* the world price of that industry good (so that $p_{it} - p_{it}^* = \tau_{it}$, the tariff rate (or subsidy) on good i at time t), and $\pi_{it}(\cdot)$ indicating the profit function for the industry, the government's trade policy function is:

$$TP_{it} = f \left[\pi_{it}(p_{it}) - \pi_{it}(p_{it}^*), p_{it} - p_{it}^* \right] \quad (1)$$

in (1) the first argument indicates the gain in industry profits or rents, and the second term represents the loss on consumer welfare from the tariff (or subsidy). The setting of the tariff or subsidy for an industry involves the interests of the industry through profits or rents, the interests of the domestic consumers of the commodity, who seek to maximize their utility; and interests of the government, which trades off industry and consumer preferences, and performs its own judgment about the importance of the industry for itself and for the economy of the country as a whole.

My purpose is to explain the difference in the structure of protection/support across industrial sectors over the time span 1988-2005. Since my interest is simply empirical, the trade policy functions come not from a formal model, but from previous empirical and theoretical work (for instance, Rodrik 1995). The variables described in the previous section will influence how these policies are set. The policy process is endogenous,

meaning that the interplay between governments, industry representatives and consumers are all included in the objective function.

My inquiry departs from the empirical observation that, even though Brazil has implemented trade reforms in the 1980s and 1990s, the country still has comparatively high levels of protection. Figure 10 in the annex shows median nominal tariffs (MFN) for selected countries in 2005. Brazil's position in the second half of the distribution indicates that its domestic economy is considerably more protected than several other countries, including similar emerging market economies. The issue is not only the still high level of protection but also its *variance*. Figure 11 in the annex shows nominal and effective tariffs in 2007 at the three digit level of Brazil's National Classification of Economic Activities (CNAE). Nominal tariffs vary from 0 to 35 percent, the consolidated margin at the WTO¹⁰⁹, an interval high enough to raise doubts about rent seeking and which impose costs on domestic resource allocation. From the point of view of effective tariffs - which take into account protection for both final products and inputs - the distortions are even higher, varying from -4 to 133 percent. (Mesquita Moreira 2008). Table 20 and figures 12 and 13 in the annex show the variations in tariff rates over time, using a more concentrated industrial classification (two digit CNAE, equivalent to Standard International Classification - SIC). What are the explanations for still relatively high level of protection and, principally, for the high variance among sectors? Why are some sectors more protected than others?

¹⁰⁹ As discussed in chapter two, the world multilateral trade system, first with the GATT then, with the WTO, was successful in promoting tariffs slash since the 1940s. According to the norms of the WTO, countries commit to an upper bound - the current level is 35 percent - of its domestic tariffs lines. For that matter, 99 percent of domestic tariff lines in developed countries and 78 percent in developing stay below the upper bound consolidated at the Uruguay Round. See, for example, http://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm2_e.htm#con.

As analyzed in other parts of the dissertation, trade and industrial policies are part of an economic development strategy. That strategy came to an end in the 1980s. Even though liberalizing due to unilateral and WTO-led trade reforms, I support the idea that the country has maintained policies in line with the ISI years. It is unquestionable that the absolute level of protection dropped, as the figures 12 and 13 show. However, policies are a function of policymaker's discretion, influenced by economic domestic institutions, which have high resilience over the years. In this chapter, I look over specific technological (factor use) and political economy variables to explain why trade policies toward some sectors have changed only partially.

To estimate the policy preference -industry tariff rate and state support share - I use a balanced panel of 10 industrial sectors comprising a period of 17 years, from 1988 to 2005. These years account for a pre-liberalizing period (1988-1990); the years of tariff schedule reduction which accelerated in 1990 and finished in 1994, which is also the year in which the Common External Tariff of Mercosur was formally established, the Real Plan macroeconomic stabilization plan was initiated, and there was a certain amount of scaling back in tariff reductions due to macroeconomic imbalances caused by external crises between 1995 and 2005. The latter period was one that included the Mexican, East Asian, Russian and Brazilian crises. My main hypothesis is that the *aggregate* level of protection has changed markedly over the years, but the relative level (*variance over sectors*) of protection/support remained more stable and is affected by technological (factor endowments use) and political economy variables. I believe special interests – bureaucratic and technocratic ones included - have maintained their ability to influence policies, despite market reforms and exogenous shocks. The use of panel data allows me

to look for specificities of each sector, which are a function of the political economy variables, such specificities would not be captured in an OLS pooled regression. Basically, I believe that the absolute levels of protection and state support have changed over time – as the graphs in the annex may indicate - but the relative (sectoral variance) level of “protection and support” has not changed that much due the rather static condition of the sector and policy characteristics. In that line, I deliberately avoid creating a variable “political favoritism”, as a composite of tariffs and subsidies, because there are different assumptions regarding the sign of the explanatory variables.

In short, I wish to measure the relationship between benefits received by each sector - tariff and subsidy - and the various components of the trade policy function which may be changing over time. The estimating equation is:

$$\tau_{it} = \alpha_i + \beta_1 C_{it} + \varepsilon_{it} \quad (2)$$

Where τ_{it} is the policy for industry i in time t , (tariffs or support), also understood as the difference between domestic prices and international prices. I include α_i which represents unobservable industry fixed effects that may be correlated with the explanatory variables. Such industry-level fixed effects are useful to control for sector heterogeneity which is common given the relatively few explanatory variables included and the many differences among sectors aside from those measured. These effects may also control for unobservable characteristics that are fixed over time. C_{it} is the vector of characteristics for industry i at time t and include trade orientation, factor endowments and competition variables, ε_{it} is the error term, composed by the v_i , assumed to be attributable to

differences between the individual unit, which is known as heterogeneity, and the second component λ_{it} , the error term modeled in normal OLS regressions, assumed to be i.i.d.. Equation (2) will be estimated using different techniques – ordinary least squares, fixed effects, random effects, generalized least squares, panel corrected standard error and seemingly unrelated regression. After a set of initial tests, I also include time trends and year dummies to see how much the results change.

My base model is given by the next equation:

$$\tau_{it} = \alpha_i + Trade_{it-1}\beta_1 + Endowments_{it}\beta_2 + Competition_{it-1}\beta_3 + \varepsilon_{it} \quad (3)$$

In the specification above, the trade variables are all lagged in one period. These include “Export share”, “Import share”, “Import share change” – measuring the change in import penetration -, the variables measuring the content of intra-industry trade in Mercosur and in the Western Hemisphere. The factor endowments variables include the “Capital-labor ratio”, “Capital intensity”, “Labor intensity”, and “Skill intensity”. I also include a dummy for technological-advanced sectors “Tech”. Finally the competition variables “Scale”, which measures employment relative to the number of firms and “Concentration”, the ratio between the number of firms in each sector and the total number of firms. These variables are also lagged. To check for the robustness of coefficients, I include regressions with year-dummies alone and another regression including two time trends starting in the second half of the 1990s (1995 and 1997), making the time trends interact with the Mercosur and the Western-Hemisphere intra-industry trade variables, respectively. Finally in this last regression, I add a dummy

(DummWTO), creating a time trend after 1995 to account for the policy shock after the establishment of the WTO and the conclusion of the Uruguay Round. Results for the dependent variable “Nominal Tariffs” are displayed in table 14 “Model 1”; table 15 “Model 2” display results for “State Support Share” as the dependent variable. In an alternative model specification, I add the variable “Herfindhal index” as an explanatory variable for Nominal Tariffs and State Support. Since data for this variable is limited, this last model was estimated for the years 1988-1999 alone. Again, all the trade and competition variables (Herfindhal, Scale and Concentration) are also lagged one year. I run this regression with the PCSE and SUR estimation techniques adding the mentioned time trends and dummies. Table 16 and table 17 (model 03 and model 04) present this alternative model.

Finally, in a final round of tests, using PCSE and SUR techniques with the first baseline specification (not adding time trends and dummies), I test interaction terms between the trade share variables (export and import) and competition variables (scale and competition), using only the longer series (1988-05). Results are displayed in Table 05.

Comments on the choice of estimation techniques:

I will briefly discuss my choice of estimation techniques. This section relies heavily on Certo and Semadeni (2006) and Beck and Katz (1995). These authors discuss applications of panel data estimation methods to management studies and comparative political economy research. First, I discuss the advantages of panel data; then the advantages and flaws of using ordinary least squares (OLS), fixed effects, random effects and generalized least squares (GLS) estimation techniques. Based on those authors, I

justify my choice of panel corrected standard errors (PCSE) technique, as the more appropriate for my data, since this technique cluster by sector and year. Finally, since I am using the same set of regressors to explain two different dependent variables, I estimate the model with Seemingly Unrelated Regression (SUR) models. The discussion of the regression results will be based on the PCSE and SUR techniques.

A panel data set is one that follows a given sample of individuals (firms, industrial, sectors) over time, providing multiple observations on each individual in the sample. The use of panel data allows one to resolve or at least reduce some of the econometric problems that often arise in empirical studies. One such problem occurs when the estimation results are influenced by omitted (not observed variables) that are correlated with the included explanatory variables (see note 18 above). More technically, panel data provide “internal instruments” for regressors, which are probably endogenous or subject to measurement errors. Panel data estimation tackles the problem of *endogeneity* by transforming the original variables using their mean. These transformations are often argued to be uncorrelated with the model’s error term but correlated with the explanatory variables themselves. As a result, no external instruments are needed. For instance, if x_{it} is correlated with v_i – the time invariant component of the error term ε_{it} -, it can be argued that $x_{it} - x_{-i}$, where x_{-i} is the time average for individual i , is uncorrelated with v_i and provides a valid instrument for x_{it} . Moreover, estimation with fixed effects, by eliminating v_i from the error term, eliminates the problem of endogenous regressors (Veerbeek 2000)

Panel data models are classified according to intercepts and slopes. (1) If it has homogenous intercepts and slopes, it means the intercept and parameter values are the

same for all units of analysis over time (pool cross section). (2) If it has heterogeneous intercepts and homogenous slopes, it means that the intercepts can vary through time or among the units of analysis, being fixed or random, and the parameters can be the same for all units of analysis and overtime. (3) Having both heterogeneous intercepts and slopes would mean that the intercept and slopes can vary through time or among the units of analysis, being fixed or random¹¹⁰

Notwithstanding these advantages, the use of panel data often creates potential statistical problems for ordinary least squares regression. Specifically, panel data may create analytic problems in the form of error terms containing heteroskedasticity, autocorrelation, or contemporaneous correlation. The presence of such conditions creates nonspherical (non-i.i.d.) error terms. (Certo and Semadeni 2006).

In the first regression in each model, I pool all the data and run an OLS regression model, with robust standard errors. OLS with robust standard errors is recommended to tackle the problem of *heteroskedasticity*, e.g. when residuals do not have the same variance. With this technique, the variance-covariance matrix of errors is corrected. In case neither the sector nor temporal fixed effects were significant, the OLS with robust standard errors estimates would suffice. However, this assertion is at odds with my hypothesis; I wish to measure differences across both sectors and time. My time span is a

¹¹⁰ In Econometrics choosing between random or fixed effects panel data models is not trivial. When only a few observations are available, it is important to make the most efficient use of the data. The appropriate interpretation must consider that the fixed effects approach is conditional upon the values for α_i , the intercept, which is specific of each individual in the data. This approach considers the distribution of y_{it} , the dependent variable, given α_i , when the α_i represents a particular country, company, or industry, as in my case. One way to formalize this is noting that the random effects models states that:

$$E\{y_{it}/x_{it}\} = x'_{it}\beta, \quad (D)$$

while for the fixed effects model estimates,

$$E\{y_{it}/x_{it}, \alpha_{it}\} = x'_{it}\beta + \alpha_{it}. \quad (E)$$

Coefficients of the β s in these two conditional expectation are the same only if $E\{\alpha_i/x_{it}\} = 0$. In my regressions, I ran Hausman tests between fixed effects and random effects specification. Most often results favor fixed effects.

period of alleged significant policy shifting. Even though my hypothesis asserts that relative special treatment has not changed substantially among sectors, there has been a decrease of tariffs and state subsidies across the years; hence, it is very probable that the error terms will have different variances. Additionally, such estimates are subject to contemporaneous correlation, that the residual of one sector in a particular period will be correlated with the residuals of other sectors in the same period; in other words, contemporaneous correlations arise when the errors of unit i at time t are correlated with errors of unit j at time t .

Hence, I use both fixed effects and random effects techniques. Fixed effect models assign a dummy variable to each unit that remains constant over time; accordingly, they are also referred as the least squares dummy variable (LSDV) model. In this model the effects of the independent variables remain consistent across units, with each unit in the models containing its own intercept. The fixed effect estimator is also known as the within estimator. Random effect models are similar to fixed effects models, because they also include a panel level disturbance (v_i) and a normal disturbance (λ_{it}). They can also be estimated by equation 2. The key distinction between them is the way in which they estimate the panel level error term. Fixed effects models estimate this panel level error with dummy variables and the disturbance for each unit remains stable over time for each unit (e.g., firm). Random effects on the other hand employ a specific GLS variance-covariance matrix of the disturbance terms to estimate equation 2. In contrast to fixed effects models, random effects models assume that the panel level disturbance changes over time, that is to say, compared with fixed effects estimators, which remain stable over

time for each unit, random effects estimators allow the unit effect to vary over time (see note 21).

Certo and Semadeni (2006), based on Katz and Beck (1995), also discuss the use of GLS panel data models techniques. In case the disturbances are assumed to be spherical (i.i.d.), OLS provides the most unbiased and efficient estimator. OLS regressions with robust standard errors include the variance-covariance matrix of the residuals in its computation of regression coefficients. But, as I have stated, such assumptions are unrealistic in this kind of data, as not only heteroskedasticity and auto-correlation of the residuals and also contemporaneous correlation, will arise. GLS techniques involve analyzing the data while considering the influence of non-i.i.d. disturbances. In that case, GLS becomes a more efficient estimator than OLS because it weights the influence of residual based on a specified disturbance matrix.

Meanwhile, Katz and Beck discuss the methodological impossibility of the GLS technique when the number of cross section units i (N) is higher than the time dimension (T), and they show how GLS technique provides biased standard errors estimators and upward bias in t-statistics “to the extent that the ratio $N(N-1)/2$ approaches NT ”. They propose the use of panel corrected standard error (PCSE) technique, that is to say, OLS with corrected standard errors, as being more appropriate to political economy data and studies in which the time points (T) have smaller or similar magnitude of cross sectional units (N). PCSE allows one to correct for heteroskedasticity, autocorrelation and contemporaneous correlation in analyzing datasets of political economy nature. My data has sample size N of 10 industries, each with time periods T of 17. This is the dataset available for estimating models 1 and 2. But, for model 3 there are

only 11 years of observations. Were N greater than T , this would qualify me to use GLS technique. However, Katz and Beck assert that the PCSE technique provides more efficient estimators, especially in the presence of contemporaneous correlation. Only when T is at least twice as large as N , which is not the case here, would the use of GLS, be justified. I tested my dataset for heteroskedasticity and autocorrelation and I can not rule out the possibility that my panel has these problems. For this reason, I use the panel corrected standard errors techniques (PCSE) with autocorrelation correction (AR1).

Lastly, since I am attempting to explain two dependent variables using the same set of regressors, there is high probability that the problem of contemporaneous correlation of residuals will arise. Seemingly Unrelated Regression (SUR) estimation is recommended for analyzing a system of multiple equations with cross-equation parameter restrictions and correlated error terms. The SUR technique estimates both models simultaneously – using GLS variance-covariance matrix of disturbance errors- while accounting for simultaneous correlated errors, leading to efficient estimates of the coefficients and standard errors. The SUR estimator requires that the T exceeds N , hence, my data fits in. The gain in efficiency depends on the magnitude of the cross-equation contemporaneous correlations of the residuals. The software STATA performs a test to verify if SUR has yielded a significant gain in efficiency, based on a Lagrange Multiplier (LM) statistic which sums the squared correlations between residual vectors i (e.g. from the model of tariffs) and j (e.g. from the model of state support), with a null hypothesis of diagonality – zero contemporaneous covariance between the errors of different equations (Baum 2007).

