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# Brazil's Trade Policy: Old and New Issues

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## Abstract

After a half century of overtly inward-oriented policies, Brazil finally moved to open its trade regime in the early 1990s. Being one of the last countries to make this move in a region that notoriously lagged behind East Asia, Brazil was quick to implement a comprehensive trade liberalization program, which had strong unilateral and regional components. In roughly five years, tariffs were slashed, nontariff barriers were removed, and Mercosur became a reality. Later on, even the possibility of a free trade zone for the hemisphere was entertained. Yet this initial momentum lost steam in the mid-1990s, undermined by inhospitable macroeconomic and international environments. When, at the turn of the century, the right macroeconomic policies were finally put in place and Brazil began to enjoy the benefits of a commodity boom, a new government took over that clearly had a skeptical view of trade. Despite initial concern, however, the political transition did not bring a significant policy reversal. But trade policy reform never regained its momentum, despite its unfinished agenda. This paper examines this agenda and argues that if Brazil really wants to fully enjoy the growth and welfare benefits of trade, it needs to further lower and rationalize its structure of protection; adopt a more aggressive, World Trade Organization-plus, policy to open markets abroad; design a regional integration strategy that makes sense to its smaller partners; and bring trade facilitation, particularly transport costs, to the core of its trade agenda.

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<sup>1</sup> Paper prepared for the conference, *Brazil as an Economic Superpower? Understanding Brazil's Changing Role in the Global Economy*, Washington, D.C.: Brookings Institution, April 28, 2008.

## **I. Introduction**

After a half century of overtly inward-oriented policies, Brazil finally moved to open its trade regime in the early 1990s. Being one of the last countries to make this move in a region that notoriously lagged behind East Asia, Brazil was quick to implement a comprehensive trade liberalization program, which had strong unilateral and regional components. In roughly five years, tariffs were slashed; nontariff barriers (NTBs) were removed, and Mercosur became a reality. Later on, even the possibility of a free trade zone for the hemisphere was entertained.

Yet this initial momentum lost steam in the mid-1990s, undermined by inhospitable macroeconomic and international environments. The country's failure to adopt sound fiscal and monetary policies led to a substantial loss of growth and the allocational benefits of opening up, with the economy alternating periods of runaway inflation with those of severe exchange rate appreciation, while enduring strong external shocks ranging from Mexico in 1994 to Asia in 1999. However, not all the benefits were lost to volatility.

There is plenty of evidence that the greater exposure to import competition boosted productivity growth in manufacturing, the most protected sector of the economy, whose stagnation was behind the country's dismal growth performance. Likewise, the evidence is unequivocal in pointing to a drastic reduction in the cost of investment, i.e., cheaper equipment, one of the key drivers of growth.<sup>2</sup>

When, at the turn of the century, the right mix of macroeconomic policies were finally put in place—a combination of fiscal austerity, inflation targeting, and a floating exchange rate—and the country began to enjoy the benefits of a more benign external environment—e.g., a China-led commodity boom—the political support for deepening the trade reforms had waned and a new government took over that clearly had a skeptical view of trade.

Fortunately for Brazil's growth prospects, the political transition, despite concern, did not bring a significant policy reversal. Yet, trade policy reform never regained its momentum, despite its unfinished agenda. This paper looks at this agenda and argues that if Brazil really wants to fully enjoy the growth and welfare benefits of trade, it needs to further lower and rationalize its structure of protection; adopt a more aggressive, World Trade Organization (WTO)-plus, policy to open markets abroad; redesign, in the light of the two previous measures,

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<sup>2</sup> See, for instance, Lopez-Córdova and Moreira 2004, Moreira 2004, and Muendler 2004. For a recent discussion on Brazil's growth constraints, see Blyde, Pinheiro, Daude, and Fernández-Arias 2007.

Mercosur to advance both the country's interest and that of its smaller partners; and, finally, bring trade facilitation, particularly transport costs, to the core of its trade agenda.

The paper is organized in six sections, including this introduction and a section that summarizes the conclusions. The four core sections take each of the topics of the “unfinished agenda” in turn: Section I makes a case for further tariff reform; section II questions the rationale of a de facto South-South, market access strategy; section III argues that the reforms and strategy discussed in sections I and II would help turn Mercosur into a more sustainable and mutually beneficial initiative; and section IV seeks to draw attention to a type of trade costs that are usually not seen on the agenda of trade negotiators but have turned into one of the more important, if not the most important, obstacle to the country's trade.

