This version: 5/29/16

TO OPEN OR TO OPEN: THERE IS NO QUESTION

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Introduction[2]

Brazil's economy is sick. This is denoted by its lack of growth, high inflation and deindustrialization. They are symptoms of the country's low productivity that is caused, among other factors, by the technological backwardness, low scale of production, and lack of specialization that characterize Brazilian firms in general. These features result from the country's economic isolation from the world economy: Brazil exports only 13% of GDP that stands for a mere 1.1% of the world total. Measured by GDP Brazil accounts for 3% of the world economy - a value nearly three times higher than its share in world exports[3]. The country is now stuck in its deeper recession in a century: it is a good time to reconsider its economic isolation and promote a greater integration to international trade.

At the end of last decade, Brazil seemed to have entered a phase of sustained growth with inflation under control. The high GDP growth rates since 2004 and the rapid overcoming of the global crisis of 2008-09 suggested this. However, economic stagnation and high inflation since 2011 indicate that the euphoria of the 2004-2010 period was illusory and could be explained by the commodity supercycle that came to a halt in 2011.

Between 2004 and 2011 Brazil benefited from an external bonanza of unique dimensions it its historical experience. A surge in the prices of commodities

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[2] Prepared for Albert Fishlow and Sidney N. Nakahodo (eds.), *Explaining Brazil*. Forthcoming, 2016. An earlier version appeared in Portuguese in Bacha (2013a). With the usual caveats, I am indebted for comments on the earlier version to Albert Fishlow, Alkimar Moura, André Lara Resende, José Tavares, Pedro Mota Veiga, Regis Bonelli, Renato Bauman, Roberto Zagha, Ricardo Bielschowsky, Samuel Pessoa, Sandra Rios, and Yoshiaki Nakano.

[3] All data for 2015. Exports of goods and services and GDP in current prices. Data for Brazil are from the quarterly national accounts of IBGE (www.ibge.gov.br). Comparative GDP data is from the IMF 2015 World Economic Outlook (www.imf.org). Comparative export data is from the World Bank World Development Indicators (www.worldbank.org).

that it exported and a sizeable inflow of foreign capital added nearly 10% of GDP to its domestic demand[4]. Domestic credit multiplied the effect of the foreign inflows, and helped funding a huge increase in domestic demand, including a higher investment rate. From the supply side, higher GDP growth resulted not only from a more intensive use of labor and capital inputs but also from technical progress embedded in additional imports. Accelerated GDP growth could occur without inflation because of a marked appreciation of the *real*'s exchange rate.

Since 2011 the external impulse cooled off: commodity prices stopped growing and began to fall; foreign capital inflows contracted due to higher risk aversion. Firms' and households' indebtedness reached an upper limit. Government budget deficits started to increase sharply even when falsified by misleading accounting practices. Price controls of critical inputs were imposed; foreign exchange swaps were abundantly offered by the Central Bank to delay a currency depreciation; and economic policy became more interventionist in general. After Dilma Rousseff won the 2014 election, monetary policy was tightened, price controls were relaxed and the full-extent of the ballooning fiscal deficit was made clear. Government debt soared, Brazil lost its investment status, and the exchange rate depreciated sharply. The economic result was stagflation; the political consequence was Rousseff's impeachment.

The next section proposes a diagnosis of the Brazilian disease that emphasizes the country's lack of integration to international trade. We argue that the post-WWII international experience suggests that the success of a country to move from middle to high income levels is associated to a growing integration to international trade. There follows the outline of an integration program for Brazil, the implementation of which depends on broad political support and internal social cohesion. These may be easier to obtain under thenew less interventionist Temer government. The final section concludes.

Diagnosis of the Brazilian disease

Traditional diagnoses of the Brazilian disease of high inflation combined with low growth emphasize a low investment rate and a high tax burden, in addition to poor education. Low labor skills, as well as the precariousness of educational standards, are patent in the periodical PISA OECD test results in

[4] For an analysis, see E. Bacha (2013b).

which Brazilian students always appear in the last places in the world. The investment rate amounted to only 18.2% of GDP in 2015[5], while infrastructure investment reached only 1.8% of GDP[6]. Both are very low in comparison either with the other BRICS or Brazil's Latin neighbors. A tax burden that reached 35.4% of GDP in 2014[7], surpassing that of the US and Japan, stifles private investment. The high tax intake fails to promote public investment because of the huge share of obligatory current spending in the government budget.

A factor of equal or bigger importance than those listed above has had a minor presence in the debate on the Brazilian disease, namely, the extremely reduced participation of foreign trade in the country's economy. This factor's importance stems from the development strategy. Trying to attack simultaneously all the problems that hamper the country's growth is a sure recipe for failure because there is no government that will have the strength to do all that is required. It is better to focus efforts on the Gordian knots that, once untied, have the power to force the alignment of the other growth requirements. It appeals to reason and is in line with international experience that a deeper integration of the country to international trade would provide a strong inducement to reduce the tax burden, to increase the investment rate, and to improve infrastructure and education quality. Such is an application of Hirschman's principle of unbalanced growth: instead of seeking an impossible simultaneous growth of all sectors, the best strategy for development is to create a regenerating unbalance, forcing other growth requirements to align themselves with a new reality[8].