Having discussed all these possible techniques, the tables below depict two models – one for tariffs and the other for state support, respectively, as the dependent variable - estimated by two different methods: panel corrected standard errors (PCSE) with autocorrelation correction (AR1), and Seemingly Unrelated Regressions (SUR). The PCSE and SUR techniques are estimated more than one time to account for lagged variables and interaction terms. Below the variables' coefficients, t-statistics are showed between parentheses. Number of observations, R^2 and Wald statistics are reported on the regressions. Overall, with respect to signs, there is not much variation, but the statistical significance of certain variables' coefficient does vary considerably.

Table 22 in the annex presents the correlation matrix of the variables used in Model 01 and Model 02, in order to check for the degree of multicollinearity among explanatory variables. Particularly, the “Capital-labor ratio” should be positively correlated to “Capital intensity” and negatively correlated to “Labor intensity”. Besides, labor intensity and scale (a proxy for union participation) and the competition variables might also present high correlations. However, the correlation of “Capital-labor ratio” with “Capital intensity” is negative (-0.176), while with “Labor intensity” is positive (0.269). I will discuss these apparently conflicting results in the next section. Similarly, “Scale” is weakly negatively correlated with “Labor intensity” (-0.094). “Concentration” and “Scale” are negatively correlated (-0.318). More highly correlated are: “Concentration” and “Skilled labor” (-0.677), meaning that sectors with more firms might employ less skilled labor; and “Scale” with “Skilled labor” (0.546) indicating that sector with larger companies might be able to employ more skilled workers. In order to avoid colinearity

problems, I exclude the variable “Skilled labor” in the regressions.¹¹¹ Table 23 presents multicollinearity diagnoses tests for the variables used in Model 01 and 02. The results do not show a high degree of collinearity among variables. The VIF (Variance Inflation Factor) of individual variables are in acceptable ranges.

¹¹¹ As discussed before, the variable “tech” is a proxy for technological intensive sector that employs more skilled labor; hence, it can be considered substitute to the variable “skilled labor”.

Table 14: Model 01 - Dependent variable Nominal Tariffs, 1988 - 2005.

Estimation Technique	PCSE			SUR		
	Baseline	Year effects	TimeTrends	Baseline	Year effects	TimeTrends
	Regression 01	Regression 02	Regression 03	Regression 04	Regression 05	Regression 06
Variables			WTO			WTO
Export Share	0.057 (0.26)	-0.126 (-1.23)	-0.046 (-0.55)	0.083 (0.51)	-0.131 (-1.54)	-0.083 (-1.06)
Import Share	0.105 (0.69)	0.172* (2.01)	0.220* (2.53)	0.288* (2.10)	0.238*** (3.66)	0.276*** (3.99)
Intra-industry trade Mercosur	2.766 (1.18)	0.906 (0.60)	2.577 (1.25)	3.387 (1.42)	0.065 (0.06)	1.907 (1.26)
Intra-industry trade Western Hemisphere	-8.927* (-2.52)	-2.020 (-1.07)	-3.673 (-1.73)	-10.767*** (-3.59)	-2.515 (-1.62)	-3.696* (-2.38)
Import change lagged	0.012 (0.57)	-0.001 (-0.15)	0.003 (0.37)	-0.018 (-0.73)	0.019 (1.32)	0.007 (0.54)
Capital-Labor ratio	-0.087* (-2.16)	0.014 (0.58)	0.012 (0.55)	-0.092*** (-3.70)	0.002 (0.16)	0.007 (0.50)
Capital Intensity	22.670*** (3.64)	1.457 (0.60)	3.389 (1.43)	30.336*** (5.83)	2.955 (1.03)	3.959 (1.39)
Labor Intensity	23.079 (0.73)	36.424* (2.40)	28.038* (2.43)	24.976 (1.41)	39.317*** (3.81)	30.907** (3.17)
Tech	-5.773 (-1.60)	-2.458 (-1.29)	-3.296 (-1.90)	-10.007** (-3.12)	-3.987* (-2.50)	-4.703** (-2.90)
Scale lagged	0.125*** (3.84)	0.061** (3.29)	0.060*** (3.39)	0.153*** (6.45)	0.084*** (7.01)	0.079*** (6.48)
Concentration lagged	-43.861 (-1.71)	23.100 (1.46)	18.473 (1.28)	-50.130* (-2.51)	18.922 (1.88)	18.973 (1.86)
Intra-Industry trade Mercosur x 95 Trend	-	-	-0.373 (-1.18)	-	-	-0.277 (-1.03)
Intra-Industry trade Western Hemisphere x 97 Trend	-	-	0.103 (0.29)	-	-	0.083 (0.27)
WTO dummy	-	-	-7.222*** (-17.75)	-	-	-7.124*** (-23.21)
N. Observations	170	170	170	170	170	170
R2	0.549	0.890	0.875	0.3967	0.876	0.8622
Wald (Chi2)	40.05	10935.73	587.48	111.8	1200.78	1063.95

legend: * p<0.05; ** p<0.01; *** p<0.001, t-statistics in parenthesis below coefficients. Constant and year dummies suppressed.

Table 15: Model 02 - Dependent variable State Support share, 1988-2005.

Estimation Technique	PCSE			SUR		
	Baseline	Year effects	TimeTrends WTO	Baseline	Year effects	TimeTrends WTO
Variables	Regression 07	Regression 08	Regression 09	Regression 10	Regression 11	Regression 12
Export Share	0.051 (0.94)	0.158** (2.72)	0.052 (0.97)	0.118** (2.88)	0.212*** (4.95)	0.121** (2.93)
Import Share	-0.063 (-1.30)	-0.096* (-2.15)	-0.070 (-1.46)	-0.167*** (-4.85)	-0.147*** (-4.49)	-0.156*** (-4.30)
Intra-industry trade Mercosur	0.687 (1.07)	1.112 (1.68)	0.499 (0.57)	1.553** (2.58)	2.241*** (3.87)	1.678* (2.12)
Intra-industry trade Western Hemisphere	2.308* (2.39)	2.023* (2.00)	2.369* (2.09)	3.599*** (4.77)	2.329** (2.97)	3.821*** (4.69)
Import change lagged	0.001 (0.15)	-0.003 (-0.64)	0.001 (0.22)	-0.002 (-0.28)	-0.010 (-1.40)	-0.004 (-0.58)
Capital-Labor ratio	0.059*** (4.85)	0.055*** (4.28)	0.058*** (4.42)	0.060*** (9.61)	0.059*** (8.99)	0.063*** (9.11)
Capital Intensity	0.879 (0.67)	0.129 (0.09)	0.763 (0.56)	0.261 (0.20)	-1.813 (-1.25)	-0.317 (-0.21)
Labor Intensity	-3.735 (-0.69)	-14.355* (-2.23)	-3.582 (-0.63)	-3.843 (-0.86)	-17.848*** (-3.42)	-5.691 (-1.11)
Tech	0.477 (0.42)	0.297 (0.28)	0.546 (0.49)	2.140** (2.66)	1.102 (1.37)	2.007* (2.36)
Scale lagged	-0.003 (-0.34)	-0.008 (-0.77)	-0.004 (-0.38)	-0.024*** (-3.96)	-0.022*** (-3.67)	-0.025*** (-3.86)
Concentration lagged	24.989*** (3.45)	19.338** (2.64)	24.769** (3.27)	22.726*** (4.53)	20.046*** (3.94)	24.492*** (4.57)
Intra-Industry trade Mercosur x 95 Trend	- -	- -	0.052 (0.35)	- -	- -	-0.014 (-0.10)
Intra-Industry trade Western Hemisphere x 97 Trend	- -	- -	0.025 (0.13)	- -	- -	-0.108 (-0.66)
WTO dummy	- -	- -	-0.096 (-0.47)	- -	- -	-0.031 (-0.20)
N. Observations	170	170	170	170	170	170
R2	0.347	0.511	0.359	0.673	0.728	0.675
Wald	39.85	951.24	44.45	349.78	455.87	353.29

legend: * p<0.05; ** p<0.01; *** p<0.001, t-statistics in parenthesis below coefficients. Constant and year dummies suppressed.

Table 16: Model 03 - Dependent variable Nominal Tariffs, 1988-1999.

Estimation Technique	PCSE			SUR		
	Baseline	Year effects	TimeTrends	Baseline	Year effects	TimeTrends
	Regression 13	Regression 14	Regression 15	Regression 16	Regression 17	Regression 18
Variables			WTO			WTO
Export Share	-0.193 (-0.51)	-0.322 (-1.86)	-0.093 (-0.65)	-0.464 (-1.57)	-0.479** (-3.08)	-0.280 (-1.94)
Import Share	-0.139 (-0.52)	0.214 (1.44)	0.198 (1.22)	0.024 (0.09)	0.283* (2.37)	0.278* (2.12)
Intra-industry trade Mercosur	3.827 (1.32)	1.315 (0.61)	2.203 (0.88)	3.425 (1.01)	0.077 (0.05)	1.842 (0.98)
Intra-industry trade Western Hemisphere	-8.630 (-1.78)	-2.159 (-0.81)	-4.753 (-1.66)	-7.786 (-1.87)	-1.785 (-0.88)	-4.282* (-2.08)
Import change lagged	0.011 (0.39)	0.004 (0.34)	0.004 (0.40)	-0.023 (-0.70)	0.026 (1.51)	0.014 (0.87)
Capital-Labor ratio	-0.118 (-1.86)	0.003 (0.09)	-0.005 (-0.13)	-0.124** (-3.05)	-0.004 (-0.17)	-0.008 (-0.34)
Capital Intensity	25.751** (3.14)	2.982 (0.92)	3.692 (1.18)	34.225*** (4.94)	5.374 (1.51)	5.930 (1.60)
Labor Intensity	38.188 (0.75)	51.035* (2.30)	34.113 (1.92)	43.819 (1.55)	56.216*** (3.38)	37.578* (2.49)
Tech	-4.881 (-1.07)	-1.967 (-0.78)	-1.737 (-0.70)	-9.508* (-2.01)	-3.571 (-1.62)	-3.710 (-1.55)
Scale lagged	0.135** (3.23)	0.077** (2.98)	0.066** (2.61)	0.180*** (5.44)	0.104*** (6.51)	0.096*** (5.68)
Concentration lagged	-43.338 (-1.13)	38.762 (1.66)	25.551 (1.22)	-37.617 (-1.25)	43.657** (2.89)	34.307* (2.18)
Herfindhal lagged	4.930 (0.65)	2.899 (0.82)	5.621 (1.78)	7.968 (0.77)	2.606 (0.50)	6.785 (1.32)
Intra-Industry trade Mercosur x 95 Trend	-	-	-0.593 (-0.52)	-	-	-0.946 (-1.08)
Intra-Industry trade Western Hemisphere x 97 Trend	-	-	1.552 (1.02)	-	-	1.938 (1.59)
WTO dummy	-	-	-7.271*** (-15.45)	-	-	-7.186*** (-18.63)
N. Observations	110	110	110	110	110	110
R2	0.570	0.896	0.881	0.414	0.8851	0.8672
Wald (Chi2)	35.6	227154.75	536.27	77.7	847.45	718.37

legend: * p<0.05; ** p<0.01; *** p<0.001, t-statistics in parenthesis below coefficients. Constant and year dummies suppressed.

Table 17: Model 04 - Dependent variable State Support share, 1988-1999.

Estimation Technique	PCSE			SUR		
	Baseline	Year effects	TimeTrends WTO	Baseline	Year effects	TimeTrends WTO
Variables	Regression 19	Regression 20	Regression 21	Regression 22	Regression 23	Regression 24
Export Share	0.039 (0.72)	0.114 (1.95)	0.039 (0.85)	0.055 (1.22)	0.113* (2.24)	0.049 (1.11)
Import Share	-0.021 (-0.54)	-0.062 (-1.50)	-0.080 (-1.93)	-0.061 (-1.57)	-0.084* (-2.17)	-0.113** (-2.82)
Intra-industry trade Mercosur	1.301* (2.00)	1.436* (2.20)	1.235 (1.60)	1.751*** (3.36)	1.914*** (3.81)	1.804** (3.14)
Intra-industry trade Western Hemisphere	2.313*** (3.68)	1.938** (2.91)	1.895** (3.12)	2.575*** (4.05)	2.059** (3.11)	2.119*** (3.37)
Import change lagged	-0.001 (-0.22)	-0.002 (-0.35)	0.001 (0.31)	-0.003 (-0.68)	-0.005 (-0.91)	-0.001 (-0.12)
Capital-Labor ratio	0.037*** (3.84)	0.028* (2.25)	0.026* (2.28)	0.035*** (5.68)	0.029*** (4.14)	0.026*** (3.61)
Capital Intensity	1.075 (0.92)	1.357 (1.08)	1.464 (1.25)	0.539 (0.51)	0.667 (0.57)	1.386 (1.22)
Labor Intensity	2.786 (0.65)	-1.999 (-0.47)	6.677 (1.53)	5.730 (1.33)	-1.309 (-0.24)	9.517* (2.06)
Tech	0.434 (0.48)	0.467 (0.55)	1.009 (1.16)	1.227 (1.70)	0.899 (1.25)	1.752* (2.40)
Scale lagged	-0.012 (-1.65)	-0.013 (-1.61)	-0.011 (-1.45)	-0.021*** (-4.16)	-0.019*** (-3.64)	-0.019*** (-3.68)
Concentration lagged	18.920** (2.67)	11.191 (1.36)	14.235 (1.81)	16.156*** (3.52)	10.675* (2.17)	12.617** (2.63)
Herfindhal lagged	-2.437 (-1.79)	-1.106 (-0.69)	-1.847 (-1.36)	-3.545* (-2.25)	-1.866 (-1.10)	-2.294 (-1.47)
Intra-Industry trade Mercosur x 95 Trend	-	-	-0.138 (-0.53)	-	-	-0.315 (-1.17)
Intra-Industry trade Western Hemisphere x 97 Trend	-	-	0.953** (3.16)	-	-	1.117** (3.00)
WTO dummy	-	-	0.040 (0.29)	-	-	0.091 (0.77)
N. Observations	110	110	110	110	110	110
R2	0.413	0.492	0.473	0.562	0.613	0.604
Wald	65.04	16323.37	190.38	141.22	173.91	167.6

legend: * p<0.05; ** p<0.01; *** p<0.001, t-statistics in parenthesis below coefficients. Constant and year dummies suppressed.

Discussion of Results

The results I am going to discuss are mainly those reported on the in Model 01 and 02, based on the longer series (1988-2005). The results presented in Table 14 and 15, overall, display a pattern of protection/state support consistent with the H-O/S-S assumptions; that is, factor share used by industrial sectors is a main determinant of trade policy, but there are some qualifications. “Capital-Labor ratio” and “Labor Intensity” do not portray the predicted signs in Model 01. This result was expected for “Labor”, as I have discussed, politicians may prefer to protect sectors that employ many workers. On the other hand, “Capital Intensity” has a positive and significant effect on “Tariffs”, but results do not hold in the year effects and time trends regressions. I expand on the explanation of these results below. In Model 02, “Capital-Labor ratio” has positive and highly significant effect on the dependent variable, hence it can be argued that it is an important determinant of subsidies policy, whereas, “Labor Intensity” has a negative and significant effect on that policy in the year dummy regressions. “Capital Intensity” has no statistical significance on “State Support”. These contradictory results might reflect the fact that “Capital–Labor ratio” is negative correlated with “Capital Intensity” (-0.173), while it is positively correlated with “Labor Intensity” (0.269). As remarked before, tests have not revealed co-linearity among these variables (Table 23 in the annex). Sectors with the higher “capital-labor” ratios are “Transport equipment” and “Electric and electronic equipment”, while for “Capital Intensity” they are “Machinery” and “Non-metallic minerals”. These different results indicate that these variables measure different things: while one measures asset specificity (fixed assets to output), the other measures the share of capital to labor, hence, they have distinct effects on the policies. I mentioned

in the theoretical section that sectors characterized by high asset specificity have incentives to look for protection

Concerning the “Industrial concentration/competition”, variables, related to collective sector characteristics; in Model 01, only “Scale” is statistically significant and have the predicted signs in all the regressions. “Competition” has the predicted negative effect on “Tariffs” in the Baseline regressions, but it loses significance when dummies and time trends are added. In Model 02, both “Scale” and “Concentration” have the predicted signs, but only “Concentration” is highly significant in all specifications. “Scale” has a statistically significant negative effect on state subsidies only in the SUR estimations. Hence, R-V and G-H assumptions, that stress the ability of industrial sectors in overcoming free-riding problems and lobbying effectively, are consistent with the Brazilian case regarding protection, but only partially with subsidies. It is also noticeable that coefficients are sensitive to changes in model specification because, in Model 02, “Scale” gets significant with a negative sign in all SUR specifications. Yet, results of regressions with PCSE and SUR techniques show that the broad patterns are maintained.