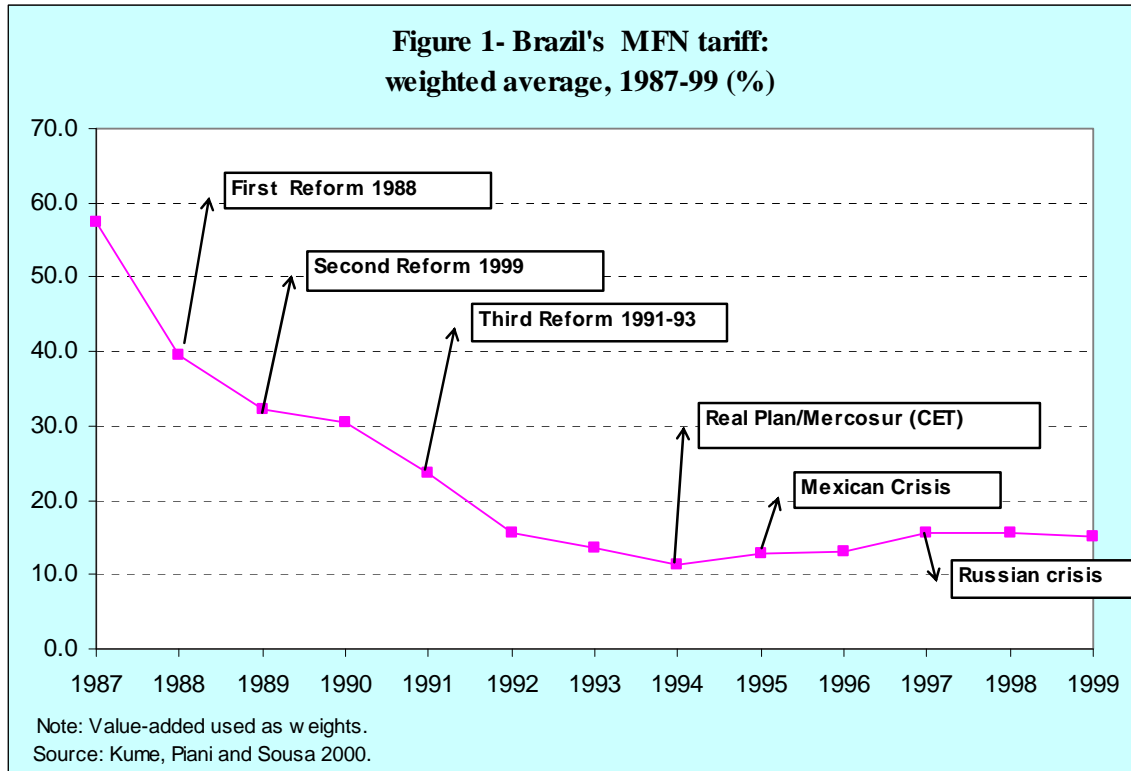
## **II. Making Sense of Protection**

There is little doubt that Brazil has come a long way towards reducing and rationalizing its tariffs. As can be seen in Figure 1, in 1987, before the first tariff reform, the value-added-weighted average tariff was as high as 57 percent. The first two tariff reforms brought this average down to 32 percent but left in place an elaborate system of NTBs, which made sure that the tariff reduction had little effect on trade.<sup>3</sup> Trade liberalization in earnest had to wait until 1991, when, after removing all the relevant NTBs, the government began to implement a four-year tariff reduction schedule and to phase in its regional integration agreement with the other members of Mercosur.<sup>4</sup> This schedule, alongside measures taken in 1994 to facilitate the implementation of a stabilization plan (the Real Plan), brought the weighted-average tariff to its lowest point in more than half a century.

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<sup>3</sup> See Kume, Piani, and Sousa 2000 for details of the tariff reforms.

<sup>4</sup> Mercosur was launched by the Treaty of Asunción, signed in 1991 by Brazil, Argentina, Paraguay, and Uruguay. The treaty asked for the implementation of a common market until 1995, which would include 90 percent of the tariff lines.

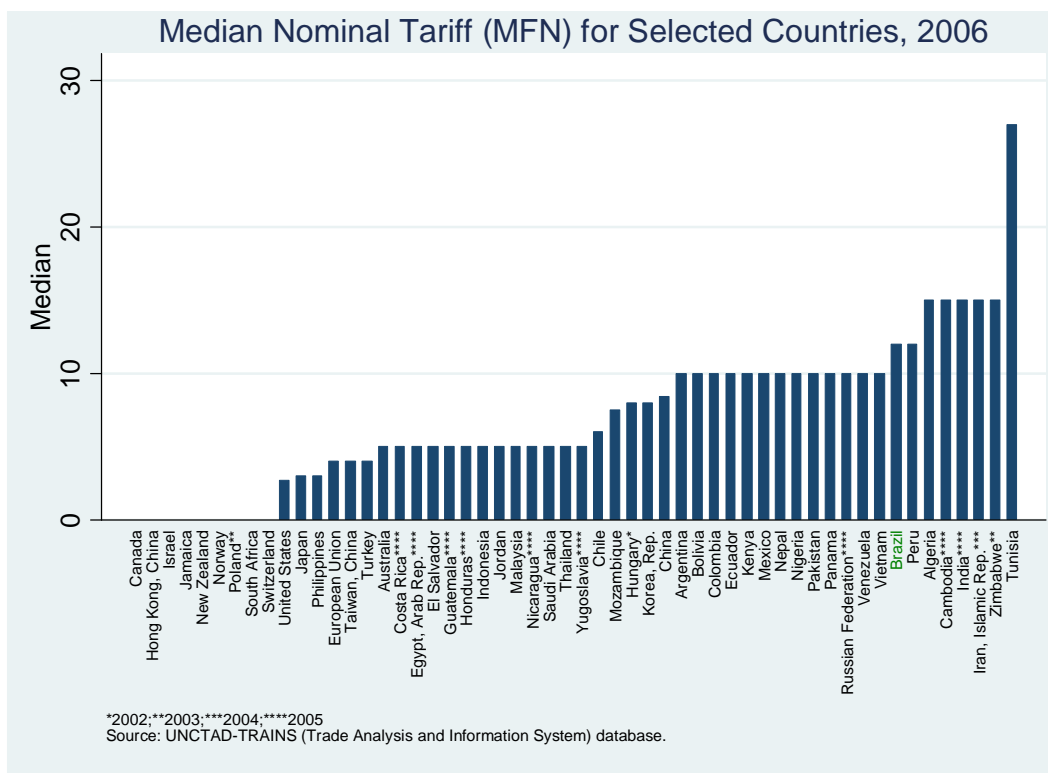


This promising first half of the 1990s, however, soon gave away to paralysis and even to a small but significant reversal of the tariff reforms, as Brazil entered a period of increasing current account deficits driven by a severe exchange rate appreciation and negative external shocks. The change of government in 2001—which took place amid increasing “fatigue” in public opinion with market-oriented reforms—did not, as expected, push the reversal to greater lengths (although it did raise the tariffs of some products such as apparel and shoes to as much as 35 percent in 2007), but it effectively ruled out any possibility of further reducing and rationalizing tariffs, unless as a part of an (increasingly elusive) agreement in the Doha Round. The prospects for further opening through comprehensive regional trade agreements such as the Free Trade Area of the Americas and the European Union–Mercosur agreement also faded away as negotiations were stalled by the intransigent negotiating positions of all the parties involved.

Without the perspective of change any time soon, Brazil remains stuck with a level and structure of protection that is not as costly as that of the late 1980s but whose reform can still bring substantial welfare and growth gains. As shown in Figure 2, the median most-favored-nation (MFN) tariff places Brazil solidly in the top quartile among a large sample of countries around world. The median tariff is used because it minimizes the problems that affect simple



(outliers) or weighted (bias towards low-tariff, high-volume items) averages, but the picture does not change significantly when these measures are used. Moreover, the use of MFN tariffs tends to underestimate the relative level of Brazil's protection vis-à-vis other large developing countries such as Mexico and China, which have, respectively, massive preferential (NAFTA and European Union–Mexico agreements) and special trade regimes.