In this context Hirschman coined the term "exportability" to characterize the way in which industrialization could lead an underdeveloped country to reach a higher income level. Nothing wrong with import substitution, he suggested, if this is the way for the country to diversy its export base. Brazil took the first step, and created a strong manufacturing sector through import substitution. But it did not take the second step, as Brazilian industry produces only for the domestic market and is not integrated to the international value chains.

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[5] Source: IBGE, *Quarterly National Accounts*.
[6] Preliminary 2015 figures provided by Claudio Frischtak. For 2014 data, see Inter B. (2015).
[7] Cf. G.L. Amaral et al. (2015).
[8] Cf. Hirschman (1958).

According to the CIA *World Factbook*[9], in 2014 Brazil occupied only the 25th position in terms of merchandise exports, although the country´s GDP was the 7th biggest in the world. This is an anomaly among big economies, because the US was number one in GDP and number two in exports. China was number one in exports, and number two in GDP. Japan was the 3rd largest country in terms of GDP and the 4th largest in terms of exports. Germany held the 4th place in terms of GDP and the 3rd in exports. UK and France came next in terms of GDP, and held respectively the 6th and the 10th position in terms of merchandise exports.

The evidence is that big countries are all major exporters. Not so Brazil. Similarly to Brazil, with a large GDP but relatively small exports, there is only India (9th biggest economy and 17th largest exporter in 2014), a poor country that is now rapidly moving into the middle class.

The objection could be made that although the US is a major exporter in 2015 its exports of goods and services accounted for only 12.4% of GDP, a figure lower than Brazil's 13%[10]. But the US stands for almost a quarter of total world GDP and is nearly six times bigger than Brazil. Moreover, the US can afford some self-sufficiency as it operates on the frontier of global technology which is far from being the case of Brazil.

An equally discouraging picture of Brazilian integration in world trade appears when we look at imports. World Bank data for 2014 has the share of imports of goods and services in Brazil's GDP at only 14%, the third lowest among the 160 countries for which the bank has data[11]. In South Korea, the share of imports in GDP was 45%. In Germany, 39%. In China, 19%. Even the US with its huge economy in 2014 imported 16.5% of GDP, almost 20% more than Brazil.

The conclusion is that Brazilians live in one of the most closed economies to foreign trade in the world. This is paradoxical because, at the same time, Brazil is a very attractive market for direct investment by

[9] Cf. Central Intelligence Agency, *The World Factbook*. GDP in current dollars. Available in: https://www.cia.gov/library/publications/the-world-factbook/geos/br.html .

[10] US data for 2015 from: http://www.bea.gov/national/Index.htm

[11] Only Nigeria and Sudan have lower import coefficients than Brazil. Cf. The World Bank, *Data/ Imports of Goods and Services (% GDP).* Available at: http://data.worldbank.org/indicator/NE.IMP.GNFS.ZS.

multinationals. According to the UNCTAD 2015 *World Investment Report*[12], in 2014 Brazil ranked sixth as the preferred destinations of foreign direct investment, behind only the United States, China, Hong Kong, Canada, and Singapore.

The explanation is that multinationals come to Brazil to explore the protected domestic market and not to integrate the country to their global supply chains, as is the case with their subsidiaries in Asia and North America. The paradox is explained by the fact that Brazil has a capital account that is receptive to investment flows, but a current account that is inimical to trade flows. As Harry Johnson warned in the 1950s, this is a sure recipe for what Jagdish Bhagwati later denominated as "impoverishing growth"[13] . Multinationals profit to invest in the country, but the rest of the economy languishes as domestic resources are deployed in the inneficient replacement of imports instead of being used in more productive export activities.

Imperative of integration

The country's isolation with respect to international trade is worrying also because the postwar evidence suggests that there is no other alternative for growth other than a fuller trade integration with the rest of the international community. In the last seventy years there are only a dozen countries that managed to overcome the so-called middle-income trap and catched up with the advanced economies. Israel and the Southeast Asian tigers - South Korea, Hong Kong, Singapore, and Taiwan --- did it with industrial exports. The European periphery - Spain, Greece, Ireland, and Portugal – did it by exporting services, including temporary labor. With their abundant natural resources and sparse populations, Australia, New Zealand, and Norway dit it with commodity exports[14]. Each did it on its own way, exploring its resource endowments and geographical environment, but all of them had one thing in common: increasing international trade integration.

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[12] Cf. Figure I.3, p. 5, at: http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf

[13] For references and a synthesis of this literature, see R. Brecher and C.F. Diaz-Alejandro (1977).

