Old Habits Die Hard Import-Substituting Industrialisation and Brazilian Trade Policy

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With protectionism being a highly relevant topic in world politics, Daniel Ferreira presents an analysis of Brazil's history to explain its position as one of the world's most protectionist nations. The paper provides a comprehensive overview of the Brazilian Import-Substituting-Industrialisation policies and how they have impacted the overall protectionist stance of the country. It finds two main justifications for the longevity – one rooted in policy-making processes and another in the negative effect an inclusion in the global supply chain might now have.

SECTION 1 INTRODUCTION

Magical realism is a form of storytelling pioneered in Latin America that blends reality and fairy-tales in a compelling narrative. In this spirit, this paper notes some parallels between the tale of Jack and the Beanstalk and Brazilian trade history; Firstly, both Jack's family and Brazil rely on selling livestock for their income. Secondly, both parties are known for their consumption of beans (though admittedly, not always the magical kind). Lastly, and crucially for our purposes, both have very good reason to mistrust any trade deals they are offered. Humour aside, Brazil's scepticism of free trade has underpinned the protectionist policies that have led to its position as one of the world's most closed economies today (Canuto, 2015). It begs the question, why has Brazil offered significant political resistance to free trade in the past? Furthermore, how does this affect trade policy today? These are particularly relevant questions in the aftermath of the 2018 presidential election, as the incoming cabinet faces an internal conflict between economic liberalism and military corporatism (FT, 2018). This essay argues that Brazilian protectionism was shaped by a period of successful Import

Substitution Industrialisation (ISI) following World War II, and the remnants of this rhetoric continue to shape modern trade policy. The essay is structured as follows; Section 2 offers a brief context of ISI in Brazil, from the conditions that led to its implementation to its use in the latter half of the 20th century. The subsequent sections tackle the central question of how ISI has shaped modern policy; Section 3 argues that ISI strengthened the economic and political power of key interest groups that oppose free trade, and cemented a nationalist ideology that informs foreign policy decisions; Section 4 posits that ISI prevented Brazilian integration into global value chains, thus reducing its global competitiveness and making trade liberalisation challenging. Section 5 concludes the argument.

Section 2 – Isi in 20th Century Brazil

Isi Context – Fall of an Export Economy (1880-1930)

In the late 19th and early 20th century, Brazil's economy was characterised by export-led agricultural growth. Its wealth of natural resources and favourable climate led to the role of a world-leading exporter of commodities like coffee, sugar, and rubber. Coffee was by far the most important of these, in both a domestic and international sense. Brazil supplied most of the world's coffee during this period - at its peak in 1906, it accounted for >80% of global coffee exports (Absell & Tena, 2015), which constituted >10% of GDP, and >50% of total exports (Abreu, 1994).

The coffee trade thus profoundly shaped Brazilian economic development, most notably in regards to policymaking and government finances. This was also the era of "café com leite" (coffee with milk) politics, where policy was dictated by the dairy and coffee producers in the south-east. Their desire for low labour costs led Brazil to be the last western country to abolish slavery in 1888 and to introduce government-subsidised immigration to replace this cheap labour (Abreu, 1994). Crucially for our purposes, in 1906 the government agreed to purchase surplus coffee in an effort to keep global prices high, an expense financed by state borrowing (Ribeiro, 2010).

This agrarian export dependency was severely hit by the Great Depression – at the time, the US market was the destination for 50% of Brazilian exports (Abreu, 1994). The sudden fall in US and global demand was disastrous for Brazilian commodities, and the financial collapse made government support for these industries challenging, with balance sheets already at precarious levels (Ribeiro, 2010). Brazil's dependency on (and valorisation of) coffee exports were largely at fault, leaving it vulnerable to overseas crises in demand and destabilising federal balance sheets (Brazil later defaulted on its debt in 1937). To many, 1930 was a turning point in Latin American trade, marking a change in an outward to an inward looking rhetoric . ISI was largely a response to this lack of external financing and demand.

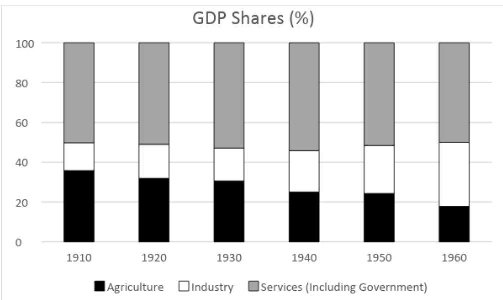
SUCCESSFUL ISI – (1930-1970)

In an economy characterised by agricultural export, the rise of protectionism overseas raised concerns about Brazil's dependence on select exports, and its underdeveloped manufacturing sector. The goal of autonomous industrialisation was thus developed for two reasons. Firstly, to increase per capita wealth - as Bergsman (1970) notes, a large and growing industrial sector is virtually a prerequisite for such growth. Secondly, to strategically reduce its dependency on trade, particularly the import of manufactured goods, in the hope of fostering economic independence from foreign interests.