Having this still relative high level of protection means that Brazil's is forgoing, apart from the traditional welfare gains, the opportunity, for instance, to boost productivity, whose level and growth are known to lag well behind those of East Asia. According to one estimate (Lopez-Córdova and Moreira 2004) based on Brazilian data, a 10 percent reduction in tariffs increases total factor productivity (TFP) by 1 percent, which would have far from a negligible impact given that in the second half of the 1990s manufacturing TFP grew at an annual rate of 2.8 percent (Lopez-Córdova and Moreira op. cit.). Relatively high protection is also a cause for concern in a world where production is increasingly fragmented and the high growth benefits of joining global value chains hinge on lower trade costs, among other competitiveness factors. Lacking large-scale North-South agreements or special trade regimes, Brazil is far less equipped than countries such as Mexico and China to take advantage of this trend and, indeed, the

available evidence suggest that the country's participation in global chains is still incipient (Calfat and Flôres 2008).

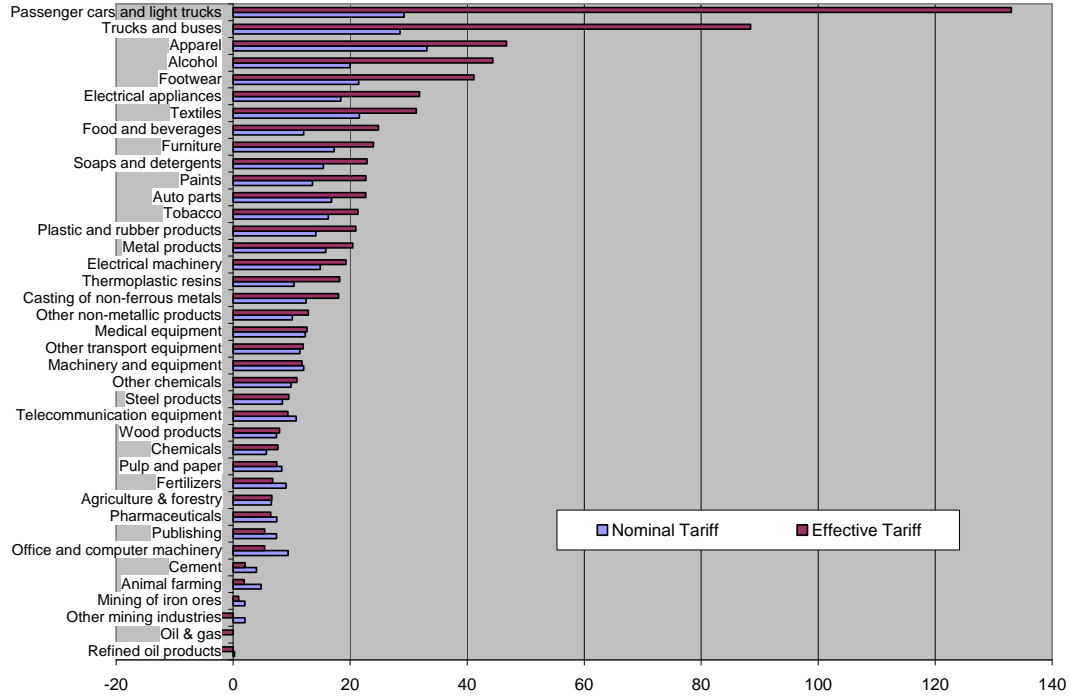
But the problem is not only the level of protection but also its variance. Figure 3 shows nominal and effective tariffs for 2007 at the three-digit level of Brazil's National Accounts Classification. Nominal tariffs vary from 0 to 35 percent, an interval high enough to fuel rent seeking and impose severe costs on resource allocation. Yet the picture is even worse from the point of view of Corden effective tariffs, which take into account protection for both final products and inputs. Rates vary from -4 to 133 percent. Such figures beg the question: What is the rationale, if any, behind such disparate rates?<sup>5</sup> The answers, though, are difficult to find. A promising explanation might be found in the power of lobbies and special interest groups in shaping protection along the lines of the "protection for sale" argument developed by Grossman and Helpman (1994).<sup>6</sup>

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<sup>5</sup> The effective rates of protection were calculated using the Corden method (Corden 1971), with free trade technical coefficients. The coefficients were estimated using 2005 data on the use of 110 intermediate goods by 55 activities of the National Accounts System Classification-SCN (IBGE 2007, Table 2, "Uso de Bens e Serviços"). The data for tariffs came from the Common External Tariff 2007 (<http://www.desenvolvimento.gov.br>). An IBGE correspondence between SCN and the NCM (Nomenclatura Comun do Mercosur) was used to combine tariff and production data.

<sup>6</sup> There some evidence that this is the case. See, for instance, Calfat and Flôres (2002).

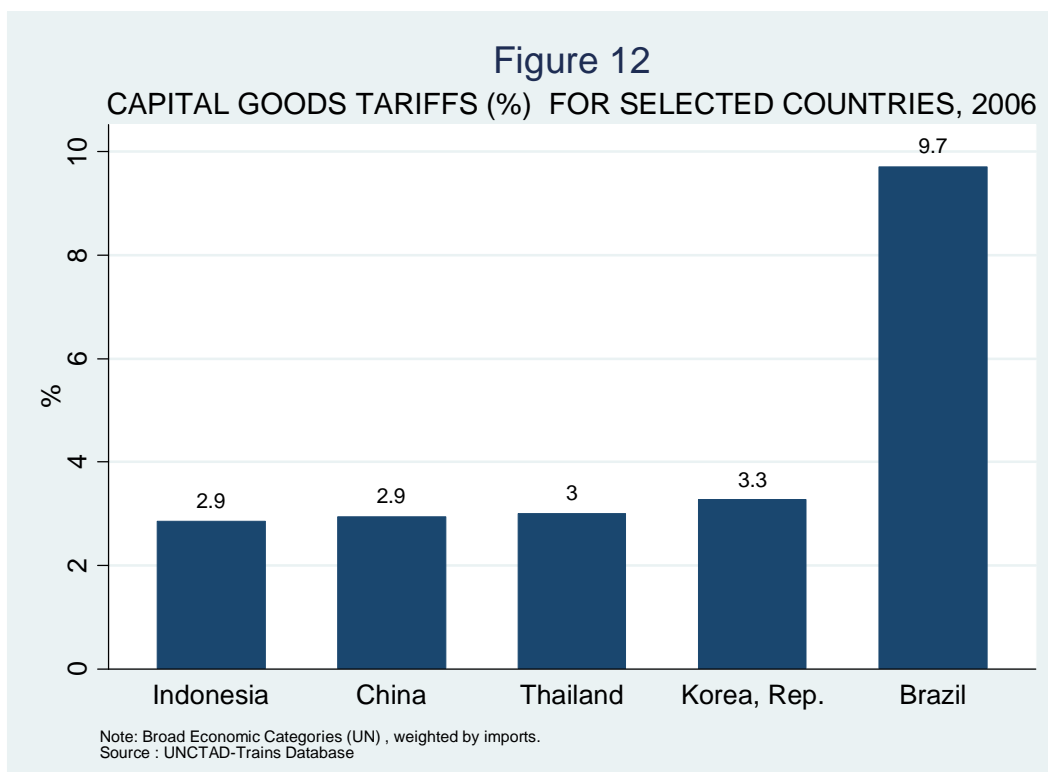
**Figure 3 - Brazil Nominal and Effective Tariffs. 2007 (%)**