Sectors with higher degree of concentration and larger scale are “Transport equipment”, “Electric and electronic equipment” and “Chemical and pharmaceutical products”. Incidentally, those are also technologically intensive sectors and characterized by relative high-skill labor. The variable that specifically accounts for human capital intensity, “Tech” – recall that “Skilled labor” was omitted due to problems of colinearity” - does display statistically significant results in both Models 01 and 02. “Tech” exerts negative effect on “Tariffs”, while it has a positive and significant effect on “State support”. “Tech” is also significant at a 10 percent level in the PCSE estimations with

“Tariffs”. Hence, my data allows me to partially support “*new growth theory*” or “*factor specificity anomalies*” assumptions, that is, sectors with high technological content – a scarce factor in Brazil – might benefit from greater trade integration and lobby for tariff slash and for more subsidies: technological sector, for instance, may want to have access to cheaper imported modern inputs, lobbying policymakers accordingly.

As I have commented, policymakers may wish to appease constituents in sectors that employ many workers; therefore labor content is also a significant determinant for protection. “Labor intensity” exerts positive and significant effect on tariffs in Model 01. These effects, however, are only existent when adding the time trends and dummies. Political concerns certainly explain this outcome. This result may also reflect the fact that Brazil is not as endowed with factor of production “labor” as recent new entrants in world markets, namely, China. Hence, trade policy in Brazil, as I am going to discuss in the next section, are increasingly reflecting the huge impact of imports in low-tech manufacturing goods coming from China, ensuing protectionist pressures from workers and business owners in labor intensive industries. Meanwhile, this effect is not so recent because “Labor intensity” does exert positive effect on “Tariffs” in the time trend regressions in Model 03, with data from 1988 to 1999.

In that line, the variable “Scale” is also related to the labor mobilization in the industry: more concentrated sectors have more powerful trade unions, which may be able influence policymakers and policies more effectively. Therefore, the positive and very significant effect of “Scale” on “Tariffs” can be explained on this basis. This is particularly true with *Transport equipment*, for example, in which the auto-industry has one of the most powerful trade unions of Brazil. Conversely, “Scale” has also a negative

and very significant effect on “State support”, in the SUR estimations. On the other hand, “Labor intensity”, exerts negative and statistically significant effects on “State support”, in the “Year effects” regressions. One can interpret these apparently contradictory results on the following basis: politicians provide protection to labor intensive industries, but these segments are not sufficiently influential to ask for state subsidization. The political economy pressures are reflected only through tariff protection.

“Concentration”, exerts positive and highly significant effect on “State support”, meaning that more concentrated industries will lobby more effectively, overcoming cooperation problems in looking for subsidies. However, these effects are not noticeable on “Tariffs”, this variable even accounts for decreasing tariffs – although only at 10 percent level - in the regressions with time trends. An explanation for this might be the number of companies has increased in all sectors after liberalization; hence, there have been more, not less competitions over the years.

Year dummy variables were created in order to account for the effects of both domestic and external shocks of the variables. First, the tariff schedule phasing out that was initiated in 1990 in the Collor presidency was concluded in 1994, coinciding with the launching of the Real Plan in the second half of 1994, which established a new currency, the Real, pegged to the dollar, in 1995. As a consequence the macroeconomic environment of the country improved markedly – inflation dropped from 941 percent in 1994 to 23 in 1995 (Figure 2, Chapter 01). In 1994, the Constitutional amendments that provided the legal framework for the privatization and deregulation reforms were also ensued. As a consequence, the pattern of BNDES support changed: finance was

increasingly geared toward infrastructure and utilities companies and less to industry. From an international political economy point of view, important policy events also took place. Mercosur was created and its tariff legal framework was concluded, with the creation of the Common External Tariffs, and finally, the WTO itself was founded with the successful conclusion of the Uruguay Round (1986-93). The absolute levels of protection dropped drastically after 1994 (table 20 and figures 13 and 14 in the annex). In order to capture, such shock, a WTO dummy variable was created, coding years in a crescent order till the creation of the WTO, after which the value remains constant. This variable accounts for the effects of this international regime on the domestic policymaking. WTO dummy exerts very significant negative effect on “Tariffs”, indicating that levels of protection were higher before 1994. The same does not happen, though, with subsidies; “WTO dummy” is not significant on “State support” As figure 14 in the annex shows, state support – presented in terms of BNDES favored loans - presents a more linear and stable pattern along the years. It is noticeable that these subsidies increased mildly along the years, towards the end of the 1990s and early 2000s, with the exception of “Transport equipment” which stands out as the main recipient of BNDES loans since late 1990s. In the regressions in Model 03 and Model 04, with the shorter time series (1988-99), “WTO dummy” enters very significant effect on “Tariffs”, but has no effect on “Support”, as well.

Finally, the trade variables present different outcomes with “Tariffs” and “Subsidies” as the dependent variable, the latter providing much more robust results. In Model 01, though, some of results do support my hypothesis. “Import Share” and “Western Hemisphere Intra-industry trade” depict statistically significant results with the

predicted positive and negative signs, respectively. In the SUR estimation and with the time trends, the effects on “Import change” are magnified. I support that increased competition from imports would prompt domestic sector to lobby for higher tariffs, whereas sectors with regional trade interests would prefer smaller tariffs. Since SUR estimation improves the efficiency of coefficients, the “Import share” result allows us to infer that increasing competition with foreign goods might explain lobbying reactions from domestic industries. Yet, the relevance of the variable in influencing policies is not as high as factor use shares and collective action (competition/scale) variables. In Model 03, with the exception of the abovementioned, the only trade variable exerting significant effects on “Tariffs”, is “Export share”, which is a significant in the SUR “Year effects” specification, with the predicted negative sign. I support that competitive sectors do not require protection and may, indeed, lobby for liberalization.

These weaker results are not at odds with the findings of the literature, though. In addition to estimation problems (causality and endogeneity), several studies did not document import competition, export orientation and intra-industry trade as significant explanatory variables for protection. Gawande and Krishna (2003) literature review displays a table reporting Baldwin (1985) and Trefler (1993) estimation results, in which trade variables are insignificant, while factor use and concentration indicators are substantive determinants for protection policies - tariffs and NTBs. Conversely, in their study about Mercosur, Olarreaga and Soloaga (1998) variables on import penetration and intra-industry trade do not show statistical significance, though their model suffer from flaws, since, variables change signals in alternative model specifications. In Ferreira (2004), - a non-published study about Brazilian trade policy – import penetration displays

positive and statistical significant effect on both nominal and effective tariffs as dependent variables. However, Ferreira and Fachinni (2005) more recent paper do not use these variables and their regressions focus on competition/concentration variables, which turn out to be robust determinants of tariff policy.

My contribution wishes to stress the importance of: first, policymaking discretion in determining policies in early 1990s, as I have discussed in other chapters; second, the fact that slow changing technological (factor of production used by sectors) and political economy (collective action) aspects explains the high variance of protection among sectors, despite the noticeable drop in average tariffs during the 1990s. My results show that the increasing competition with imports and the increasing internationalization of the Brazilian industrial sectors is a secondary aspect influencing tariff determination. Hence, the assumptions of Ornelas (2005) and Baldwin (2007), who argue that RIA commitments might decrease tariffs toward third parties, are only partially verified by my test. The variable “WH Intra-trade” does display negative and significant, whereas “Mercosur Intra-trade” is insignificant. However, the former may be capturing the effects of the latter.

Regarding the trade variables, it is worth remarking that model specification techniques influenced the results, since I used PCSE with autocorrelation of errors correction. Removing autocorrelation correction from the PCSE regression makes some of the coefficients of trade variables statistically significant, but possibly inefficient and biased. Hence, with this kind time series data, one can not rule out the possibility of serial correlation of errors. I tested my data for serial correlation on and results identified that this problem was present.

For Model 02, though, the estimates reveal the trade effects to be quite robust, especially in the SUR specifications: all trade related variables, with exception of “Import share change” are significant with the predicted signs. Results are also strong with both PCSE and SUR techniques. The negative sign of “Import Share” suggests that sectors experiencing higher import penetration in a given period are less able to obtain subsidies, quite possibly because the firm’s position was already too weak so that they had neither the means nor the will to make much of an effort to secure those subsidies. Sectors experiencing steeper increases in import penetration include some capital intensive industries, which certainly would in other respects be more likely to be successful in obtaining compensation, but also segments such as “Rubber and plastics” and “Textiles and clothing”, whose other characteristics are not favorable to such success. Indeed, these latter experienced a fivefold growth in import penetration in the period, but they are comparatively less concentrated – and probably less politically powerful - and cannot lobby effectively. This suggests that an interaction term between import penetration and collective action variables (scale/competition) might provide important insights about the leverage of sector. In Table 06 – Model 05, I test specifications with interaction terms.

Certain sectors experiencing import penetration are also characterized by high export share (Machinery, Transport equipment, Electrical and electronic equipment), which means that they present high levels of *intra-industry trade* as well. Although “Intra-industry trade Mercosur” is non-significant in the PCSE specifications, it is significant in all SUR ones. “Intra-industry trade Western Hemisphere” does display statistically robust results in all the above-mentioned regressions. Adding time trends interacting with the “regional intra-industry shares” has not changed the coefficients of

the regional intra-trade variables. They continue robust¹¹². This result might suggest that, in fact, sectors experiencing increasing returns to scale and with regional trade participation might be more active in searching benefits and influencing state support policies. These effects may also be enhanced by the size of the market, which is larger in the Western Hemisphere than in Mercosur. The very robust results for trade variables in the SUR specification, in which coefficients are jointly calculated and are more efficient, indicate that intra-industry and regional trade are important forces behind state supporting policies. In fact, as I will discuss in the next section, certain sectors have great participation in regional trade flows.

Results of the alternative model in Table 04 and 05, regressions with PCSE and SUR techniques, with data from 1988-1999 and including Herfindhal index – supposedly a more efficient benchmark to measure market power –, do not portray very different figures from the models with longer time series. Herfindhal index is insignificant in all regressions on “Tariffs”; however it does exert a significant and negative effect on “State support” in the “Baseline” SUR regression in Model 04. This counter intuitive outcome probably reflects the decrease in subsidies in the mid-1990s, which has affected even sectors with concentrated “market shares”. The result, meanwhile, does not hold with the time-trends and dummies. “Scale” is very significant with “Tariffs” as the dependent variable, probably indicating an immediate and defensive response of concentrated and unionized sectors after the initial years of liberalization. Likewise in Model 04, this variable exerts a negative and significant effect on “State support”, suggesting that

¹¹² Two new variables are created and added to the specification. The time trends are two dummies coded with ordinal number beginning with 01 after 1995 and after 1997, till 2005. These dummies are interacted with “Mercosur Intra-industry share” and “with Western Hemisphere Intra-Industry share”, respectively. Their coefficients are not statistically different from 0, meaning that time trends do not influence the “dependent variables” and the coefficients of the “intra-industry trade shares” remain robust.

powerful sectors have fewer incentives to act upon subsidies compared to tariffs. Of note, the very significant result of “Capital-Labor ratio” on subsidies; and “Labor intensity” on tariffs. Finally, the performance of trade related variables with State Support as the dependent variable, with the exception of “Import share change”, is robust as well. These results might be capturing the initial trade liberalization drive and the creation of Mercosur itself, when export orientation increased a great deal.

Finally, in order to check for the joint effects of trade share variables (import share and export share) and the characteristics favorable of to collective action (scale/competition), I test specifications with interaction terms (“Import share” x “Scale” and “Import share” x “Concentration” on “Tariffs”; “Export share” x “Scale” and “Export share” x “Concentration” on “State support”; and all four interaction variables simultaneously on both dependent variables), for the longer series (1988-2005) with the PCSE and SUR techniques. These results help us to verify the hypothesis that economic powerful sectors (or those with more active unions) experiencing import penetration might have higher capacity to influence tariff policy. Conversely, higher exporting shares interacting with “Scale” and “Competition, might indicate that sectors might be able exert more leverage on industrial subsidies policy. Results displayed in Table 05 show that the interaction terms do not have effect on “Tariffs”. Only the interaction variable between exports and competition has statistical significance on “State Support” in the SUR specifications), with a negative sign. This rather counterintuitive result suggests that less concentrated exporting sectors demand less subsidies, which might reflect the fact that sectors with numerous firms, such as “Textiles and Clothing”, “Food Products” and “Metallurgical Products” are important exporters, but do not receive as much

governmental financial assistance as concentrated segments, such as “Electronic and Electric equipments” and “Transport Equipment”, which are also important exporters.

Table 18: Model 05 - Dependent variables - Nominal Tariff and State Support share, 1988-2005, with interaction terms.

Estimation Technique	PCSE	PCSE	SUR	SUR
Variable	Nominal Tariff	State Support	Nominal Tariff	State Support
Export Share	0.079 (0.37)	0.133 (1.25)	0.730 (1.64)	0.256* (2.27)
Import Share	0.547* (2.10)	-0.072 (-1.46)	0.559 (-1.43)	-0.309** (-3.12)
Intra-industry trade Mercosur	2.980 (1.29)	0.961 (1.55)	4.578 (1.91)	1.862** (3.06)
Intra-industry trade Western Hemisphere	-8.519* (-2.32)	1.979 (1.95)	-9.125** (-2.84)	2.691*** (3.30)
Capital-Labor ratio	-0.098* (-2.15)	0.052*** (4.09)	-0.097** (-3.14)	0.054*** (6.81)
Capital Intensity	19.607** (3.15)	0.727 (0.58)	24.388*** (4.43)	0.272 (0.19)
Labor Intensity	42.526 (1.27)	-1.575 (-0.28)	59.597** (2.26)	-6.945 (-1.22)
Tech	-5.905 (-1.67)	0.868 (0.75)	-8.997** (-2.80)	2.665** (3.27)
Scale lagged	0.133*** (4.16)	-0.005 (-0.52)	0.172*** (7.07)	-0.028*** (-4.47)
Concentration lagged	-32.176 (-1.27)	36.359*** (3.97)	-16.727 (-0.51)	37.287*** (4.45)
Scale x Import Share	-0.025 (-1.63)	-0.006 (-0.23)	- -	0.011 (1.59)
Concentration x Import Share	-4.482 (-1.24)	-6.200 (-1.46)	- -	-0.002 (-0.21)
Scale x Export Share	0.001 (0.11)	-0.053 (-1.56)	- -	1.201 (1.11)
Concentration x Export Share	-0.777 (-1.50)	-2.405 (-1.01)	- -	-1.207* (-2.00)
N. Observations	170	170	170	170
R-Squared	0.558	0.376	0.4476	0.6951
Wald	42.42	45.57	137.75	387.59

legend: * p<0.05; ** p<0.01; *** p<0.001, t-statistics in parenthesis below coefficients.

Summing up, overall, results show that the degree of factor share use by industries and collective action variables are important variables influencing both “Tariffs” and “State support”, whereas trade shares act more intensively upon “State support”. This pattern was somewhat maintained in the several specifications, albeit there are some small variations. These results confirm the H-O/S-S assumptions. However, there are some qualifications. “Capital” exerts more pressure over subsidies rather than tariffs; and it is noticeable an increasingly protection of labor intensive industries. Additionally, industrial concentration and scale (collective action characteristics) are significant intervening variables, explaining differences in protection and support across sectors but, while the latter acts upon tariffs the former influences only subsidies. The theories that remark the importance of exporting interest, especially in a regional integration framework, are also consistent with the tests. Factor use variables can be considered exogenous, relating to long run characteristics of economic sectors, based on factor endowments of the Brazilian economy - while competition and trade related variable can be somewhat endogenous to the policies (the reason why they were lagged in the models). Finally, the time trends and WTO dummy are extremely important variable to explain the variations in the policies over time, reflecting the policy shocks of the 1990s. My interest was to explain the changes in the dependent variables over time and the variance in the benefits received by the different sectors. The use of a simultaneous equation framework also allowed me to tackle, from a methodological point of view, the clear complementarities between the two policies – tariffs and state subsidies. In the next section, I elaborate on Brazil’s national trade strategy.