Infant industry arguments were used to justify ISI – Many industries were too young to compete on a global scale, but given time to mature, they would be able to compete in future, and potentially generate knowledge spill-overs to benefit the wider economy (Feenstra & Taylor, 2011). The tools used to protect domestic manufacturing were import licensing, tariffs and quotas among others. These primarily targeted intermediate and finished consumer goods for strategic sectors, like metal products, where vertical integration gave Brazil a natural advantage (Bergsman, 1970). In particular, high trade barriers were placed on goods for which domestic substitutes were available.

ISI was largely successful in industrialising the Brazilian economy and accelerating growth, particularly in the post-war period. It managed to establish a successful steel and automotive industry, among others (Cardoso, 2009). Most of this additional manufacturing was for domestic use, given the lack of competitiveness of infant industries globally. The GDP share of industry increased significantly (Figure 1), as did GDP and GDP per Capita over 1940-1970 (Maddison, 2018).

Figure 1



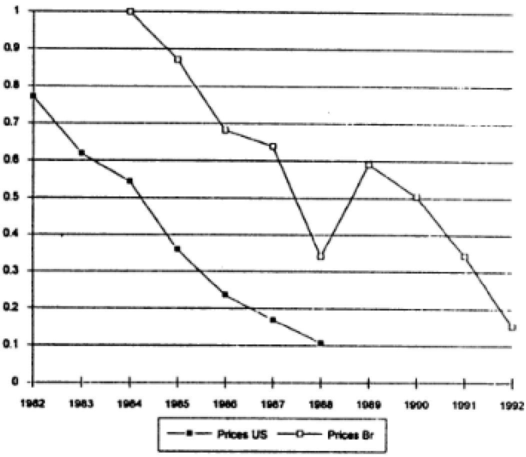
(Abreu, 1996)

ISI Aftermath – (1970-1990)

The success of the ISI policy was both unique and temporary. Brazil's scale ensured a sizeable market for the domestically produced goods, permitting cheaper and more diversified industrialisation than similar smaller countries (Bergsman, 1968). Veiga & Rios (2015) maintain that ISI promoted structural transformation up until the 1970's, but stalled thereafter – Nevertheless, it explicitly governed trade policy until the Uruguay round of GATT negotiations in the 1990's. Continued ISI created economic imbalances through increased debt levels in the pursuit of fully inducing competitive integration into international markets (Cardoso, 2009). Sachs (1995) further emphasises these imbalances by positing that such inward-looking policies financed by borrowing were a catalyst in the Latin American economic crises of the 1980's.

The case of Brazilian personal computers (PC) in the 1970's and 80's exemplifies the failure of ISI. PC imports were banned, and Brazilian firms produced their own, mimicking IBM models popular in the US, but using components from national suppliers (Feenstra & Taylor, 2011). Due to regulation and expensive silicon chips, Brazil was never able to produce computers competitively and match US prices (See Figure 2), the success metric for ISI. This raised costs for consumers and for Brazilian firms who required PC's for their own manufacturing. This policy was eventually lifted in 1990.

Figure 2



(Luzio & Greenstein, 1995)

The persistence of ISI could still be seen in trade liberalisation negotiations in the 1990's, as only select industries were liberalised, with traditionally insulated industries like automobiles and textiles remaining protected (Veiga & Rios, 2015). Oliveira (2009) argues that the supposed liberalisation in the 1990's was simply a necessary response to economic shocks, and did not represent a change in the ruling protectionist ideology. Regardless, the economic impact of liberalisation was promising – both Hay (1997) and Gonzaga et al (2006) observe positive results, with the former noting increased firm-level productivity and the latter finding a reduction in skill earnings differentials.