Source: Own calculation based on National Accounts and Ministry of Development, Trade and Industry data. See text for details.

The prevailing structure of protection is particularly damaging for growth. Most economists would agree that high investment rates in equipment and machinery play a key role in sustaining high rates of growth. De Long and Summers (1991), for instance, show that there is a strong and negative correlation between growth and the relative price of capital goods, and a strong and positive correlation between growth and investment in capital goods. Such types of evidence suggest that there is a link between trade and growth other than productivity. Since machinery and equipment are tradable goods, trade liberalization would lower their relative prices, reducing the cost of investment and boosting growth.

There is suggestive evidence that the trade liberalization of the first half of the 1990s made a substantial contribution to lower the prices of capital goods in Brazil. Their relative prices, measured by the wholesale price index (IPA) and general price index (IGP), fell by 47 percent in 1990–2001, a drop that appears to be strongly correlated with the rise in import penetration (Moreira 2004). As Figure 4 shows, there appears to be considerable room for further reducing these prices. Tariffs on these goods (9.7 percent in 2006) are still well above those practiced by the fast-growth economies of Asia, clearly punishing investment.



True, when measured by actual (tariff revenue divided by imports) rather than nominal tariffs, protection seems to be lower (7.2 percent in 2007; [http:// www. receita.fazenda.gov.br/Historico/Aduana/Importacao/2007/dezembro/RenunciaFiscal.htm](http://www.receita.fazenda.gov.br/Historico/Aduana/Importacao/2007/dezembro/RenunciaFiscal.htm)). Yet, this is still considerably higher than the nominal tariffs seen in Asia, and this figure alone tends to underestimate the costs of importing capital goods. The lower actual tariff is mostly the result of special import regimes, which target capital goods not produced locally. The discretionary nature of these programs is a fertile ground for red tape and corruption. In other words, they carry hidden costs that are not captured by tariff revenue.

Overall, there seems to be no clear economic justification for Brazil to continue to pay the costs of this chaotic and counterproductive structure of protection. One can argue that maybe this is not the right time for a tariff reform because of the WTO negotiations or because Brazil is yet again facing the consequences of a steep exchange rate appreciation driven by the recent

commodity boom.<sup>7</sup> Though legitimate, these arguments do not undermine the case for urgent reform.

First, Brazil was a latecomer to trade reform, and there has already been more than a decade since the last measures was taken to cut and rationalize tariffs. The cumulative costs of these delays in terms of welfare and growth are hard to measure, but given the level of protection and the gap between the country's growth performance and those of countries that have adopted a more open trade regime, they are likely to be substantial and to continue to escalate, particularly as some of the initial gains are reversed.

The potential gains from waiting for the conclusion of a WTO negotiation have to be balanced against these welfare and growth costs. In fact, these costs call for Brazil's to temper the "enlightened mercantilism" (Krugman 1991) that has prevailed in its recent trade policy with a more careful assessment of the costs and benefits of further delaying tariff reform—the more so because the offers seen so far on the Doha negotiating table do not seem to translate into any significant change of the status quo.

For instance, the last text produced by the chair of the Doha Round negotiations on nonagricultural market access (February 2008) called for "Swiss formula" coefficients of 19 or 23 percent for developing countries<sup>8</sup>, which would imply tariffs cuts for Brazil of between 55 and 60 percent, with tariff ceilings equivalent to the coefficients. Given that there is a considerable difference between Brazil's bound and applied tariffs, a coefficient of 23, for instance, would only affect approximately 56 percent of the applied tariff lines, and to a considerably smaller extent than the bound tariffs.<sup>9</sup> In addition, these cuts are likely to be accompanied by "flexibilities," which would exempt 5 to 10 percent of the tariff lines from the full extent of the cuts, with a phase-in period of between 8 to 9 years.

Despite its modest impact, the press reports that Brazil and its partners in Mercosur see the proposal as a threat to their industries and are asking for a coefficient of 35 (see for e.g. [www.ictsd.org/weekly/08-04-17/story1.htm](http://www.ictsd.org/weekly/08-04-17/story1.htm)). Negotiating tactics aside, it seems reasonable to

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<sup>7</sup> According to Brazil's Central Bank (<http://www.bcb.gov.br/?INDECO>), in the first quarter of 2008, the real exchange rate against the dollar was roughly at the same level it was in December 1998, before the Real prompted mega devaluation.

<sup>8</sup> See Bridges Weekly Trade News Digest Volume 12 No 13 April 17 2008 ( <http://www.ictsd.org/weekly/08-04-17/story1.htm> )

<sup>9</sup> Own calculation using published bound ([http://www.wto.org/english/tratop\\_e/schedules\\_e/goods\\_schedules\\_table\\_e.htm](http://www.wto.org/english/tratop_e/schedules_e/goods_schedules_table_e.htm) ) and applied tariff data (<http://www.desenvolvimento.gov.br/sitio/interna/interna.php?area=5&menu=1848> )

assume that is very unlikely that the Doha Round would do much to address the more blatant distortions of Brazil's current structure of protection. In other words, the "wait-for-Doha argument" would make sense if the government's negotiation position included a scenario where both the level and structure of the country's protection would be significantly overhauled. From what has been revealed so far, that does not seem to be the case.