Section III - Brazilian trade balance structure and destination 1990-2005

This section adopts a more descriptive approach. I discuss trade balance trends and destination of Brazil from 1990 to 2005. I comment on the recent debate about the political economy of trade liberalization, industrial policy and manufacturing exports. I also examine some macroeconomic implications and I comment on how these trends relate the trade strategy options for the country. Finally, I relate the picture presented in this section to the econometric results of the previous section.

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Brazil's trade openness and export performance have been improving in the 2000s (figures 3 and 4, Chapter 01), providing mounting trade and current account surpluses, thus building up financial stability. Simply taken, the trade surplus can be credited to the booming world economy, and in particular the demand for primary commodities coming from China¹¹³. In the more recent picture, influenced by the international financial crises, there are some not so positive trends, but overall the foreign trade of the country is in good stance, as I will discuss with the in table 07. Despite world demand, strategies aimed at expanding foreign markets and diversifying exports should not be taken for granted. Bonelli and Pinheiro (2007a) point to the importance of policy with respect to industries such as aircraft and cell phones, which benefited from governmental support in the past and are now standout sectors in the recent export drive of Brazil. These industries are characterized by a high flow of components and outsourcing of services, contributing to domestic local economy. Hence, the positive aspect of increasing manufacturing

¹¹³ Bonelli and Pinheiro (2007b) present empirical results suggesting the world demand has been the major force behind recent Brazilian trade balance increase.

exports relates to industrial complementarities and technological spillovers. From this point of view, the support to manufacturing industries paid off.

On the other hand, industrial policies have by no means been universally successful. Ferreira (2005) argues that industrial policy *per se* is neither necessary, nor sufficient condition for economic growth. He comments that countries with high participation of commodities in exports, such as Australia and Norway, have high income per capita. These countries were able to climb the technology ladder and to add value to natural resources based exports (CEPAL 2006, chapter 04). He also points out that the experience of East Asian Tigers, perhaps the most successful example of industrial policy and export promotion, was accompanied by several other prudent policies, such as macroeconomic and fiscal balance and educational upgrading. Abreu (2005), as well, draws attention to the complementarity between of macroeconomic policies – such as fiscal balance, low inflation and favorable (not overvalued) exchange rates– and a successful industrial strategy¹¹⁴.

Brazil has adopted a piecemeal approach toward trade liberalization using tariff protection and state support as complementary policies, similarly to what the successful East Asian Tigers and China had done earlier. Yet, the growth record of Brazil, as well of Latin America as a whole, is decidedly inferior to that of the Asian countries (Figures 6 and 7, Chapter 02). The macroeconomic result of the country in the 2000s was enhanced by the vigorous boost in foreign trade, contributing to price stability and the accumulation of dollar reserves. Notwithstanding the macroeconomic improvement, Brazilian trade performance cannot be compared with more successful countries. Lall, Albaladejo and Moreira (2007) describe the lackluster presence of Latin American countries in

¹¹⁴ In that line, these Brazilian authors endorse the opinion of Rodrik (1996), see chapter 2.

international trade vis-à-vis East Asian and China in the last two decades (1990s and 2000s), particularly in more knowledge intensive sectors. With the exception of Mexico, which benefits from a preferential trade agreement with the U.S. and Canada under NAFTA, other L.A. countries were not able to tap into competitive markets and to expand their portfolio of manufactured goods. Brazil is in an intermediate point because it was able to climb the technology ladder of its exports. Still, as Moreira (2007) argues, Brazil is currently experiencing a trend, toward a return to natural resource-based exports after “manufacturing export overshoot” in the previous decades, just like other Latin American countries. In sum, after years of ISI and OEI policies in Latin America, declining export dynamism causes apprehension on the part of serious commentators (Ocampo and Martin, 2003: chapter 2).

Critics in certain academic and industrial circles defend that “de-industrializing” trade liberalization, combined with privatization and deregulation, weakened the capacity of the state to use policies to increase domestic competitiveness. Structural reforms exposed industrial sectors to excessive competition, but economic benefits of these adjustments were small¹¹⁵. The recent upsurge of commodity exports has triggered reactions from these groups, claiming that the country is experiencing a process of “Dutch disease” – nominal exchange rate overvaluation harming manufacturing exports competitiveness. The influx of dollars is caused not only by booming world demand for commodities in international markets but also by high domestic interest rates. As a consequence, Brazil and other L.A. countries are said to end up specializing in commodity-based export economies. Although the macroeconomics of Brazil is evidently

115 In fact, from 1990 to 2000, economic growth in Latin America stands at 2.9 per cent per year and at a meager 2.8 in per capita terms in Brazil (WDI 2007).

in better shape than in the late 1980s, when structural reforms started, this “commodity based” trade specialization would not be suitable for the country because it would displace industrial economic sectors, causing harsh economic adjustments.

The whole rationale toward avoiding deep integration commitments with advanced markets, both at the WTO, and at the regional (FTAA) and trans-regional agreements (UE-Mercosur), relies on the logic that liberalization is beneficial to certain economic interests, but not to the national economy as whole, because the country would end up specializing in primary goods. The concern of negotiators to include provisions such as domestic content of “government procurement” in the European Union-Mercosur negotiations, for instance, is based on the premise that trade agreements should be used as an instrument of industrial policy development.

Recent evidence, however, does not support the thesis of “de-industrialization” and an objective view of the trade balance must take into consideration several other factors, including macroeconomic aspects and world economy developments. First, Brazil has been a major exporter of manufactures since late 1970s and it has a rather diversified export portfolio, both in terms of factor and technology intensity of goods and market destinations (Figures 15 and 16, data from CEPAL 2006). The numbers (not reported) behind the graphs show that the country remains an important exporter of manufactures, even after the *neoliberal* reforms of the last two decades and the recent nominal exchange rate overvaluation. For instance, processed food and beverages, vehicles, machinery and mechanical equipment, iron and steel account for almost 50 percent of shipments, or almost US\$ 58 billion, in 2005. The data from CEPAL depicts the export portfolio of the country keeping similar shares between 1990 and 2005, even experiencing a gradual

trend toward technological upgrading¹¹⁶. For example, middle technology goods were 25.7 percent in 1990 and 33.2 percent in 2005 of total exports. The performance of high technology exports was also far from insignificant: the value of sales increased eight fold, from US\$ 1.3 billion to US\$ 9.5 billion, from 4.3 percent in 1990 to 8 percent of in 2005. It is also true that Brazil widened its deficit in high technology goods – from US\$ 1.8 billion to US\$7.1 billion, while keeping its surplus in primary goods. During the nineties, this deficit was even wider and included mid-tech goods, this segment reversed the trend, picked up by the end of the period and experienced a surplus of 5-6 US\$ billions in 2003-2005.

Figures 15 and 16 also portray important messages about Brazilian trade relations with different countries and regions of the world. They indicate that, whereas Brazil is a global player in primary goods, it is a regional player in industrial goods, including high-tech exports. Brazil experiences trade surplus in mid tech and high tech industrial goods with Latin America, which is a consequence of being one of the most industrialized countries in the region and of the preferential trade arrangements under the Latin American Development Association (ALADI) and with Mercosur countries. It also reflects the fact that Brazilian industrial sectors do present some level of competitiveness in the region. Brazil sells mid and high technology goods (electronics) and durable consumer goods (appliances, automobiles) to Latin America, while it imports primary goods from the region, e.g. natural gas from Bolivia. Low technology industrial goods, such as textiles and apparel, are also an important part of the country's hemispheric exports. The same pattern of exports happens with the U.S., adding the fact that Brazil is a large supplier of high tech goods to that market, selling items such as middle size

¹¹⁶ In the graphs, I merge middle and high technology sectors in order to make series and results more visible.

aircraft and machinery, while imports from the U.S. comprise value added goods, such as chemicals and pharmaceuticals, electronics and machinery and parts. There is a large content of intra-industry trade with the U.S. as well.

In contrast, in its transactions with the European Union and Asian Pacific 10, which includes the highly competitive East Asian Tigers, Brazil experiences a deficit in high-tech and mid-tech goods, though it has a small surplus in low-tech with Europe and mid-tech with Asia Pacific 10. Trade with Europe happens along “*neo-colonial*” lines: Brazil exporting primary or natural resources based industrialized goods, while it imports industrial goods. In the Asian markets, there is strong presence of mineral ores in the Brazilian export portfolio. The pattern of transactions with China and Japan reflects this natural resource specialization: Brazil sells primary goods (soy, iron ores), while it buys technological consumer goods, such as electronics, but also low-tech goods, such as toys. Note the impressive upsurge in the commerce with China between 1990 and 2005. The trade barely reached US\$ 500 million in 1990, but climbed to US\$ 11 billion in 2005. This surge is a consequence of the extraordinary growth of China during the 1990s, and its huge demand for raw materials and commodities.

Brazilian foreign policy initiatives toward China and other “South” countries date back from the 1960s and 1970s when the military government promoted an “independent foreign policy”, to detach the country from a Cold War international order. In the case of China, Brazil reestablished diplomatic ties with that country in the 1970s. In 1988, the first Brazilian civilian president after 20 years of authoritarian regime, visited that country, symbolizing this rapprochement. Hence the upsurge of these flows can also be viewed as a consequence of foreign policy measures. Despite foreign policy initiatives,

the flood of low-tech manufactures from that country and the constant trade deficits, might explain why the “Labor intensity” variable in the econometrics tests presented positive and significant effect on the level of protection, “Nominal tariffs”. Besides, although Brazil recognized China as a market economy in 2004, this country is the subject of several recent anti-dumping investigations and measures under the Brazilian Trade and Industry Ministry (MDIC).

Transactions with the rest of the world – in the chart “Other” - are characterized by a relative stagnation of industrial goods exports and by a steady increase in natural resources based goods since 2000. This group includes Russia – which is an important buyer of processed agricultural products -, and African and MENA countries. Regarding these last two groups; Brazil had a very active foreign economic policy toward them during the 1970s-80s, seeking to sell manufactured capital intensive goods (e.g. weapons, aircraft) and services (engineering). These countries were one the first outlets of Brazilian value added exports. The 1980s debt crisis, the ensuing troubled state budgetary balance in Brazil, and security problems in that region, such as civil wars in Africa and the Gulf War in the Middle East, disrupted these connections. After years of meager trade flows, Brazilian commercial diplomacy is seeking to reestablish political and economic ties with those countries.

The bottom right chart in figure 16 “World”- aggregate trade with the entire world – is very indicative. It expresses Brazilian comparative advantages and structure of specialization in the world economy: due to factor endowments, the country is a main export of primary and natural resources based industrial goods, as well as of low technology industrial goods, and it has a small deficit in mid and high-tech goods (300

millions) in 2005. The well established industrial exporting capacity does not prevent a country from being a net consumer of high-tech goods, which is understandable since several high-tech goods used as capital goods have been experiencing an import boom since liberalization in the 1990s. The recent overvaluation of nominal exchange rate in the early 2000s has been also stimulating the purchase of these capital goods by Brazilian firms. Commentators and authorities acknowledge this as a positive tendency since firms are investing in productive capacity.

However, the apparent diversification of destinations conceals structural shortcomings. Brazilian exports of high/middle technology industrial goods are confined to the Western Hemisphere region, where they benefit from tariff preferences under ALADI and Mercosur, while exports to the rest of the world are indeed “commodity based” (Moreira 2007). In the technology segments, Brazil and other Latin American countries have been losing market shares to China, both worldwide and in the Western Hemisphere (Barbosa et al 2004, Schott 2006, FIESP 2007, Moreira 2007)¹¹⁷.

In short, although industrial exports are regionally concentrated, because of tariffs preferences, this reveals a degree of competitiveness and localization advantages. Overall, the country maintained the participation of value added goods in its trade portfolio. It is worth stressing, however, that much of the industrial exports to North America is by foreign owned enterprises - with the exception of EMBRAER, the Brazilian aircraft company - and intra-sectoral flows, carried out by multinational also contribute to a high bulk of the Mercosur trade

¹¹⁷ The example of Mexico is remarkable, as this country’s manufacturing exports, even possessing a FTA with Canada and the U.S. , have been substantially displaced by Chinese goods in the North American market (Wise and Quiliconi 2007).

There are some additional questions that must be addressed in order to clarify the debate about trade liberalization and industrial exports. First, the high demand for commodities coming from emerging economies is benefiting the Brazilian economy, which has comparative advantage in producing these goods. Trade among developing countries is growing quite satisfactorily. For example, between 1997 and 2005, while world trade grew at 6.6 percent rate, the growth rate of developing countries trade reached 9.0 percent surpassing advanced countries by 3.2 percentage points (WDI 2007). Due to the high demand from large emerging market economies – China and Russia - Brazil is benefiting from positive terms of trade gains in its products. Therefore, the surge in “commodity based” exports is a very good response to world economy situation. Secondly, there are some value added and capital intensive goods which stand out in the recent export drive, for example, transport equipment. Third, some of the new commodity based exports do include a fair degree of value added, such as processed food, which despite being natural resource based manufactures, include several integrated production chains.

Table 7 below presents a nuanced picture of recent Brazilian trade balance after the liberalization and reforms of the 1990s. It comprises four distinct periods and four groups of products¹¹⁸. According to the table, terms of trade per se are not the only force behind surpluses. If one looks to the first period (93-94 to 97-98) despite relatively favorable prices of exports, there were ubiquitous deficits, lasting until the phasing out of tariffs and overvalued nominal exchange rate. This period was also characterized by a steep increase in domestic demand that deviated production to the domestic market.

¹¹⁸ The goods presented in the table are classified accordingly to CNAE/IBGE; however, they differ from the 10 sectors presented in the regressions because I merged some sectors for data necessity. See Annex, methodologies of construction of variables.

Between 97-98 and 01-02, in the aftermath of the Asian crisis, export value was influenced by steep downward price swings but the floating exchange rates benefited and the period was characterized by surpluses. From 01-02 to 05-06, despite relative overvaluation of the currency and less favorable than expected terms of trade (only 1.9 percentage variation in the period) there has remained a consistent surplus. The exchange rate appreciation caused Brazilian products to become more expensive in world markets and the low prices for Brazilian exports should shrink trade surplus margins. Yet, the huge demand coming from international markets (China) benefited several Brazilian products (“Mining and Quarrying” in especial, but also non-processed agricultural commodities). Finally, in the last phase (05-06-07-08), it is noticeable a decrease in the rate of growth of the surpluses, despite the increase in terms of trade (3.9 percent), probably capturing the impact of international financial crisis, in the second half of 2008. Out of this there would seem to be four distinct groups of sectors: those with *high surplus*, *new surplus*, *low deficits* and *high deficits*. Among those experiencing surplus, the traditional agrarian and natural resource based goods in which the country has comparative advantage, but also some industrialized mid- and high-tech goods such as transport equipment and electrical equipment, and labor intensive textiles and furniture. Among deficit sectors, the predominance is of high- and mid-tech goods (pharmaceuticals, machinery, and electronics) as well as oil, chemicals and related. It is clear, however, the deficit of the new surplus sectors in the last period.

Table 19 also explains the wide variation in figures IV-6 and IV-7. The swings are related to variations in terms of trade and nominal exchange rates, which were particularly acute in destinations where the trade portfolio depended on a narrow range of

products experiencing changes in relative prices, for instance, panels “Other” and “Asia Pacific 10”.

Summing up, table 19 provides a more complex picture of commercial balance in which several capital intensive manufacturing goods are indeed experiencing deficits but the country also presents surplus in new emerging sectors, besides the highly competitive “natural resources based” sectors. Hence, the idea of an export concentration in agricultural and mineral commodities is not empirically verified. Furthermore, in addition to comparative advantage, some sectors experiencing surpluses have indeed benefited from domestic policies, namely, BNDES loans. Figure 14 in the annex shows that there has been a steady influx of subsidies. Although the graph depicts figures with a higher level of aggregation, food products, metallurgical products and transport equipments are among the main recipients of subsidies. Hence, despite the reforms of the 1990s, one can not declare that industrial policy instruments disappeared in the period. Quite to the contrary, figure 14 shows steady figures in constant U.S. dollars.

Table 19: Variation in Trade Balance and in Terms of Trade per sector, selected years.

