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The Mixed Nature of Brazilian Policies: Excellent, Dynamic, and Inexplicable

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Decision after decision in Brazil's energy policies over the last 10 years have turned out to be remarkably successful. The country's macroeconomic and social policies were less than stellar until the introduction of the *Plan Real* in 1994, which set the stage for the largely healthy economic situation that exists in Brazil today. Along with other features of the Real Plan (to establish a stable currency, reduce inflation, and get control of the country's fiscal situation), Brazil drastically lowered its import barriers but has since resisted efforts in trade negotiations to reduce them further. The Treaty of Asunción in 1991 establishing Mercosur (the Common Market of the South, consisting of Brazil, Argentina, Paraguay, and Uruguay) was feted with great fanfare, but the trade provisions of the agreement have largely languished since then.

Brazil altered the structure of its energy institutions in the mid-1990s in the hope of improving its uncertain energy situation. The government now controls most of the voting shares of Petróleo Brasileiro (Petrobras), but the majority of common shares are privately held and traded in stock exchanges around the world. This mixture of a national oil company in which the government continues to have the final say on the company's policies together with the requirement to maximize profits to benefit private shareholders has turned out to be a winner. Petrobras' monopoly on oil-related activities was terminated, and prices were freed from state control in 1997. The National Petroleum Agency was created at that time with responsibility for issuing exploration and production licenses and monitoring energy regulations.

Over the years, Petrobras developed great skill in deepwater exploration based on its own endeavors and personnel training, aided by joint ventures with experienced oil companies, private and national. This paid off remarkably well in the past year with a finding of 5 to 8 billion barrels of oil, plus natural gas, at Tupi, located five kilometers below sea level in the Santos Basin, plus the finding of a large deposit of natural gas at Jupiter, offshore from Rio de Janeiro. There are indications that Tupi could be part of a large deepwater oil river that may contain as much as 30 billion barrels of oil. When the technical problems are solved and the infrastructure is in place, estimated to be five to eight years hence, Brazil will be a major oil player in Latin America and probably self-sufficient in natural gas. The country may then face the danger of contracting the Dutch disease—that is, exchange rate appreciation that could prejudice the competitiveness of its non-oil exports. This would involve solving a problem of prosperity and not confronting one of oil and gas shortage.

Some 40 years ago, in the face of a domestic oil shortage, Brazil began its experiment to use sugar cane for the production of ethanol. Government subsidies were high, and there was considerable criticism inside and outside Brazil that this was a costly boondoggle. Today, Brazil produces about 365,000 barrels a day of ethanol, second only to the United States in ethanol production, and there are no longer any direct subsidies. Brazil is the largest exporter of ethanol in the world. Ethanol now makes up 40 percent of Brazil's light vehicular transportation fuel. About a third of Brazil's vehicular fleet consists of flex-fuel cars that can run on any mixture of gasoline and ethanol, and 90 percent of new vehicles produced are flex fuel. To give an idea of how much more competitive Brazil's sugarcane-based ethanol is than U.S. corn-based ethanol, Brazil can profitably export ethanol to the United States over a 54 percent a gallon import duty plus a 2.5 percent ad valorem U.S. tariff and a $.51 a gallon U.S. production subsidy. Most of Brazil's sugar cane is grown in Sâo Paulo state and not in the Amazon, where practically no sugar is produced.

The estimate for GDP growth in Brazil this year is about 5 percent, roughly the same as it was in 2007. This year's increase in consumer prices is running about 5 percent; in four of the five years between 1989 and 1993, just before the Real Plan was introduced, Brazil's inflation exceeded 1,000 percent a year. In an article in the *Wall Street Journal* on May 13, 2008, Matt Moffet noted that Brazil seemed to be on the edge of debt default in 2002, while today its reserves exceed its foreign debt and it is a creditor nation for the first time in its history. Moffet points out that foreign direct investment into Brazil this year is running at an annual rate of $34.6 billion. A few weeks ago, S&P upgraded Brazil's external debt to investment grade. The government announced on May 12 that Brazil is setting up a sovereign wealth fund of $10 billion to $20 billion whose objectives, according to Finance Minister Guido Mantega, are to promote the internationalization of

Brazilian companies, support strategic projects of interest to Brazil, help absorb fluctuations in economic cycles, boost the profitability of public sector financial assets, and stimulate domestic savings.