It is not also clear the Brazil's bargaining power would be severely reduced if the country sat at the negotiating table with lower and more homogenous applied tariffs. The negotiations are about bound tariffs, and there are also other important trade-offs to put on the table, such as the expiration of the peace clause for agriculture, which, by the way, has allowed Brazil's to challenge the U.S. subsidies for cotton. Open markets and the elimination of subsidies for agriculture are clearly welfare- and growth-enhancing outcomes for Brazil. What is not clear is that the country has to punish its economy with a dysfunctional tariff structure to achieve these results.

As to exchange rate appreciation, it is hard to dispute the fact that the recent steep appreciation of the exchange rate poses a challenge to the survival of manufacturing in Brazil, at a time when already-fierce competitive pressures from India and China are only bound to increase. Yet tariffs are a very blunt instrument to deal with this issue. This is a job for classical fiscal, monetary, and exchange rate policies. If every time the notorious volatile exchange rate moves, the government decides to change tariffs, the damage to price incentives and to resource allocation is likely to be severe—particularly because it is very likely that constant changes in tariffs are going to trigger special interest pressures that would inevitably shape an unexpected and undesired outcome. But even if we ignore these issues, the appreciation argument is a case for keeping tariff levels where they are right now. It does not give any justification to keep the wide variation of tariffs across sectors seen earlier.

Leaving aside those very circumstantial arguments about trade negotiations and the exchange rate, the road ahead for Brazil's tariff reform could not be clearer. The country should aim for a homogenous tariff across sectors, close to the OECD average (between 4 and 6 percent) (Moreira 2004), which could only be changed by Congress. This is important not only for the country to enjoy the full benefits of trade but also to ensure that its commercial policy is transparent and less vulnerable to lobbies and special interests. To put it simply: to ensure that protection in Brazil "is not for sale."

### III. Market Access and Regional Integration

There is both theoretical and empirical evidence suggesting that the gains from trade are maximized when a country not only opens up its own market but also has greater access to markets abroad (see, for instance, Harrison, Rutherford, and Tarr (2003)). This was not so much a concern for Brazil in the late 1980s since protection was so high that the gains from bringing it down alone would dwarf any progress made in market access. At the current levels of protection, though, a strategy that combines lower tariffs at home with greater market access abroad is more likely to produce the best results. Unfortunately, Brazil's results in opening markets have been mixed.

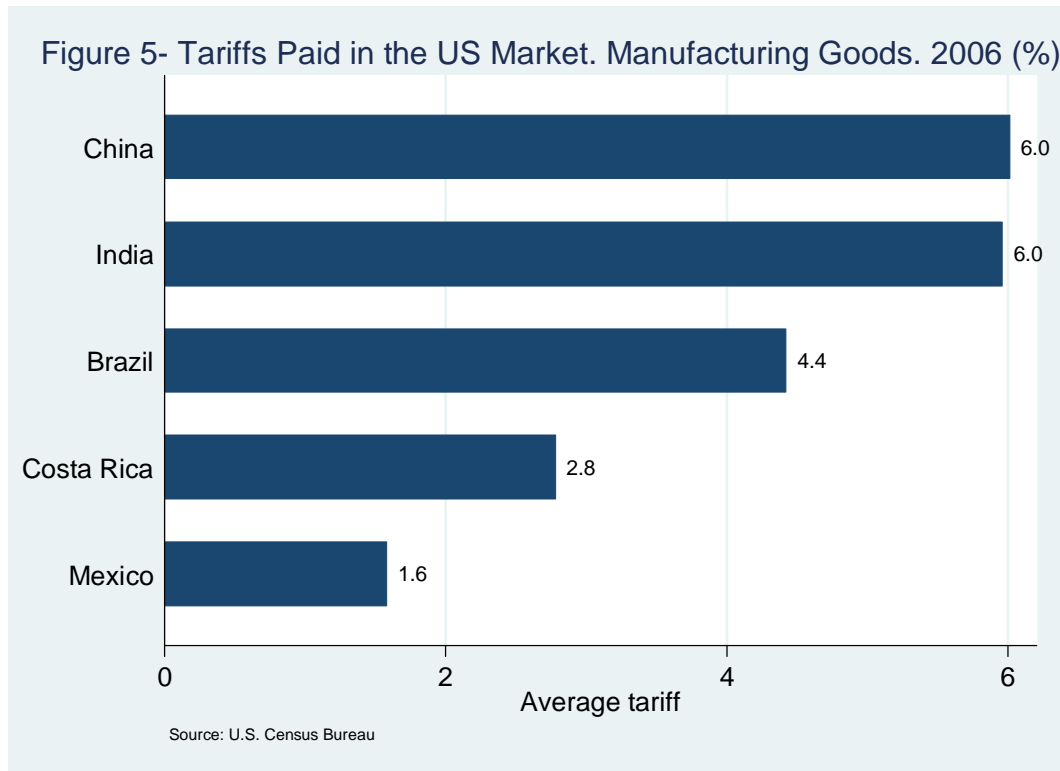
**Multilateral cum South-South Strategy**—The country's market access strategy appears to be a combination of a multilateral thrust with an emphasis on South-South agreements. On the multilateral front, there were important advances in agriculture as Brazil, together with its partners in the G-20, successfully managed to push an agenda of substantial tariff cuts and greater discipline for subsidies and specific tariffs—issues that remained off limits during the last round of international negotiations. These gains, though, have yet to materialize since the completion of the Doha Round remains uncertain and elusive. Brazil's reluctance in opening up its own market for manufacturing goods might not be the main obstacle to the agreement, but it clearly does not work in its favor.

It is the other strand of the strategy, though, that gives more cause for concern. Judging by Brazil's attitudes towards preferential agreements in the last decade, there appears to be an assumption that South-South agreements bring more net gains than their North-South equivalents. This is an assumption that may survive in the realm of politics, but it has a very short life when it comes to economics. This is not to deny that the trade gains of free trade agreements (FTA) such as Mercosur are important and worth fighting for, but their limitations cannot be ignored.

The limited size of the market and the similarity of factor endowments impose severe constraints on scale and efficiency gains (Venables 2003). By contrast, the gains of North-South agreements are more promising for involving considerably larger markets and a longer array of comparative advantages. True, the risks of this type of initiative are higher, especially of dislocation of knowledge-intensive, growth-enhancing sectors. Yet Brazil's response to trade liberalization in the last decade plays down the likelihood of any catastrophic scenario.