	Trade balance ¹ (US\$ millions)				Terms of trade variation ² (%)			
	97-98/93-94	01-02/97-98	05-06/01-02	08-07/05-06	97-98/93-94	01-02/97-98	05-06/01-02	07-08/05-06
High surplus	2,229.70	3,474.90	30,735.00	75,402.20	-	-	-	-
Mining and quarrying	733	120.6	5,524.80	19,903.1	-22	10.2	-30.6	1.36
Meatpacking	108.3	1,583.00	5,161.10	16,506.5	-21.9	14.2	-14.6	-22.66
Steel	-862.8	-250.9	4,769.90	8,303.7	9.9	-11	-1.8	16.63
Agriculture	706.9	1,557.30	2,995.00	15,966.0	16.6	1	-0.8	6.43
Sugar	976.7	336	2,854.50	5,530.6	-	-	-	-
Furniture and timber	91.8	765.4	1,882.20	3,387.4	68.4	-6.3	3.6	-7.75
Vegetable oils	251.7	15.2	1,101.20	7,099.1	-4.5	14.3	-23.7	11.93
Shoes and leather	-86.8	473.8	1,010.80	3,717.6	3.2	-4	24.6	12.16
Coffee	904.2	-1,559.50	1,745.70	5,498.9	-	-	-	-
Paper, printing and publishing	-620.5	701.9	1,333.70	4,643.6	21.1	-23.6	-11.5	13.95
Processed vegetable products	354.8	-283.8	1,356.40	3,709.6	3.7	-7.3	13.1	-14.01
Non-ferrous metallurgical products	-327.5	16.1	1,000.00	1,089.2	9.3	0.3	-13.9	-8.33
Newsurplus	-5,366.70	5,660.40	8,459.60	-2,518.2				
Automobiles, trucks, buses	-988.1	1,975.20	3,630.40	-411.7	10.4	-12.4	-6	11.02
Parts, components and other vehicles	-1,192.80	2,171.50	1,865.30	364.1	43.1	20	-9.8	3.24
Textile	-633.2	928.1	373.2	-912.8	16.4	-6.1	9.3	-0.58
Non-metal mineral products	-266.7	212.6	381.6	-101.2	24.6	-4.9	3.5	12.34
Other food products	-863.4	889.3	183.1	57.0	0.1	-4.8	-3.1	-3.87
Electrical products	-1,422.60	-516.3	2,026.20	-1,513.6	67.1	-15.2	28.5	3.52
Low deficits	-1,874.50	880.4	-59.3	-3,176.6				
Dairy industry	-284.7	292.2	171.5	391.3	-	-	-	-
Apparel and clothing	-303.6	155.7	-138.3	-756.3	-	-	-	-
Rubber	-285.2	3.8	-88.3	-935.2	42.2	-10	-8	5.78
Plastics	-243.1	104.1	-43.1	-532.6	-	-	-	-
Other metallurgical products	-757.9	324.7	38.7	-1,343.8	86.2	-17.1	33.6	13.60
High deficits	-14,060.80	4,197.80	-2,886.20	-69,059.10				
Chemicals	-744.3	281.4	1,104.90	-1,976.50	15.5	-0.9	29.8	3.44
Machinery and tractors	-4,412.60	1,904.40	2,701.20	-9,788.10	50.8	-6.6	3.8	13.66
Pharmaceuticals and perfumery	-1,030.90	-200.1	-470.8	-5,203.90	-	-	-	-
Miscellaneous industries	-1,236.10	357.8	-1,117.70	-	51.1	-5.8	-3.2	28.86
Oil refining and petrochemicals	-2,094.60	103.9	438.7	-16,183.40	-1.2	-7.5	5.7	-4.11
Miscellaneous chemicals	-809.6	-313.5	-1,252.80	-13,383.20	17.1	-6.8	-12.6	-17.19
Oil and coal	-376.8	526.2	-1,600.70	-6,028.10	15.7	-32.7	1.7	15.58
Electronic equipment	-3,356.00	1,537.70	-2,689.10	-16,485.90	33.8	13.9	-37.1	3.5
Total(1)	-18,607.50	14,610.50	37,530.00	20,548.80	24.1	-12.2	1.9	3.8

Source: Funcex/Ribeiro (2008)

(1) Total balance differs from the sum of sector surpluses due to the non-inclusion of a small number of non-classified products.

(2) There are six sectors in which price indexes of exports and imports are not calculated, therefore, it is not possible to get terms of trade

How figures 15 and 16 and table 19 relate to the econometric results?

First, it is important to remark the methodological differences between the 10 sectors used in the regressions and the classification of CEPAL (2006) and Ribeiro/FUNCEX (2008). Besides, table 19 and figures 15 and 16 encompass agricultural goods and non-processed minerals, which I do not include in the statistical exercise. Still, some insights can be extracted from these comparisons. Overall, capital intensive industries have experienced deficits, but also some important surpluses (automobiles and parts). These sectors are important recipients of state support. As the regressions showed, the political economy of protection in Brazil tends to protect capital intensive sectors, despite liberalization in the 1990s. Competitive sectors, based on natural resources, do not require as much protection but are also important recipients of state support, for example “Food products”. Conversely, according to table 19, some labor intensive industries, such as “Plastics and Rubber” and “Clothing and Apparel” experienced deficits in the period. Tariff protection was recently raised in these labor intensive industries. These industries are suffering from trade liberalization adjustments and from the competition with Chinese goods. This is the reason why my results showed the very significant effects of the variable “Labor intensity” on the dependent variable “Tariffs”¹¹⁹. The causation might not be so recent because, “labor intensive” industries account for protection even with the results with data from 1988 to 1999. But it was precisely in this period that “Apparel and Textiles” and “Rubber and Plastics” – labor intensive industries – experienced a fivefold increase in import penetration

¹¹⁹ Although my data did not comprise recent measures, in 2007, CAMEX proposed modification to the TEC to increase protection of clothing and apparel, among other labor intensive industries. These segments now have applied rates of 35 percent, the WTO upper ceiling.

I support that trade policies are explained more in terms of factors share used by sectors and by political economy factors (collective action/market power) rather than contemporary shifts in trade balance. Nevertheless, results in Model 02 showed statistical relationship between trade shares and subsidies. Regional intra-industry trade indexes seem to play a role in state support. Conversely, capital/technological intensive exports are regionally concentrated, as showed in figures 15 and 16. These capital intensive sectors are included in the *new surplus* group in table 19. Hence, there is a connection between participation of these sectors in regional markets, their trade surplus and the level of state support. The direction of causation, to my point of view, is from intra-regional trade interests to subsidies.

Section IV - Conclusion

This chapter aimed to provide a quantitative picture of the differences among industrial groups, regarding trade policies, seeking to understand the political economy factors that have been hindering further Brazilian trade integration toward developed markets. It also commented on some recent foreign trade trends of the country. The picture that can be extracted from this exercise is that the political economy of trade policy is still characterized by a level of “dirigisme” and “protection”. This posture partially explains Brazil’s cautions trade liberalization proposals in world trade negotiations, particularly, when these commercial agreements involve surrendering domestic mechanisms to support industrial sectors and integration with advanced markets.

Brazil has reaped important economic gains after the major push toward trade liberalization and structural reforms of the 1990s, such as taming skyrocketing inflation, correcting current account deficits and amassing dollar reserves. Microeconomic benefits are also reported in the literature showing gains in productivity (Ferreira and Rossi 2003, López-Cordova and Mesquita Moreira 2005). These real and supposed benefits were not enough to convince social actors about the benefits of further trade liberalization and integration. For the broad public, trade integration with advanced markets – the U.S. and the E.U. – may not be associated with alleged deleterious effects of globalization, such as unemployment,; but domestic constituents are not interested and do not join these highly abstract discussions about the trade strategy of the country. As a consequence, policymaking discretion drives the process and because this is influenced by long-standing worldviews, the deeper trade commitments remained stalled.

Economic and social actors do not regard trade as a zero-sum game, but there are not trade liberalization oriented lobbies. This attitude, in a certain way, benefits interest groups, due to absence of debate about further trade liberalization. My regressions showed this reactive position of economic sectors, as both labor and capital intensive industries lobby for protection/support. Finally, there is an offsetting effect of the decrease in tariffs toward enhancing subsidies to capital intensive industries. This is, to my point of view, the utmost explanation for the cautious commitment of the country to “North-South” integration processes.

I conclude this dissertation commenting on the possible trade policy choices for Brazil in a situation of breakdown of the multilateral world trade negotiations at the WTO and the stalled North-South discussions in the FTAA and European-Union-Mercosur

Agreements, amid world financial crisis that might trigger widespread protectionist interests.

Section V - Methodological Annex

Data sources and methodology for construction of variables.

Data for the 10 manufacturing sectors identified in table 20 were obtained from the Annual Industrial Survey (PIA), from the Brazilian Institute of Statistics and Geography (IBGE), in a two digit level categorization, *National Classification of Economic Activities* (CNAE). CNAE is similar to the two-digit Standard International Classification (SIC). For data equivalence purposes, I have merged some lines. For an explanation of Brazilian manufacturing sectors classification and their equivalence with U.S. classification (NAIC and SIC), see Professor Marc-Andreas Muendler web-page (<http://econ.ucsd.edu/muendler/>) and Muendler (2001).

Exports and Imports by technological content – The graphs in figures 15 and 16 below use data from Economic Commission for the Latin America and the Caribbean-CEPAL (2006) and Lall et al (2007). Products classified according to incorporated technological intensity, Standard International Trade Classification – SITC, Version 2, are divided in: Primary Goods, Natural Resources Based Manufactured Goods, Low Technology Manufactured Goods; Middle Technology Manufactured Goods; High Technology Manufactured Goods.

Dependent variables

Nominal Tariffs - This is a proxy for protection, it comes from Arruda de Almeida (2004) and from the World Integrated Trade Solution (WITS), software developed by the World Bank and the United Nations Conference on Trade and Development (UNCTAD) (www.wits.org). From 1986-1988, I use data from Arruda de Almeida; from 1989-2005, data comes from WITS. Sectors are in CNAE/IBGE classification and two digits

Standard International Classification (SIC). *Effective Tariffs* data is from Abreu 2004b, Kume, Piani and Souza (2000) and Kume, Piani and Miranda (2003). Effective tariffs series were built by these authors using input-output tables for the Brazilian economy. It is worth noticing that the Brazilian consolidated nominal tariffs are subject to several exceptions under the Mercosur Common External Tariff (CET), thus, at this level of aggregation, *effective tariffs* would make more economic sense in order to gauge each sector's political economy differences, however, since this series is shorter I opted for nominal tariffs.

State Support Share – This is a proxy for industrial policies. This series measures subsidies - in terms of loans of the National Bank for Economic Development (BNDES) received by the 10 manufacturing sector divided by value of production in each sector from 1986-2005. Values for production come from FUNCEX/IBGE. Values for state support are disbursements (loans) of the Brazilian National Bank for Economic and Social Development (BNDES). These figures come from the Ministry of Finance, the Ministry of Industry and Development, the BNDES itself and Batista (2002). This last author is the only source for BNDES disbursements between 1986 and 1989. Values in constant 2005 US\$ dollars.

Explanatory Variables

Trade Orientation variables – Data source Center for Foreign Trade Studies Foundation – (FUNCEX). Downloadable at www.funcex.com.br:

Export share - This series measure the share of domestic sector output that goes to exports, in percentage points, using current US\$ dollars, from 1986-2005.

Import share - This series measures the share of the domestic demand supplied by imports, also called by the literature as “import penetration”, in percentage points, using current US\$ dollars. It covers 1986-2005.

Imported Inputs Share– Value of imported inputs by each domestic sector divided by the production in each sector. Inputs comprise both primary and intermediate goods. Data is in percentage points and in 2005 US\$ dollars. This series covers only 1990-2005.

Intra-industry regional trade indexes – these series were built using the Grubel-Lloyd index of intra-industry trade, which measures the amount of each sector transactions within a given region, with data of imports and exports from FUNCEX. The formula for this index is: $1 - [| \text{exports} - \text{imports} | / (\text{exports} + \text{imports})]$. I measure the exports and imports within Mercosur and within the Western Hemisphere separated.

Factor endowments variables.

Capital-Labor Ratio – I built this series to create a *proxy* for the relative proportion of capital to labor in each industrial sector. They were obtained with data from the PIA/IBGE. For labor, I use employed personnel per sector, end of year. For capital, I use fixed assets (*ativo imobilizado*) per sector, which comprises real state, buildings, machinery and inventories etc. This is a measure of “capital stock”, end of the year. There are substantial methodological differences along the years in the Brazilian data. Data from 1988-1995 comes from table 2221 of the PIA; data from 1996-2005 comes from table 1732 of PIA. Muendler (2001) uses this same data from the PIA/IBGE. Alternatively, I have data on the Capital-Labor Ratio for the USA, using the series from the Bureau of Economic Research (BEA/USA): for capital, “Historical-Cost Net Stock of

Private Fixed Assets by Industry”, capital stock in billion of dollars end of the year; for labor, “Gross-Domestic-Product-by-Industry Accounts - Full-Time and Part-Time Employees by Industry“. Since series for capital stock in Brazil were subject to these methodological changes, I found more reliable to use the USA series.

Capital Intensity– This variable was built with data of the PIA/IBGE is the ratio of fixed assets to industrial output in each sector. Data from 1988-1995 comes from table 2221 of the PIA; data from 1996-2005 comes from table 1732 of PIA, and they have changes in methodologies. This variable is a ratio in decimal units. Both numerator and denominator are in 2005 US\$ dollars.

Labor intensity– this variable was built with data of the PIA/IBGE is the share of expenses with wages to value added in production process. Data from 1988-1995 comes from table 2221 of the PIA; data from 1996-2005 comes from table 1732 of PIA, and they have changes in methodologies. Numerator and denominator are in the Brazilian currency of the time, thus, the number is a ratio in decimal units.

Skill Intensity– this variable, with data of the PIA/IBGE, is the share of wages to total employment in each sector. Data from 1988-1995 comes from table 2221 of the PIA; data from 1996-2005 comes from table 1732 of PIA, and they have changes in methodologies. The numerator (wages) is in constant 2005 Brazilian R\$, the denominator is the number of employees, end of the year. The number is a ratio in decimal units.

Dummy for technology intensive sectors – This variable sets the value of 1 to electrical and electronic equipment, transport equipment and chemical and pharmaceuticals – sectors considered high technology by international methodologies - and 0 to all the other sectors.

Industrial Organization/concentration variables

Scale – Employment to number of firms– this series also comes from PIA/IBGE, it depicts the share of employment end of the year to number of establishments in each of the 10 industrial sectors. I use only establishments with more than 20 employees, which are considered middle size companies in the Brazilian methodology. Data from 1988-1995 comes from table 2221 of the PIA; data from 1996-2005 comes from table 1732 of PIA, and they have changes in methodologies. Nicita and Olarreaga (2006) use the same data of concentration for Brazil, in the Trade, Production and Protection database, but their series cover only 1985-1995.

Concentration – this variable, following Olarreaga and Soloaga (1998), is calculated as a ratio between firms in each sector to total firms in the 10 industrial sectors. This variable uses the same sources and tables of Scale.

Herfindhal index - measures the market of share of firms in terms of sales. The closer the number to 1, the more concentrated is the sector. I use data from Resende and Lima (2005) calculated upon sales data, covering 1986-1998. They calculate the Herfindahl concentration index - defined by $H = \sum_i s_i^2$, where s_i stands for the market share of the i -th firm.

Section VI - Tables and Graphs

Table 20: Brazilian effective tariffs, manufacturing sectors (percentage).

	1986-1990	1991-2000
Non-metalic mineral products	50,44	14,34
Metallurgical products	38,64	15,21
Machinery	41,95	20,59
Electrical and electronic equipment	58,72	25,84
Transport equipment	149,80	69,75
Paper, printing and publishing	36,73	11,44
Rubber and plastics	71,50	20,78
Chemical and pharmaceutical products	45,92	11,88
Textiles, clothing and leather	91,73	25,52
Food products	58,69	20,33
Average	64,41	23,57
Standard deviation	34,36	17,02

Source: Kume et al (2003)

Table 21: Summary statistics (all variables).