Section 3 – Entrenchment In Policymaking

Economic & Political Interest Groups

The Stolper-Samuelson model of trade outlines how trade liberalisation increases the return to a country's abundant factor and reduces the return to its scarce factor. In a Brazilian context, this theory suggests that liberalisation is advantageous to sectors like agriculture (i.e. the 19th century commodity exporters), and damaging to industries like manufacturing, which are more capital intensive. A period of successful ISI strengthened the economic and political power of the latter (Oliveira, 2009). Protectionism designed to encourage industrialisation resulted in large swaths of the population being employed in capital-intensive sectors (e.g. automobile manufacturing), increasing both their role in the Brazilian economy and the political influence of their owners. It thus strengthened import-competing sectors at the expense of exporting sectors, effectively entrenching protectionist measures in Brazilian trade policy. As Rogowski (1989) notes, industries with scarce factors of production tend to lobby for protectionist policies, while owners of resource abundant factors lobby for trade liberalisation. As trade liberalisation is against the interests of these empowered key groups, it is politically challenging to implement. Additionally, there are traditionally significant short-term costs associated with trade liberalisation for those inefficient industries. Their increased economic importance from ISI makes the removal of protection an unpopular option, despite the potential long term reward. This increased influence can be seen in the aforementioned trade liberalisation in the 1990's (where key import-competing sectors remained protected).

An interesting complement to the above argument was made independently by Abreu (1994). He observed that pre-war tariff levels in Brazil were already high, despite the dominance of coffee and other export commodities. This seems to contradict the above conclusion, which implies an export focus would encourage trade liberalisation. However, despite a rising cost of production in coffee as tariffs increased, Brazilian coffee exporters were minimally impacted. As Brazil accounted for most of the world's coffee, it was a price-maker – the increase in production costs was reflected in the higher price of coffee globally. Brazil's effective monopoly, combined with the price inelasticity of demand for coffee (Astorino, 2012) meant domestic policy influenced world coffee prices, and this increased cost was passed off to the consumer. This left little incentive for the export lobby to fight against protectionist policies, as occurred in other commodity exporters like Argentina (Abreu, 1994). The passivity of key export groups combined with the rising influence of import-competing industry illustrates how ISI was able to entrench protectionism into Brazilian trade policy.

Nationalist Ideology (Developmentalism)

It would be erroneous to imply that Latin American protectionism began with ISI - Coatsworth & Williamson (2002) highlight rising tariffs in Brazil during the belle époque period of globalisation, and that such policies were commonplace in post-colonial Latin America. The roots of this economic nationalism have been attributed to a myriad of factors. For instance, the historical revenue-maximising concerns for weak governments (Coatsworth & Williamson, 2002), and the belief that economic self-sufficiency is a prerequisite for true political independence (Behrendt, 1941). Regardless of its genesis, it is a rhetoric that continues to underscore modern policy decisions, and its persistence is likely a result of ISI's success over the 20th century.

It accomplished this in two ways – firstly, by tying the concept of autonomous industrialisation to the national development project, ISI made self-sufficiency in manufacturing a primary policy goal thereafter (Veiga and Rios, 2015). This link is not without foundation; manufactured goods tend to have higher margins, and the potential dynamic benefits of fostering industry could boost productivity, education, and economic growth, as seen in the comparable region of South-East Asia (The Economist, 2014). Additionally, the previous system of specialising in select agricultural exports and relying on the import of manufactured goods was shown to be unsustainable in the post-Depression era, where international trade collapsed. Secondly, ISI further cemented a distrust of foreign powers into economic policy. The scepticism of alien interests in the country was by no means novel; from colonialism to the exploitation of natural resources, Brazilian nationalism has been shaped by its desire for independence from foreign interests (Gordon, 2003). International involvement was seen as a threat to "the national project", and trade policy as a tool to neutralise that threat. ISI was thus central to this developmentalist rhetoric, furthering the industrialisation that was intertwined with economic growth at the time.

This overarching sentiment is epitomised in the "Carta Testamento", the suicide letter of President Getúlio Vargas in 1954, who pioneered protectionism and ISI in Brazil:

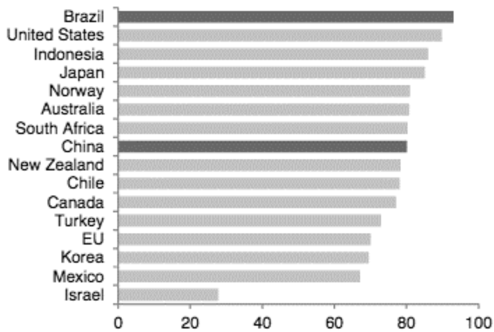
> After decades of dominance and exploitation by international financial and economic groups (…) I have returned the government to the people. (Vargas, 1954)

The letter goes on to condemn the "subterranean campaign of international groups" that opposed Brazilian ownership of natural resources, destroyed the coffee trade, and brought in fraudulent multinational corporations. It embodies the antagonism between Brazil and international forces, and its release renewed support for protectionist policies like ISI (Skidmore, 2010). The opposing political movements of the time, which favoured free trade, were thus seen as acting against the interests of the people, and foregoing national development. The prolonged era of contemporaneous high tariffs and high growth in 20th century over a period of reduced foreign influence on the economy served to reinforce this dichotomy between national and international interests.