Moreover, one cannot overlook the costs of nonparticipation, i.e., the prospect of seeing Brazilian exporters paying higher tariffs than their competitors in the world's large markets and, therefore, being on the receiving end of trade diversion. Rather than a theoretical possibility, this is already the reality they are facing in the U.S. and EU markets where an increasing number of agreements are being signed (NAFTA, CAFTA-DR, Peru-U.S. FTA, U.S.-Australia, the EU enlargement, the EU-Mexico, and EU-Chile FTAs, to name but a few) and implemented.

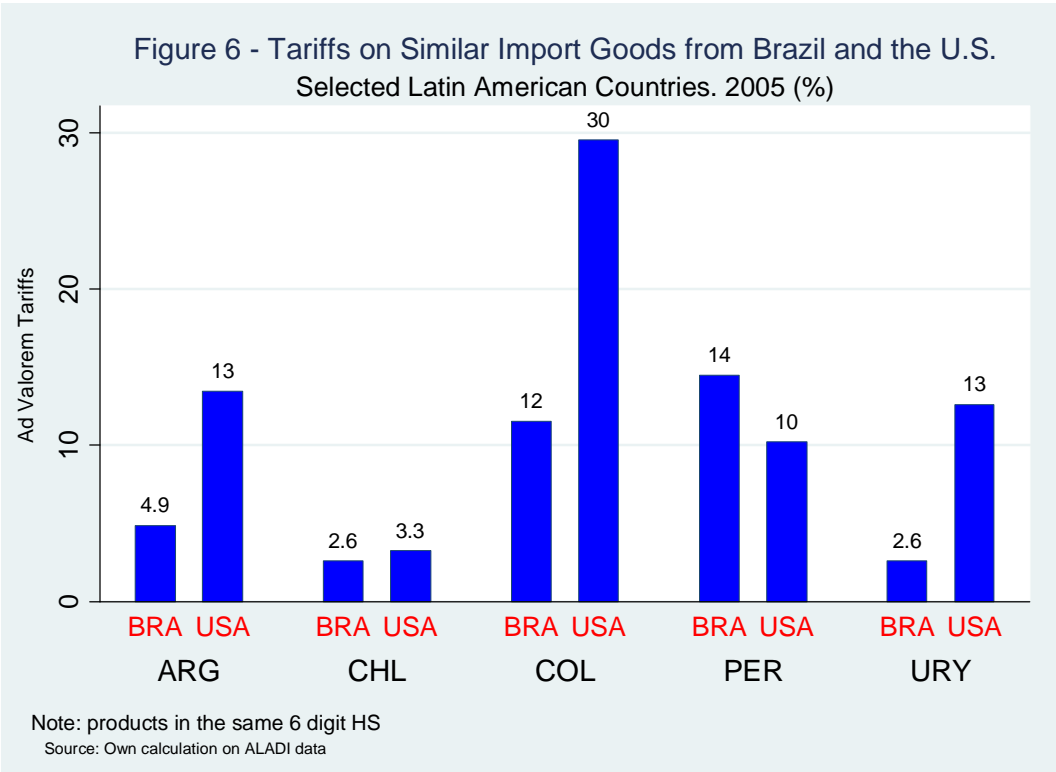
The cost of nonparticipation acquires particularly dramatic contours in the context of the emergence of China and India, whose labor costs and size advantages leave Brazilian manufacturers in no position to forgo preferences in the markets of the North, particularly in the U.S. market (see, for instance, Moreira 2007). As shown in Figure 5, the tariff levied on Brazilian goods entering the U.S. market are not that different from those levied on Chinese and Indian goods and are well above those paid by Mexico and Costa Rica. With the implementation of the new generation of agreements signed by the United States with Australia and Central and South America, Brazil's disadvantages are only going to increase.





To make things even more worrying, Brazil’s preference for the South has only produced a very limited number of very limited trade agreements, which, with the exception of Mercosur, either cover a very limited number of tariff lines or have a long period of implementation (e.g. Brazil-Mexico, Mercosur–Andean Community, Mercosur-India, and Mercosur–Southern African Customs Union). This not only increases the costs of not having signed any major agreement with countries in the North but also leaves Brazil vulnerable to “negative preferences” or to having its preferences erode in the markets of the South, even in its own region.

Figure 6 illustrates this point, by comparing the “real “ tariffs (tariff revenue divided by the value of imports) paid by similar Brazilian and U.S. goods when entering selected markets in Latin America. Whereas preferences are considerable in Mercosur and Colombia, that is not the case in Chile and Peru. In the case of the latter, U.S. preferences are even higher. With the full implementation of the U.S.-Chile and U.S-Peru FTAs, Brazil’s position will deteriorate further, as it will be case with Colombia if its FTA with the United States is eventually approved by the U.S. Congress. Data for Central America are not available, but given the depth and scope of CAFTA-DR, it is very likely that Brazil will face a difficult situation there too.



**Mercosur**—The South-South strategy faces steep challenges even in its more successful achievement: Mercosur. Despite repeated signs of discontent with the results of the agreement among the smaller partners, there is no evidence that Brazil is willing to tackle the fundamental flaws of the initiative.

The problems begin with misguided expectations. Mercosur was to great extent sold on the idea it would help industrialize the smaller partners. Whereas it seems warranted to expect that an enlarged common market would deliver gains of scale and efficiency to all members of the bloc, there was nothing in the economic fundamentals of the countries involved that would indicate that this outcome was likely. Quite the contrary. Economic theory suggests that custom unions between partners that have similar factor endowments (and therefore similar factor prices, such as labor and capital) are more likely to promote the concentration of manufacturing activities in the largest partners, given the interplay of economies of scale and transport costs (see, e.g., Venables 2003).

The expectation of the industrialization of the smaller Mercosur members looks even more misguided when the mix of policies and incentives adopted by member countries is taken into account. For instance, Brazil, apart from being the largest and most industrialized economy, has by far the most generous industrial policy in the bloc.<sup>10</sup>

But the coup de grâce on these expectations comes from the available empirical evidence, which show that the distribution of manufacturing activity among the bloc's members has not changed significantly since 1991 (Sanguinetti 2006; Blyde 2008), with the bulk of the industry still concentrated in Brazil. To be sure, given the similarity of factor endowments and the asymmetries of size and policy, it is somewhat surprising that Brazil's share has not increased substantially. Yet Mercosur was just one of a large number of developments that have affected these economies during this period, ranging from unilateral liberalizations to different stabilization plans and different exchange rate policies, to name but a few.