Variable	Observations	Mean	Standard Deviation	Minimum	Maximum
Effective Tariffs	130	31.103	28.373	6.100	197.850
Nominal Tariffs	180	21.092	12.513	7.977	72.883
State Support Share	180	2.968	3.367	0.290	22.870
Export Share	180	12.125	7.040	1.800	35.350
Import Share	180	10.257	9.503	0.800	48.955
Mercosur Intra-industry	180	0.458	0.303	0.000	0.983
Western Hem. Intra-industry	180	0.524	0.298	0.000	0.994
Capital Labor Ratio	180	72.979	50.968	7.520	278.160
Capital Intensity	180	0.190	0.156	0.020	1.171
Labor Intensity	180	0.154	0.052	0.062	0.303
Skilled Labor	180	0.279	0.112	0.079	0.522
Scale	180	111.702	49.480	56.100	291.100
Concentration	180	0.106	0.072	0.035	0.275
Share of Imported Inputs	150	6.590	5.462	1.190	30.951
Herfindal Index	120	0.155	0.118	0.024	0.680

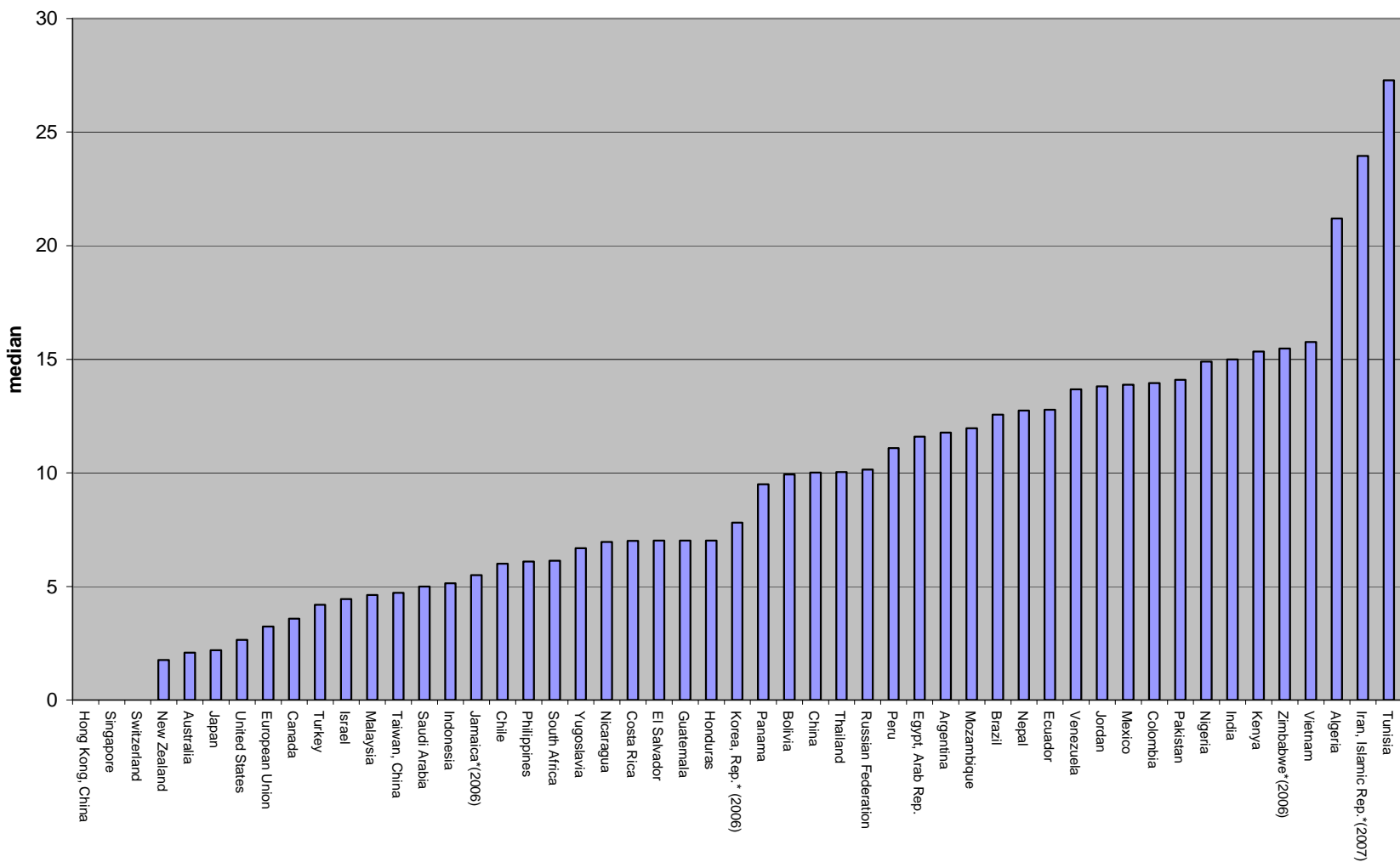
Table 22: Correlation Matrix (variables used in Models 1 and 2)

	Nominal Tariffs	State Support Share	Export Share	Import Share	Mercosur Intra-Industry	Western Hem Intra-Industry	Capital Labor Ratio	Capital Intensity	Labor Intensity	Skilled Labor	Scale	Concentration
Nominal Tariffs	1.000											
State Support Share	-0.106	1.000										
Export Share	-0.033	0.604	1.000									
Import Share	-0.181	0.181	0.371	1.000								
Mercosur Intra-Industry	0.048	0.261	0.148	0.238	1.000							
Western Hem Intra-Industry	-0.077	0.182	0.192	0.426	0.411	1.000						
Capital Labor Ratio	-0.097	0.491	0.401	0.545	0.181	0.038	1.000					
Capital Intensity	0.399	0.174	0.121	-0.253	-0.055	-0.006	-0.173	1.000				
Labor Intensity	-0.086	0.136	0.295	0.172	0.130	-0.125	0.269	-0.351	1.000			
Skilled Labor	0.037	-0.036	-0.145	0.377	0.183	0.335	0.364	-0.095	-0.165	1.000		
Scale	0.355	0.191	0.249	0.157	0.318	0.355	0.379	0.090	-0.094	0.546	1.000	
Concentration	-0.021	0.132	0.307	-0.402	-0.094	-0.060	-0.537	0.291	0.138	-0.677	-0.318	1.000

Table 23: Collinearity diagnosis (variables used in Models 1 and 2).

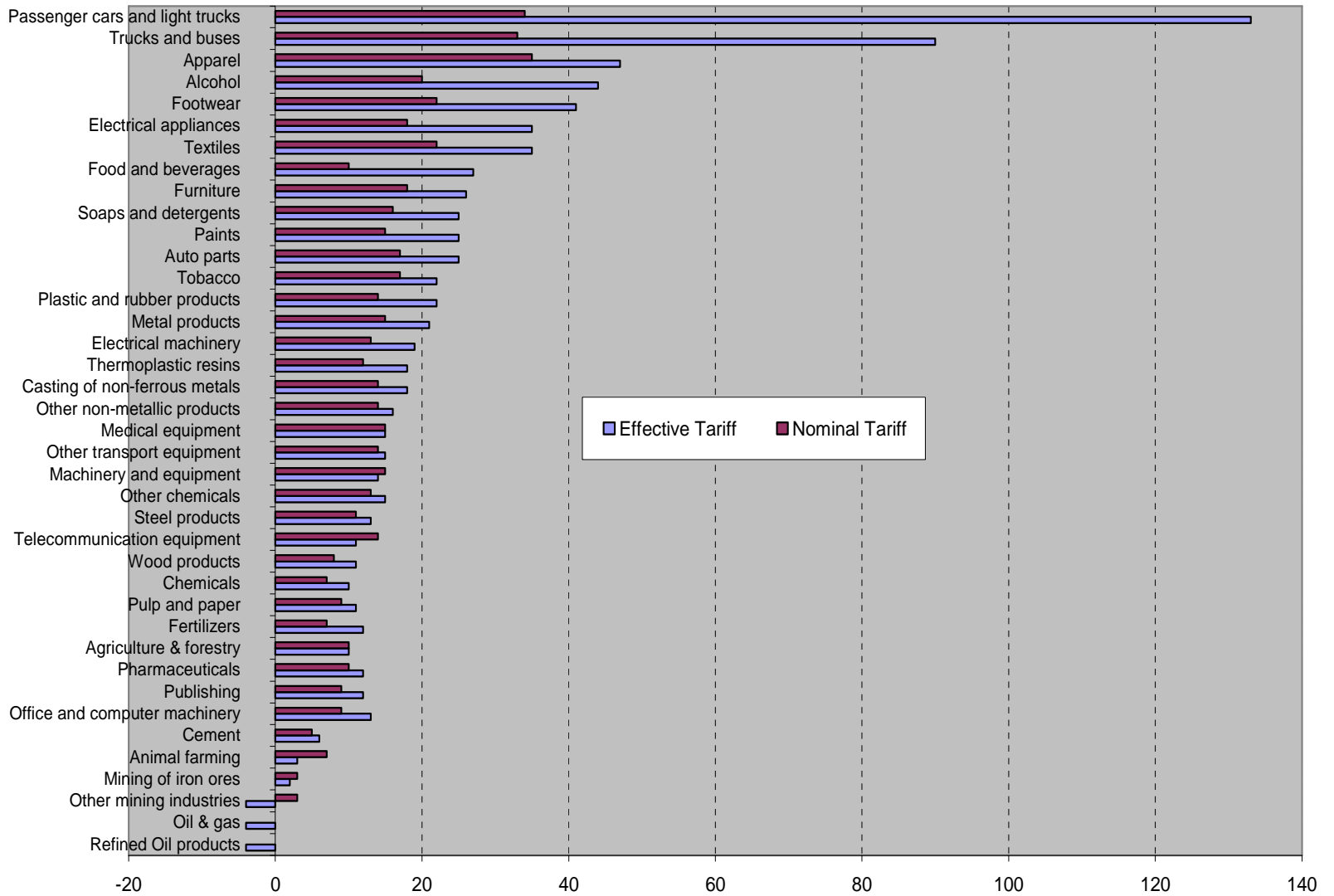
Variable	VIF	Square Root VIF	Tolerance	R-Squared	Eigenvalue	Conditional Index
Export Share	3.870	1.970	0.259	0.741	3.866	1.000
Import Share	4.910	2.220	0.204	0.797	1.841	1.449
Mercosur Intra-Industry	1.560	1.250	0.642	0.358	1.604	1.553
Western Hem. Intra-Industry	2.370	1.540	0.423	0.577	1.102	1.873
Capital Labor Ratio	4.610	2.150	0.217	0.783	0.792	2.209
Capital Intensity	1.470	1.210	0.681	0.319	0.607	2.525
Labor Intensity	2.450	1.570	0.408	0.592	0.461	2.896
Skilled Labor	3.380	1.840	0.296	0.704	0.362	3.269
Technology dummy	6.720	2.590	0.149	0.851	0.201	4.381
Scale	3.860	1.960	0.259	0.741	0.108	5.979
Concentration	6.580	2.570	0.152	0.848	0.058	8.198
Mean VIF	3.8					

Figure 10 - Median Nominal Tariff for selected countries, 2005.



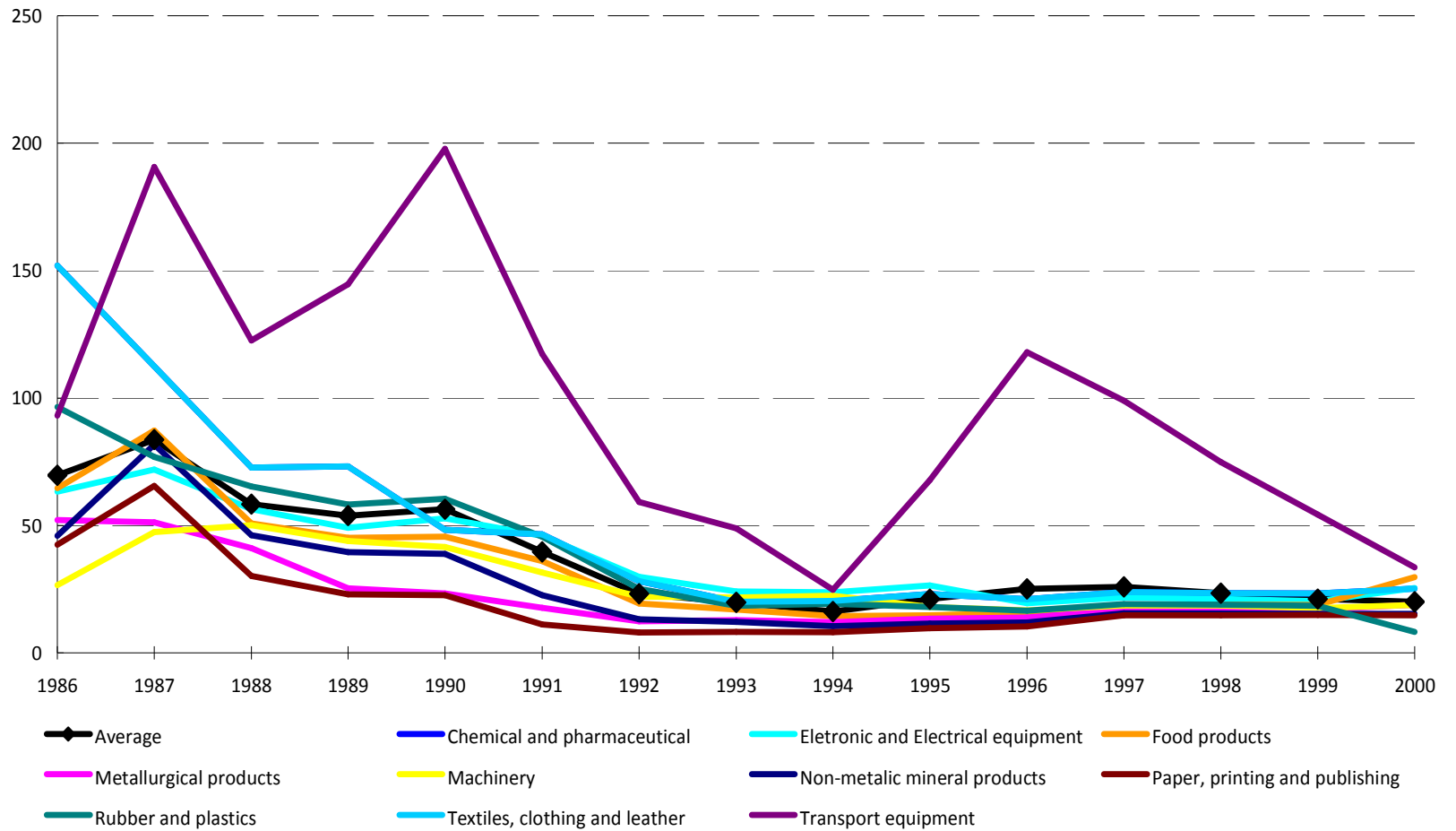
Source: UNCTAD-TRAINS

Figure 11: Brazil, nominal and effective tariffs, 2007 (percent)



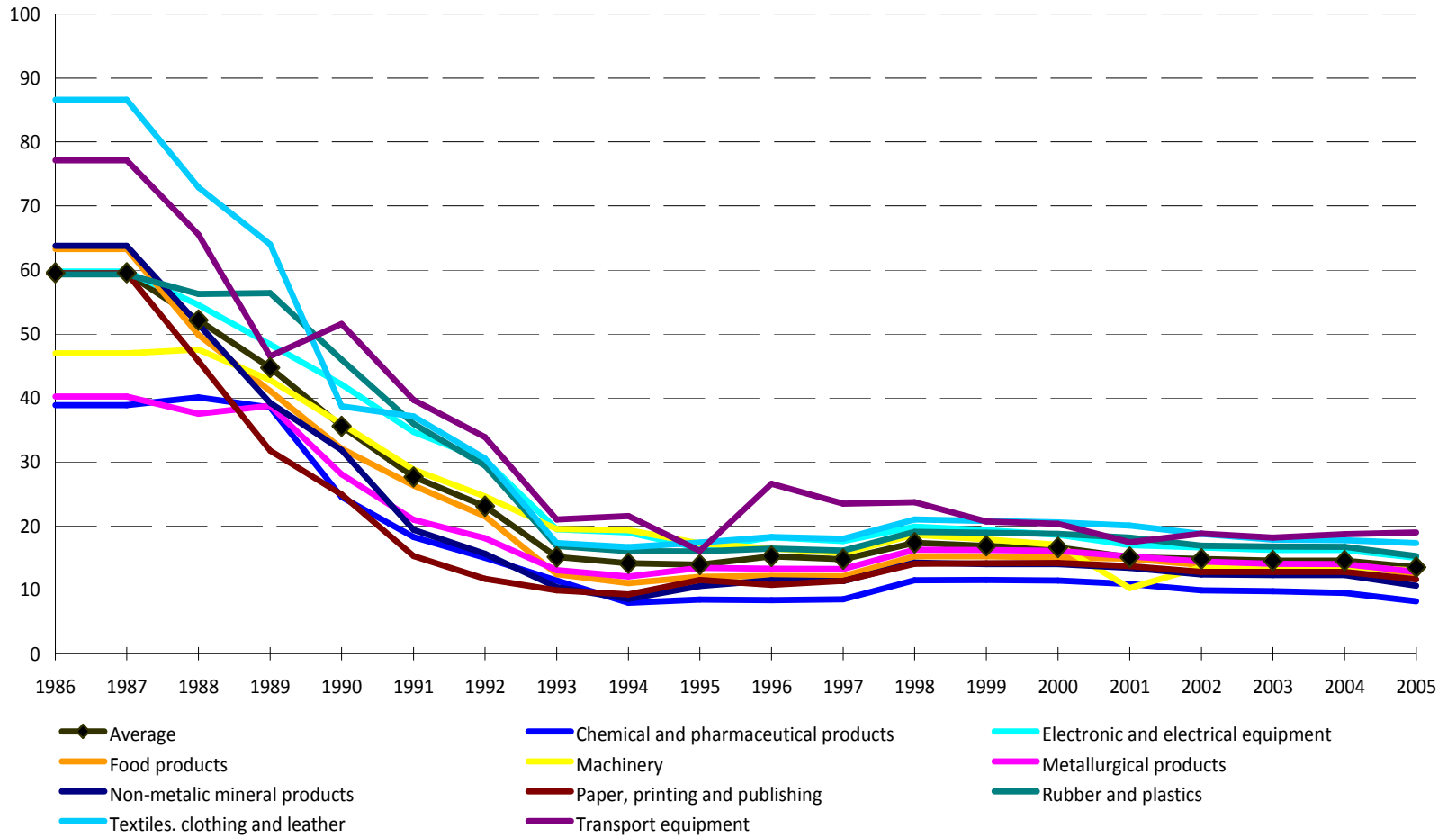
Source: Moreira (2008)

Figure 12: Effective tariffs, 1986-2000 - Sectors (percentage points).