Brazil's economy is dynamic, but there are weaknesses. Fiscal expenditures rose by 9 percent in 2007—i.e., at a rate higher than GDP growth; fiscal expenditures rose again in the first quarter of 2008, but at a lesser rate than last year. Brazil maintained its primary fiscal surplus last year (the budget surplus omitting debt payments), but this required a tax burden of about 35 percent of GDP. (As a point of reference, the federal tax burden in the United States is about 20 percent of GDP.) Compared with the past, 5 percent is a high figure for GDP growth in Brazil, but it is lower than that attained by the other three BRIC countries—Russia, India, and China. The 5 percent growth was made possible by high export prices for Brazilian commodities, such as soybeans, but this may not be a durable crutch on which to lean. Brazil has an effective antipoverty program that has reduced the degree of poverty of its population to about 22 percent, as defined by the World Bank. On the other hand, Brazil's Gini coefficient, a commonly used measure of income inequality, despite the slight improvement in the last few years, is 0.56, one of the highest, perhaps *the* highest, in the world.

Brazil's trade policy since President Luis Inacio "Lula" de Silva took office in 2003 has been defensive, or as Brazilian trade expert Pedro de Motta Veiga put it, one of minimizing risks rather than seeking opportunities in international markets. Nominal tariffs vary between 0 and 35 percent (the median is 12 percent) and are higher than import tariffs in Asia, let alone those in developed countries. The interval is even larger for effective tariffs (which take into account protection for inputs as well as final products), which vary from -0.4 to 133 percent; the higher figure is for passenger cars and trucks. Brazil's overall exports have been increasing in recent years and reached $161 billion in 2007; the largest increase was for basic goods, which grew by 28 percent. Brazilian companies that produce and export promising manufactured goods chafe at policies that limit their opportunities while the government continues to practice import-substituting industrialization that favors less-competitive sectors. Their argument is that Brazil's progress from an emerging to a developed country requires the durable exploitation of promising global markets.

The negotiations for a Free Trade Area of the Americas (FTAA) are dormant, in large part because the countries of Mercosur, led by Brazil and Argentina, were unwilling to move ahead. The United States responded by concluding bilateral and plurilateral free-trade agreements with countries in the hemisphere. The stated reasons for Brazil's recalcitrant position in the FTAA were that U.S. income subsidies in agriculture would not be reduced in a regional negotiation and that Brazil was not prepared to take on the GATT-plus obligations on issues like intellectual property, investment, and trade in services. Brazil opted instead to become a leader in the Doha Round negotiations of the World Trade Organization, where it was able to espouse the reasonable position to drastically lower the level of subsidies in U.S. and European Union agricultural support programs. It is unclear at this writing what will happen in the Doha Round.

Brazil did not help its position in the Doha Round by its refusal to make clear what its reciprocal concessions would be for its imports of manufactured goods and services, at least until after the agricultural concessions by the United States and the European Union had been agreed. The evidence, based on analysis by Brazilians, is that Brazil intends to cut many bound tariffs as opposed to applied tariffs (a tariff binding commits a country not to exceed a specified tariff level, even if the tariff actually applied is lower) and to seek exceptions to tariff cutting beyond that. As Brazilian trade analyst Mauricio Mesquita Moreira has put it, "…it seems reasonable to assume that it is very unlikely that the Doha Round would do much to address the more blatant distortions of Brazil's current structure of protection." The senior negotiator from another country in the Doha Round told me that he was impressed by the brilliance of the Brazilian trade negotiators but found them unable or unwilling to close a trade deal.

Brazil seems to put much emphasis on the political as opposed to the economic aspects of trade agreements. Mercosur is justified on the political ground of unifying the member countries. This assertion omits the fact that member country Uruguay seeks a trade deal with the United States because of its disappointment with the trade benefits it receives in Mercosur. Many analysts and traders in Brazil find their government's trade policy to be inexplicable—and this word is used in the title of this essay.

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