The main problem with Mercosur, though, is not one of misguided expectations or asymmetric policies but one of policy design. The key pillar of the agreement, the common external tariff (CET), closely reflects Brazil's industrial interests and promotes an unfair

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<sup>10</sup> For a thorough discussion of the policy and economic asymmetries within Mercosur, see Blyde, Giordano, and Fernández-Arias (2008).

distribution of costs and benefits. This is the bloc's most serious deficiency and the one that puts in doubt its long-term sustainability.

Since Brazil applied tariffs follow closely the CET, the latter has exactly the same problems of level and variance as the former, but with the aggravating circumstance that it shifts part of the burden of protection to Mercosur's smaller partners. When the CET charges up to 16 percent on capital goods (<http://www.desenvolvimento.gov.br/sitio/interna/interna.php?area=5&menu=1848>), it is shifting demand from producers outside the bloc to producers in Brazil (where regional production is concentrated) and is asking consumers in Uruguay and Paraguay to help pay the extra cost without getting any of the benefits.

Fortunately, and precisely because of its shortcomings, the CET has not been fully implemented, which has helped to attenuate the costs. Yet without a functioning common external tariff, countries cannot enjoying the full-scale benefits of a common market as they are forced to introduce costly regulations, such as rules of origin. Tariff reform for Brazil along the lines advocated above would do more to consolidate the future of Mercosur than any amount of presidential declarations of commitment and support. With a more solid economic base and with down-to-earth expectations about what the bloc can deliver, it would be easier to advance in other problematic areas such as the harmonization of policies and incentives.

#### **IV. The “Other” Trade Costs**

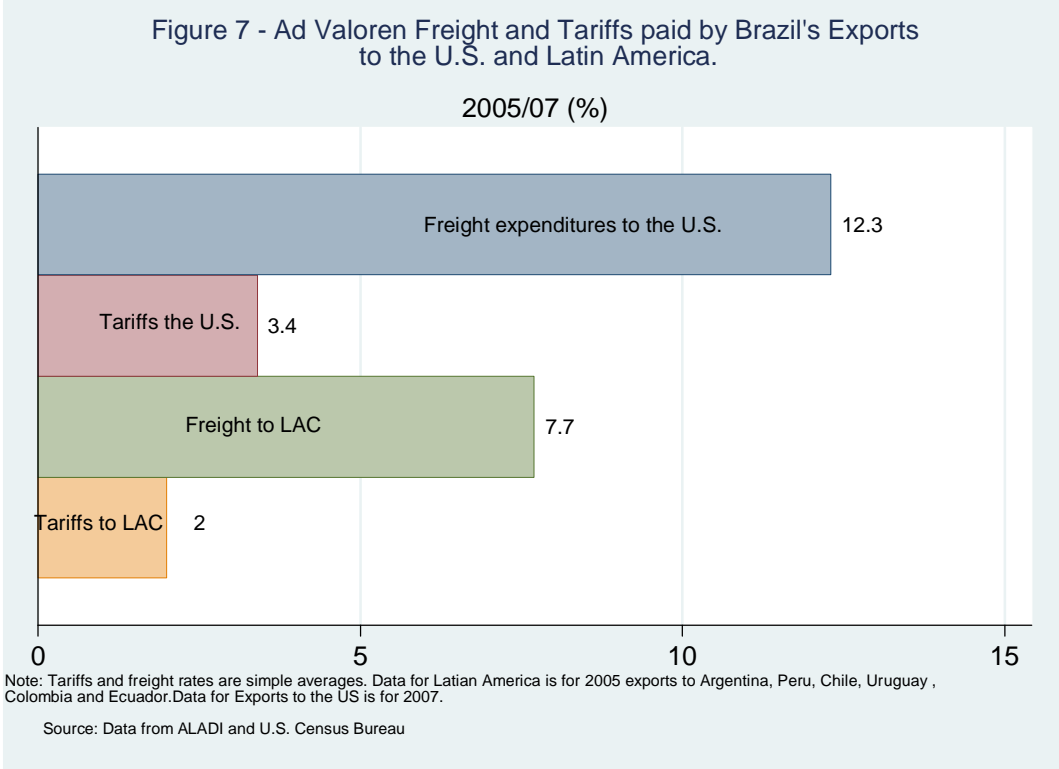
As in most of Latin America, trade policy in Brazil during the last two decades has been mostly about bringing down tariffs and NTBs and signing trade agreements. Whereas the focus on this single source of trade costs was justifiable in the earlier 1990s given their sheer size, the country now faces a different reality.

For one thing, as shown above, unilateral trade liberalizations and preferential agreements have brought those barriers to a fraction of what they were in the past, and even though they are still unduly high for both imports and exports in some sectors and markets, they have clearly lost relevance vis-à-vis other less visible trade costs, as transportation and regulatory costs.<sup>11</sup> Figure 7 illustrates this point vividly. As can be seen, the average freight expenditure for

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<sup>11</sup> For a thorough discussion of the impact of transport costs on trade in Latin America, including Brazil, see Moreira, Volpe, and Blyde (forthcoming).

Brazil's exports to the United States stands well above what is paid for import tariffs and exports to Latin America.



For another, Brazil now faces a much transformed world economy, which bears little resemblance to that of the 1980s and early 1990s. The combination of worldwide trade liberalization—which has brought vast and resourceful countries such as China and India into the world markets—fast technological development, and falling communication and transport costs has reshaped countries' comparative advantages and has imposed a much higher penalty for economies that are complacent about nonpolicy trade costs.