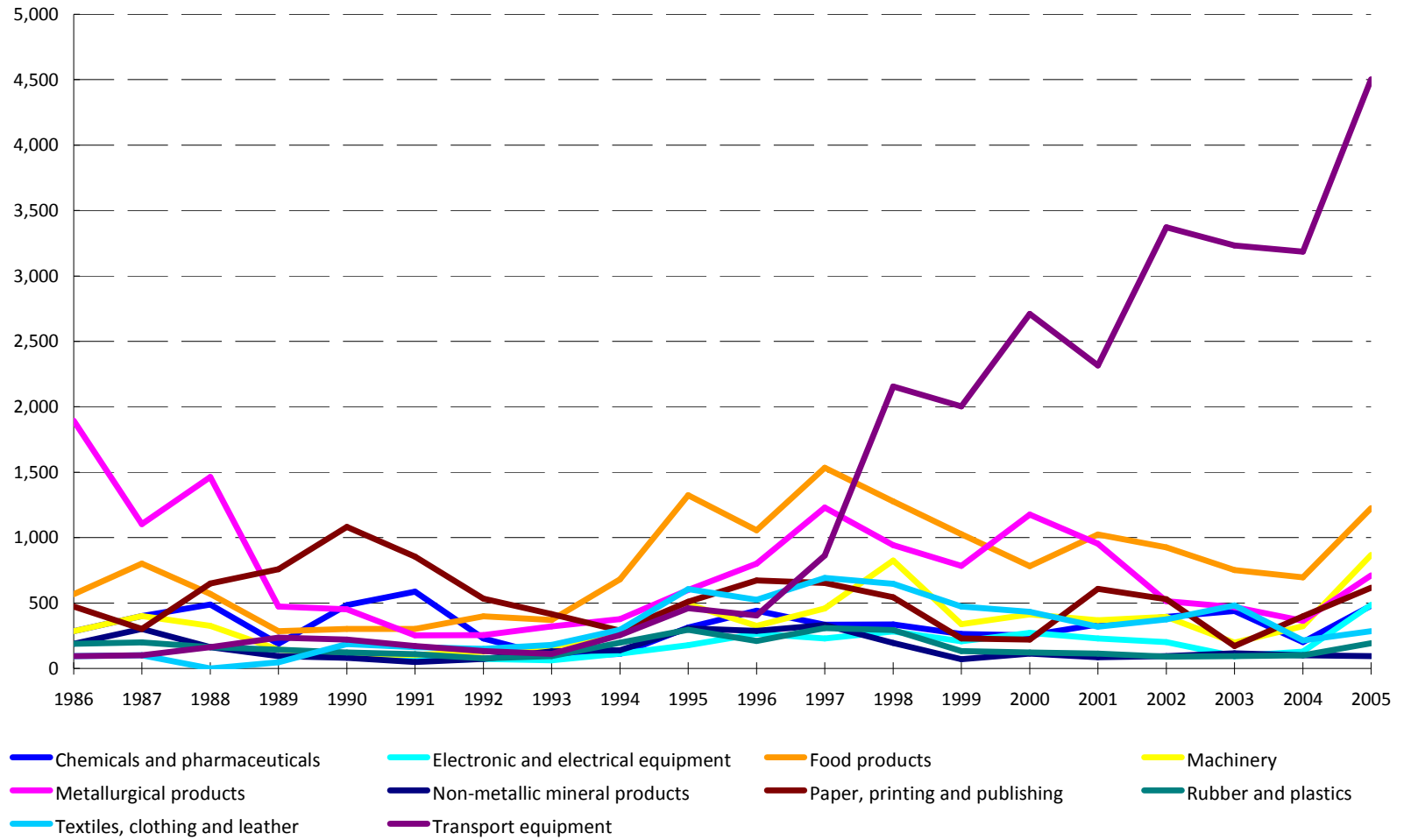
Source: Kume et al (2000), Kume et al (2003)

Figure 13: Nominal tariffs, 1986-2005 - Sectors (percentage points)



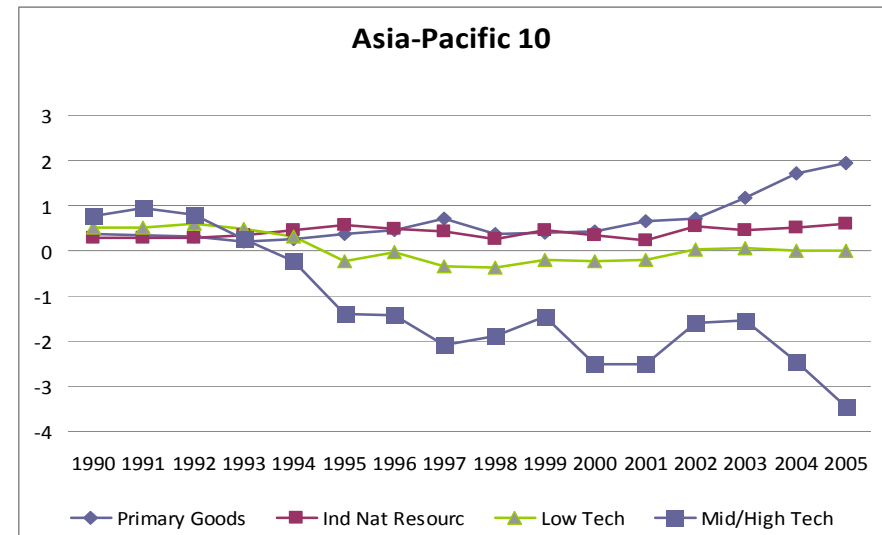
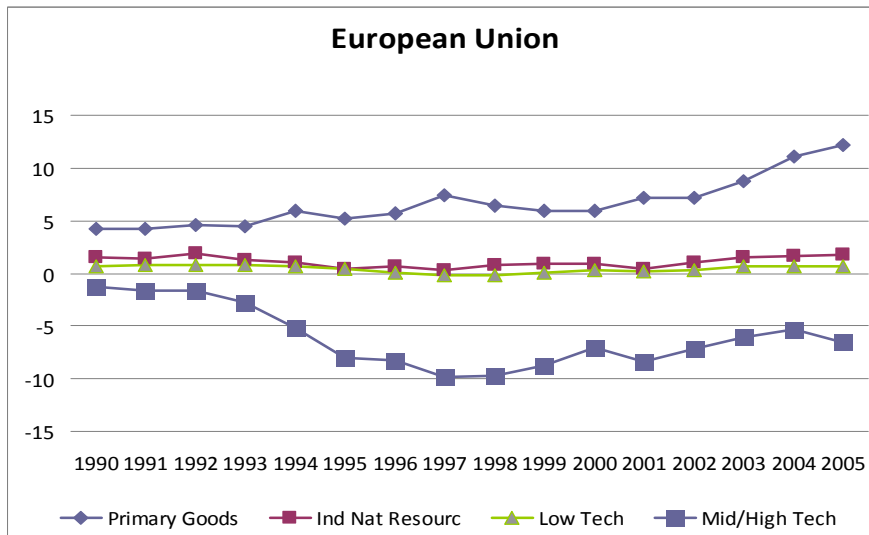
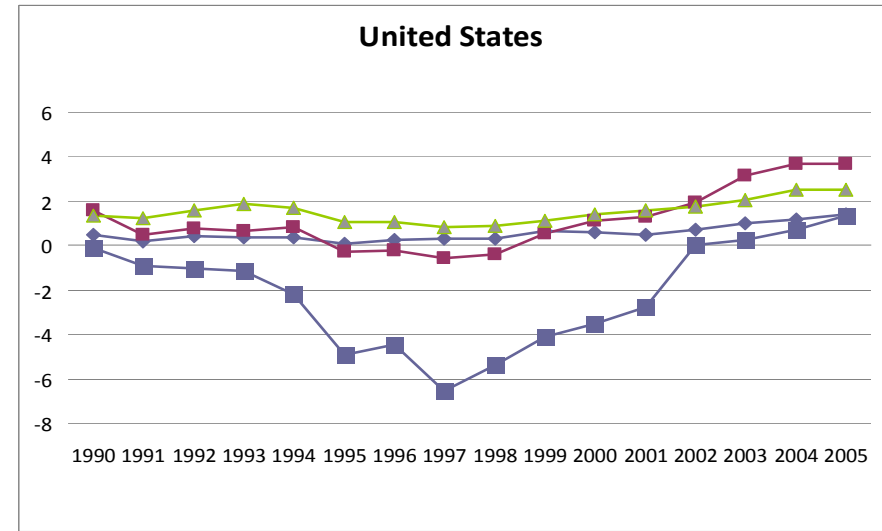
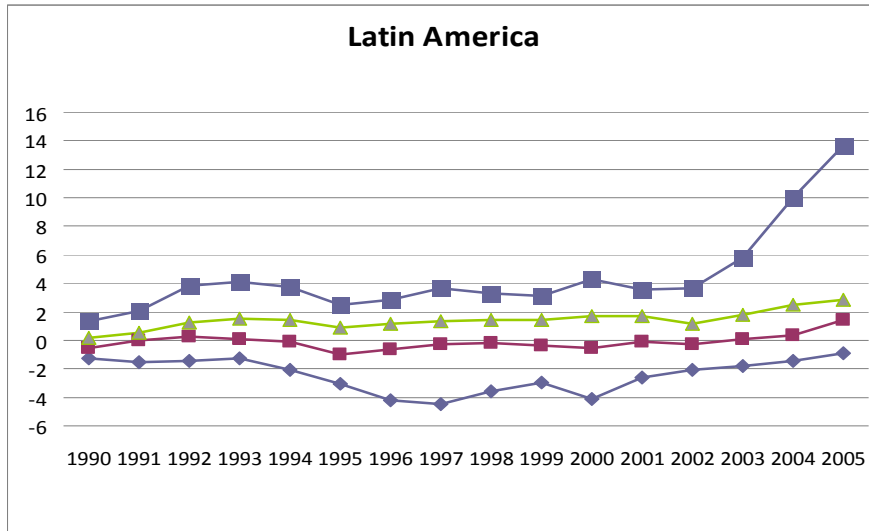
Source (Arruda de Almeida 2005, UNCTAD-TRAINS 2008)

Figure 14: BNDES Disbursements, 1986-2005 (constant US\$ millions)



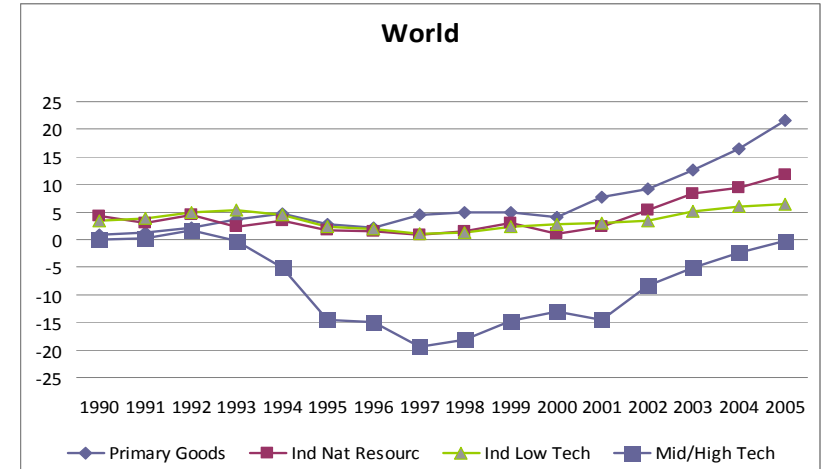
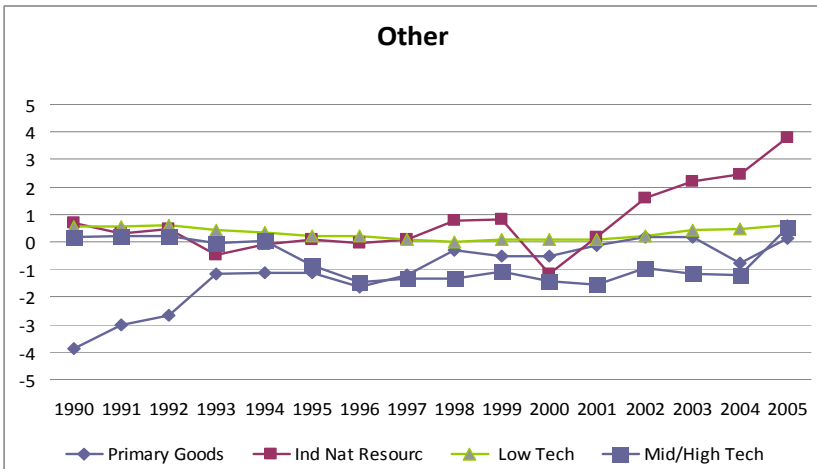
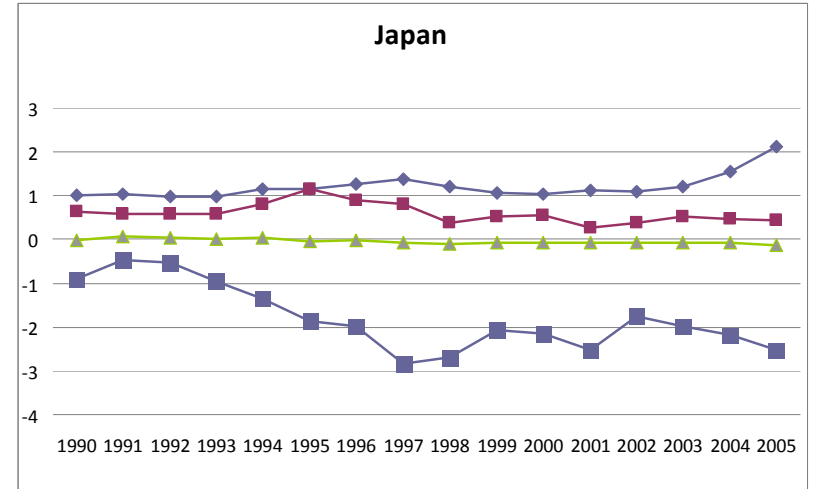
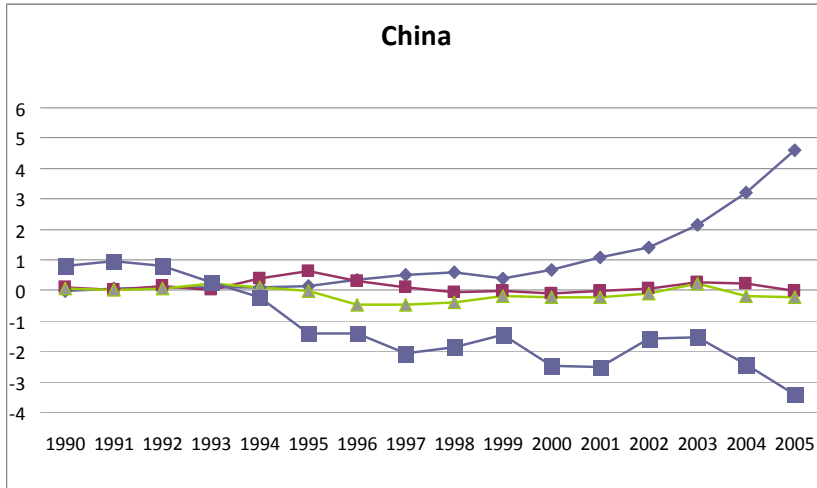
Source: BNDES, Ministry of Finance, Ministry of Development, Industry and Foreign Trade

Figure 15: Trade balance by category of products and market destinations, 1990-2005 (constant US\$ billions).