SECTION 4 – GLOBAL VALUE CHAINS

The economic aftermath of ISI has presented significant challenges for Brazil's potential to open up trade. Perhaps the most salient of these is Brazil's lack of integration in global value chains. ISI, almost by definition, involves building a domestic supply chain in lieu of a global alternative. As a result, when the dispersion of global value chains occurred in the 1980's, Brazil was largely excluded as a result of its trade policy and high cost of business (Canuto, 2015). The resulting production chain density can be seen in the high domestic value added in manufacturing exports of 93% (Figure 5). This exclusion has hampered Brazil's global competitiveness through increased costs and reduced productivity, thus complicating trade liberalisation and fostering continued support for protectionist policies.

Figure 3



(World Bank, 2014)

The phenomenon of "Custo Brasil" (Brazil Cost), is well known among the population. The significant tariffs placed on foreign goods inflate costs – anecdotally, Brazil is the most expensive country to buy an iPhone, at twice the US price (Forbes, 2014). More broadly, "Custo Brasil" represents the high cost of doing business in the country, which encompasses regulation and costly logistics as well as tariffs. This increased cost is partly responsible for Brazil's exclusion from global value chains - it is consistently ranked among the worst countries to do business (WTO, Annual). Ironically, this very exclusion inflates costs by preventing cheaper imports for production. Brazil's aforementioned attempt to manufacture computers exemplifies this phenomenon which has considerably impacted its export sector. Empirically, Canuto (2015) has shown that Brazil has an unusually low number of exporters, with the top 25% of firms making up 98% of exports. The increased costs of production mean that only the most efficient firms are equipped to overcome sizeable export barriers and compete in international markets. This, in combination with high bureaucratic costs, results in few new exporting firms and a highly concentrated export sector (Canuto, 2015). This implies the benefits of liberalisation would be concentrated among relatively few firms unless accompanied by significant changes in regulation.

Brazil's exclusion from global value chains contributes to its comparatively poor productivity in recent years (Canuto et al, 2013). Trade openness is generally accepted to benefit productivity through a variety of dynamic mechanisms - It gives firms the opportunity and incentive to increase productivity/efficiency by offering cheaper production and more competition, and opening new markets abroad for export (Coelli et. al, 2016). Crucially, it also exposes the economy to new technologies which spill-over to other industries, and increases productivity through "learning by doing" (Arrow, 1962). Integration in international supply chains would likely reallocate skilled labour and other scarce resources to more productive activities, increasing overall productivity (Canuto et al, 2013).

ISI resulted in Brazil's exclusion from global value chains by using import tariffs to favour domestic production chains. Baldwin (2011) argues that the fragmentation of global supply chains had two main effects; it facilitated industrialisation for developing countries, and consequently, reduced the significance of industrialisation to economic development. Exporting industrialised goods was no longer the hallmark of a developed economy, but merely signified its stage on the production line. Ironically, this undermines ISI's developmental goal of autonomous industrialisation. In the Brazilian case, its continued use increased business costs, reduced the competitiveness of its export sector, and hampered productivity growth. These factors reduce global competitiveness, complicating trade liberalisation – i.e. significant change is needed, and the short term costs will likely be severe (Canuto, 2015).

Section 5 – Conclusion

There is a common saying among Brazilians – Brazil is the country of the future, and always will be. Its abundance of natural resources and geographical advantages should provide the ingredients for a thriving economy. Its consistent failure to achieve this has inspired developmentalist policies like ISI. This essay argues that ISI shaped Brazilian protectionism, and continues to influence trade policy today. The paper first illustrated the circumstances in which ISI became a useful trade policy tool, described its successful implementation, and outlined its effects in the late 20th century. Subsequently, two different explanations are offered to justify its persistence – firstly, that of entrenchment in policymaking. The period of ISI cemented the power of interest groups who opposed trade liberalisation, and fuelled a nationalist rhetoric that defines trade policy. Secondly, ISI excluded Brazil from global value chains during a crucial period of globalisation, thus making it difficult for Brazil to compete internationally. This favours the protectionist status quo by requiring significant structural adjustments and short term costs to successfully liberalise trade and reap the associated benefits. In conclusion, though ISI is not the root of Brazilian protectionism, it has undoubtedly strengthened this rhetoric in a modern policy context. It remains to be seen how the incoming government will contribute to this trade history.

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