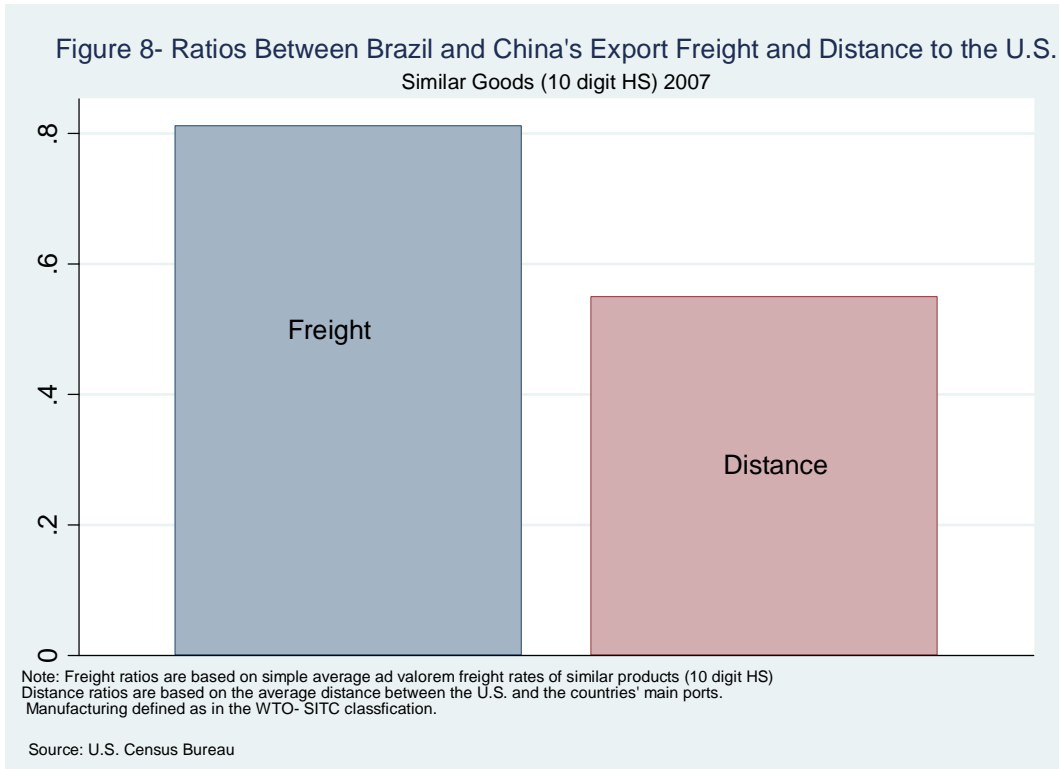
This new reality calls for a more balanced trade agenda, where the government would strive not only to cut tariffs and NTBs at home and abroad (a job, as shown, which is far from over), but would also focus on what is generally referred to as trade facilitation. The pressing need for this new agenda is clear for both intra- and extraregional trade. Without, for instance, improving a poor transport infrastructure—whose development was biased towards extraregional markets by centuries of colonial rule, and which has suffered badly from underinvestment in

recent decades—it is unlikely that Brazil will maximize the gains of scale and specialization that can arise from preferential agreements such as Mercosur.<sup>12</sup>

Likewise, to expand and diversify its exports and take full advantage of the increasing fragmentation of production and the time-sensitiveness of international trade, Brazil can no longer rely solely on trade agreements, relative proximity to large markets such as that of the United States, low labor costs, and on an abundant supply of natural resources. Having much higher labor costs than Asia's (and lower productivity growth) (Moreira 2007) and having seen its geographic advantage being eroded by rapidly falling air freight rates and by economies of scale and oligopolies in ocean transport, Brazil's role as a producer of manufacturing goods hinges crucially on improvements in its dilapidated transport infrastructure. Figure 8 gives some perspective on the urgency of this agenda. As can be seen, Brazil's export transport costs to the key U.S. market do not reflect its proximity advantage. Issues such as the volume of trade, the quality of infrastructure, and the degree of competition on shipping routes seem to be behind these figures (see Moreira, Volpe, and Blyde, forthcoming).

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<sup>12</sup> Brazil's investment in infrastructure has fallen abruptly in recent decades, dropping from 5 percent of GDP in the early 1980s to 2 percent during the 1990s. The decline in transport infrastructure has been even more drastic, falling from 1 to 0.2 percent over the same period (Calderón and Servén 2003).



Transport costs also play a key role in Brazil's ability to extract the full benefits of its abundant natural resources. The deficiencies in its infrastructure have been depriving producers of a substantial part of their profits. This seems to be the case, for instance, for soy producers in western Brazil who reportedly spend four times more to ship their product abroad than their counterparts in the U.S. Midwest. Along the same lines, worldwide ship shortages, driven mainly by growing Chinese demand for raw materials, have been pushing shipping rates to ever-growing heights. The Baltic Dry Index, which reflects freight rates for transporting raw materials, has increased by a factor of 6 since 2001 (as of January 2008), leading to odd situations such as that of iron ore, where ocean shipping from Brazil to Asia can be more expensive than the cargo itself.<sup>13</sup>

<sup>13</sup> The Baltic Dry index is published by the Baltic Exchange (<http://www.balticexchange.com/>). See, for instance, *Wall Street Journal*, October 22, 2007.

## V. Summing Up

Brazil's trade agenda has both old and new issues, which are equally challenging. The old issues are related to a process of trade liberalization that clearly came to a halt in the 1990s. Whereas considerable progress was made until then, there is still an important job ahead to give Brazil the best chances of enjoying the welfare and growth benefits of trade. Protection is still relatively high and has a structure that is as dysfunctional and costly as it is incomprehensible. It distorts the allocation of resources and punishes growth with its high tariffs on capital goods and can only be understood as product of lobbies and special interests. The way ahead is clear: a low, homogenous structure of protection that would remove once and for all these lingering trade costs from Brazil's trade agenda.

Unilateral liberalization alone, though, would not be enough to exploit the full benefits of trade. Market access remains high on the agenda, and Brazil's dual, multilateral, South-South strategy has been producing mixed results. On the positive side is the progress made in putting agriculture at the center of the multilateral agenda. Concrete results, though, have yet to come. On the negative side is a South-South agenda that has left Brazil without preferential access to the world's major markets, while failing to sign enough and significant South-South agreements to at least reduce the disadvantages of not making inroads in the North. Even Brazil's most significant achievement in the South, Mercosur, faces significant problems of misguided expectations and dysfunctional incentives, the latter due in great part to Brazil's unfinished job in opening its economy.

The new issues on the trade agenda have come from the increasing strategic importance of nonpolicy trade costs, which traditionally have been left out of the main thrust of trade policy. Costs such as transportation have gained importance in part because tariffs and NTBs are these days much lower than they were a decade ago. But that is not the whole story. The transformation of the world economy—which, on the one hand, has increased the fragmentation of production and the timeliness of trade, and, on the other, has brought large and extremely competitive economies to the world markets—is also behind the growing importance of trade facilitation. For a country like Brazil, which has traditionally underinvested in its infrastructure, the need to respond to these changes is gaining even more urgency and calls for a trade policy that can be effective in quickly reducing all costs that are relevant to trade.

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