Source: CEPAL 2006, based on official figures. Products classified according to incorporated technological intensity (Standard International Trade Classification – SITC, Version 2)

Figure 16: Trade balance by category of products and market destinations, 1990-2005 (constant US\$ billions).



Source: CEPAL 2006, based on official figures. Products classified according to incorporated technological intensity (Standard International Trade Classification – SITC, Version 2)

Conclusion

This dissertation proposed to answer the question: what determines trade policy in Brazil? The discussion was conducted, especially, in the North-South trade negotiations the country was recently involved, both at the multilateral and regional realms, against the backdrop of a stable domestic institutional-bureaucratic framework. The task was accomplished, by using political economy theories from Economics and International Relations and Political Science. This interdisciplinary approach was expressed in the methods used: an historical-comparative methodology that described the Brazilian economic policy formulation, combined with econometrics tests applied to the Brazilian context.

The purpose of this dissertation was to understand the contradictory political and economic forces that shape Brazilian trade policy, with an emphasis on both external and domestic influences. It focused on Brazil's trade strategy vis-à-vis the world trade scenario, marked by concurrent multilateral and regional integration processes. The question posited here is: if the international context is a constant to all countries, why do (trade) policies among them vary so much?

The use of international trade theories applied to domestic trade politics attempted to answer this question: comparative advantage is different across countries; hence, not all domestic sectors will benefit from trade liberalization and will lobby governments accordingly. Neoclassical international trade theory (Heckescher-Ohlin and Ricardo-Viner hypotheses), as well as more modern trade theories (new growth theory), were applied to discuss the Brazilian case. In addition to that, as I have much argued in the dissertation, I emphasized the ideological world view of policymakers and their

interaction with domestic constituents and bureaucracies as essential components to shape the policy outcome. I described these interactions through a narrative that explicated the contexts of policies as part of domestic economic institutions. Finally, I carried out along the chapters a discussion about “globalization” and world economy forces, anchored in an international political economy theoretical framework, and how they influence Brazil’s domestic responses.

Specific issues

My fundamental aim was to explain the ways in which trade tariffs have been gradually liberalized in Brazil since the 1990s, while subsidies in some product lines are still the norm. This dichotomous trend has evolved against the backdrop of a predominantly mercantilist and protectionist discourse that has prevailed over this time period, which lingered even after the “Washington Consensus” recommendations of the late 1980s and 1990s. Brazil – and other Latin American countries – has embarked on structural reforms wave that swept the continent, in order to tackle severe macroeconomic imbalances ensued after the demise of the ISI model and the debt crisis of the early 1980s. The structure of incentives among policymakers and constituents changed the balance of policy outcomes toward the path of macroeconomic orthodox policy and fiscal adjustment. Severe inflation, balance of payment and fiscal constraints prompted this reforming path, which was accompanied by unilateral trade liberalization. In face of this situation, there were not many options allowed for Latin American politicians, policymakers and the main economic actors. As I described, concurrently, countries anchored these reforms in trade integration initiatives, both at the regional (Mercosur, Nafta) and at the multilateral (GATT/WTO) levels.

However, more to the end of the 1990s, due to other set of incentives determined by the domestic institutional framework – Brazil did not feel compelled to opt for the deepening of trade agreements, which other countries had taken under the realm of regional integration between developed and developing countries. Despite the stalled multilateral trade negotiation order, Brazil maintained an autonomist position—emphasizing this multilateral track and “South-South” negotiations. Why did Brazil opt for this strategy while other Latin American countries (Mexico, Chile, Colombia, and Peru) seek market access to developed countries?

Brazil opted for an autonomous path, emphasizing the multilateral WTO track, but relying on the size of its domestic market and by a regional integration scheme in which the Brazilian economy is patently bigger than those of the other country members’. Hence, as the 2000s unfolded, Brazil maintained this autonomous trade position.

In addition to the qualitative discussion about the domestic institutional policy framework, I captured how economic forces shape government decisions using statistical methods, through an analysis of ten manufacturing sectors. I inferred that tariff liberalization was largely a result of Brazil’s increasing commitment to global trade integration under the auspices of the 1994 Uruguay Round agreement and the World Trade Organization (WTO), whereas the government’s maintenance of hefty trade subsidies reflects the continued resistance of domestic producers to deeper levels of trade integration, prompted by domestic political economy and collective action factors. These policies are also part of an institutional inertia – described in chapter one, that hinders deeper trade commitments. Summing up, taking the global context into account, throughout this dissertation, I emphasize that Brazilian trade policy preferences and

negotiation strategies are a function of the country's domestic political-economy and institutional characteristics.

Having said that, it is worth asking: would Brazil be in a better position if it had chosen otherwise?

The breakdown of the Brazilian trade balance and destination provides an important avenue of analysis for the country's negotiation strategy at multilateral and regional integration forums. As a competitive exporter of primary goods and natural resources based industrial goods, Brazil has important stakes in the Doha round of the WTO. Thus, the country's push for agricultural liberalization and the alliance with the G-20 is understandable. Regarding regional integration discussions, Brazilian capital intensive exports to the U.S. and to Latin America, in theory, would provide motivation for pushing for further trade integration. However, like other trade integration initiatives, Western trade negotiations have been muddling through, not only because of Brazil, but also because of the lack of interest in the U.S. Mercosur institutional deepening and consolidation, as well, have been experiencing rough times, as remarked in chapter two. As a common market, Mercosur should have a cohesive trade policy negotiation position, but, the lack of institutional deepening is also hindering such a position.

The empirical results presented in chapter 04 suggest that capital intensive industrial sectors are indeed able to exert pressure for compensatory policies – subsidies. The justification for the support is based on the perception, advanced by the trade policy circles in the diplomatic corps, in the Trade and Industry Ministry, and in the business community, that industrial sector would be harmed by an eventual North-South integration under the WTO, the FTAA and the EU-Mercosur agreements. Despite the fact that some capital intensive industrial sectors are experiencing recent surpluses, due to

demand coming from regional (Latin America) and developed markets (US), the caution position has prevailed. The alliance between the more “protectionist” forces in the Brazilian state and the business interests groups seemed expedient to maintain this piecemeal liberalization approach. In short, Brazil has chosen a gradualist and heterodox path in its international economic relations. This trend is epitomized in the maintenance and even enhancement of subsidies to special interest groups during the period analyzed (1988-2005).

Which groups benefited more from protection and support? My results show that H-O patterns shape policies. However, while capital-intensive sectors have indeed experienced a drop in tariffs, due to the external pressure; there was an offsetting trend with the increase of subsidies to those sectors facing adjustments. Conversely, labor, otherwise considered the abundant factor in Brazil, is also receiving comparatively more protection. To my point of view, as the country opened its economy to global trade, the competition with other “labor” abundant countries created a backlash in liberalization. The protection of labor intensive industries in Latin America is not new and it was the rule in the early twentieth and nineteenth centuries, as Williamson and O’Rourke (1999) claim.

In this context, the regional integration path, principally in Latin America, could provide a logical and convenient outlay for Brazilian value-added exports. Mercosur itself, notwithstanding the theories suggesting political economy liberalization interests of intra-industry trade and productivity enhancing effects of RIAs with advanced countries, has not provided stimulus for trade integration with developed countries. In fact, Mercosur has several sectors excepted from the Common External Tariff (CET) –

including the automobiles, which have a special regime. As it continues to include some exceptions to protect industrial interests, it deviates from the original idea of “open regionalism”, which would foster competition inside the block. Quite the opposite, as empirical results showed, “concentration” is an important determinant of protection in Brazil and, by association, in Mercosur. With the lack of domestic competition, maintaining captive the big domestic market, industrial sectors do not have further incentives to expand toward foreign markets. However, the robust results for the variables describing the intra-regional trade in the Western Hemisphere suggest that the internationalized sectors could benefit from closer ties toward continental trade and could become a force to push forward deeper integration initiatives.

The descriptive data in chapter four suggests that, despite the maintenance of heterodox initiatives after the 1990s (industrial policy toward value-added exports), the country is experiencing a trade balance more in line with its natural comparative advantage, with deficits in capital intensive sectors, but surpluses in industries related to natural resources, such as minerals and food products. This trend is also related to the global competitive advantage of domestic industries and to the huge demand coming from world markets (China and Russia).

Since the Labor Party presidency in 2002, Brazilian foreign policy has further emphasized political-diplomatic ties with Latin America and with non-traditional partners, which include large markets such as China, India, and Russia, members of the so-called BRICs with Brazil - the South-South strategy. However, negotiations among Latin American neighbors toward expanding and deepening South American free trade areas have been riddled with mixed signals and delays. While there is much rhetoric

about expanding regional integration trade agreements, the existing ones still lack solid rules, creating coordination deficit within the RIAs. Conversely, there are certainly potential economic benefits of a South-South strategy, because countries such as China and Russian demand goods which Brazil has comparative advantage. From a perspective of industrial goods, nevertheless, Brazil is not a competitive exporter of industrial goods to these “non-traditional” markets.

Even though Brazilian foreign trade policy has been used as a complement to domestic industrial policy, in search for competitiveness and new markets for diversifying exports, my research suggests the country does not possess free-trade oriented coalition. Policy circles and industrial sectors advocate state supporting mechanisms to enhance the competitiveness of Brazilian value-added exports. However, these same interests sponsor a cautious approach toward further liberalization with advanced markets and support eventual tariff escalation, administrative measures and exceptions to the Mercosur CET to avoid foreign goods penetration¹²⁰.

Trade liberalization, under unilateral, multilateral or in regional integration possibilities present complex choices for policy-makers, seeking to appease constituents and pressure groups. Even though trade liberalization provides net welfare gains for the domestic economy, adjustment costs can be steep. For example, recent general equilibrium exercises for Brazil point out that low-skill and agricultural sectors would be the main winners, whereas industrial interests would bear steeper adjustments costs, particularly in the North-South integration scenarios (Harrison et al 2005; Flores and Watanuki 2008).

¹²⁰ For instance, the use of antidumping measures has increased since liberalization and the end of pegged exchange rate in 1999 (Kume and Piani 2004, Bown 2006).

Summing up, I have discussed along the chapters, initial trade liberalization (tariff reductions) was a function of policy discretion looking for macroeconomic stability, in a context of deteriorating terms of trade and inflation (Rodrik 1994), and this policy shift was reinforced by international agreements, which tied the hands of policymakers, as in the two-level game model (Putnam 1988). These economic shocks changed the mindset of policymakers since mid-1980s, prompting the reforms of the early 1990s. These reforms were partially consolidated in trade agreements such as Mercosur and WTO, which were decided by the government with barely any consultation to the interest groups positions. After the initial policy shock, these sectors have organized and demanded compensations. Brazilian policymakers shirked from further agreements with developed countries (FTAA and Mercosur-EU) to maintain policy discretion and to provide subsidies to targeted special interests. Therefore, while partially committing to trade reforms, Brazilian policymakers were very cautious to preserve the policy space, to foster industrial policies and to protect the interests displaced by earlier trade reforms. Acting in the loopholes of both regional and multilateral commercial agreements, policymakers maintained certain policy instruments, while they avoided further liberalization in “deep integration” (WTO-plus) agreements. Hence, I discussed the complementary of the two policies (tariffs and subsidies) in my econometrics results.

These policies are both part of the same “*developmental*” ethos, which believes that the domestic industrial sectors must be protected and fostered and that Brazil must search industrial autonomy and value added exports, surpassing the status of a simple producer and exporter of commodities. This “developmental approach” has its roots in domestic

political economy factors and it is also deeply influenced by the ideological biases, which have shown much resilience in the mindset of policymakers.

Curiously, the same “technocratic” worldview that influenced the reforms of the early 1990s defends mechanisms to support domestic economic sectors. State ranks, even in more fiscal conservative and macroeconomic aligned bureaucracies – The Central Bank, the Ministry of Finance and the Ministry of Planning – do not have a clear free-trade position. This happens because trade policy is not the priority of economic policymaking, which still privileges macroeconomic and fiscal issues. Trade policy can be considered marginal to the economic policymaking circles, but it is still regarded as possessing a strategic component, being treated as a foreign policy instrument for the country. Finally, domestic constituents (as electors) are not interested and do not join these highly abstract discussions about the trade strategy of the country. As a consequence, policymaking discretion and group interests drive the process and because of this, trade policymaking is influenced by long-standing foreign policy worldviews and by pure particularistic views.

Prospects for the future

From the perspective of epistemologies and methodologies applied to the problem, it is worth mentioning that the econometrics tests conducted here, though have contributed to clarify the research problem, deserve further elaborations. First, the increase of the number of industrial sectors used in the regression would allow testing the same hypothesis with a simpler OLS framework. Second, the use of dynamic specification, which accounts for the change in the dependent variable (policies), may offer more compelling explanations. These possibilities are going to be tested in the future. Finally, this kind of political economy research may suffer from problems of

omitted variable bias, multicausality, context-conditionality and endogeneity (Franzese Jr 2006). Hence, my attempt to use political economy tools to the Brazilian case deserves improvements to the extent that the research of comparative political economy improves and accounts for such complex problems.

From the perspective of the substantial research problem, what are the current perspectives of trade commitments for Brazil? The world economy is currently characterized by severe macroeconomic problems. Whereas a steep protectionist wave in the U.S. and in the EU is not likely yet, with the deepening of the international financial crisis and the fear of global recession, protectionist pressures coming from displaced sectors decrease the prospects for a successful conclusion of the multilateral trade agenda. The current stalemates at the WTO and in several regional integration agreements cast doubt on the extent to which short term trade liberalization is feasible, amid policies that tend to compensate sectors mostly damaged by the downturn and which have political leverage to do so, such as the automobile sector (Grugel and Hufbauer 2009). In short, the current global imbalances have further clouded the prospects of multilateral trade liberalization.

Finally, regarding Brazil, these international macroeconomic aspects have been creating strains for the country, while also fostering a cautious and lukewarm approach to further trade commitments. As mentioned in chapter four, the sizable trade surpluses can be credited to soaring commodities prices in international markets. The booming world economy helped Brazil to correct current account deficits and to amass foreign reserves, which hit to US\$ 150 billion in mid-2007. Yet, the weak dollar and the over-evaluation of the Brazilian real hurt domestic export interests. Despite the trade surpluses, business

interests often complain about the domestic exchange rate. For now, the Central Bank is shielded from pressure and is carrying out a strictly technical monetary policy, but there are critics even inside the government that defend faster interest rate cuts and limits to the currency appreciation. Against this backdrop of a fairly orthodox financial and macroeconomic policy, trade policy presents the possibility for heterodox and autonomist positions. The ongoing “subprime” financial crisis, and its impact on global economy, can have dire consequences for trade surplus of Brazil, which hugely benefit from world demand in the mid-2000s. Furthermore, as I support in this dissertation, trade-policy in Brazil is characterized by permanent features, favoring cautious and piecemeal liberalization and heterodox policies, even in moments of trade upturn. Hence, the global economic downturn is an extra ingredient that contributes to this cautious approach and can potentially hinder Brazil from committing toward integration agreements, especially those that involve North-South formats.

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