[14] Norway was already a relatively developed country in the late 1960s, but it was the discovery of oil in Norwegian shores in 1969 that transformed it from the poorest of the Nordic countries to one of the richest countries in the world today.

To reach middle-income status there is no need for a lot of trade when the domestic market is relatively large, as is the case of Brazil. Through import substitution, it is possible to attract to urban centers the underemployed rural population. The growth of aggregate productivity that this labor force displacement provides is enough to raise incomes in the early stages of development, as diagnosed in the classical analysis of Arthur Lewis on growth with unlimited supplies of labor. However, once this growth source is exhausted, the additional productivity gains necessary to lead from middle to high-income levels depend on firms with technology (including modern inputs), scale, and specialization – and this can only be achieved through integration to international trade.

In the 1960s, South Korea's per capita income was lower than that of Brazil. However, its industrialization strategy was based on export promotion while Brazil persisted with import substitution. In 1970, exports of South Korean goods and services accounted for 15% of GDP, while in Brazil the ratio was 7%. Forty-five years later, in 2015, South Korea's exports stood at 48% of GDP, 3.2 times higher than in 1970. Meanwhile, Brazil's export ratio was 11.2% of GDP, only 1.6 times higher than in 1970. South Korea became a developed country, with a GDP per capita of USD 36,700 and the sum of exports and imports of goods and services standing at 88% of its GDP. Brazil remained a middle-income country with a GDP per capita of USD 15,800 and a trade flow slightly higher than ¼ of its GDP[15]. There is no doubt that the extraordinary export potential of South Korea is associated with its excellent infrastructure, the technological superiority of its leading firms, and the good education of its labor force. But all of this would have been difficult if not impossible to put in place were it not for the conviction of the Korean leadership, already in the 1960s, but especially after the first oil shock of 1973, that "exportability" was essential to its development process.

This is the challenge that Brazil faces. To overcome the middle-income trap it is imperative that it ceases to be one of the most closed economies in the world to international trade. It needs to develop a competitive integration strategy to the global value chains. This does not mean that the country will

[15] Data for Brazil's trade ratios are from IBGE's National Accounts System and the Quarterly National Accounts. Data for trade ratios in South Korea are from the Bank of Korea / Economic System Statistics: http://www.bok.or.kr/eng/engMain.action . The GDP per capita (PPP) data are for 2015 from the CIA World FactBook.

become an export platform for Brazil is too big for that. Even in the case of an extraordinary success of an integration program, in which the share of exports in GDP doubles to 25% of GDP, exports would still represent only 1/5 of the country's aggregate demand; the other 4/5 would continue to come from domestic demand[16].

The increase in the share of exports in GDP would not be made at the expense of a domestic demand reduction. The objective is not to achieve a trade surplus; on the contrary, exports and imports would grow at a similar pace. For a given GDP, domestic demand will be the same, except that a larger portion of it will be met by imports, as a larger share of GDP will also be destined to exports. Therefore, even in the short term the integration scheme proposed in the next section is fully consistent with an improvement in the living standards of the population. In fact, the presumption is that trade growth generates higher labor demand and an increase in the real wage.

Only by rasing significantly the share of exports in GDP is that Brazil will manage to become more than a commodity exporter, and be able to develop internationally competitive manufacturing and services sectors. The example of Embraer, which imports 70% of what it exports, points to the way of the future. The fact that virtually all relevant multinationals already have facilities in the country eases the proposed transition. While the multinationals came to Brazil to explore its domestic market they will not leave the country when it opens up if they are offered appropriate incentives to develop an export activity, complementary to that of their affiliates in other parts of the world. The massive presence of multinationals in the country is an important asset to facilitate Brazil's integration to the global value chains.

Features of an integration program

Our suggestion for an integration alternative is a pre-announced program to be implemented gradually, over a number of years. As it is a gradual program not a shock treatment it will be necessary to build political and social support to implement it. Now that Brazil has a less interventionist government, this support could possibly be reached from two considerations.

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[16] From the accounting identity between aggregate supply and demand: Y + M = A + X (where Y is GDP, M imports, A domestic demand, and X exports), if X = 0.25 * Y and M = X, then X / (X + A) = 0.2.

The first is that if Brazil persists on the current course of economic isolation it will continue to stagnate without managing to escape from the middle-income trap. The evidence of the country's lethargic economic performance in the last thirty-five years shows clearly that import substitution is not a way out. The disastrous economic experience with increased protectionism under Dilma Rouseff's government only strengthens this evidence. There is undoubtedly a huge growth potential for the country to explore with the emergence of the so-called new middle class. There is also ample room for the improvement of infrastructure and public services through concessions and public-private partnerships. In the near future, the subsalt oil fields will join the exploitation of minerals and the expansion of agriculture to make the country a powerhouse in the area of commodities[17]. But all of these opportunities will be waisted if an anti-competitive mentality prevails that attempts to preserve the domestic market for local producers alone; if an inadequate design of concessions and public-private partnerships continues to be adopted; and if the exploitation of the subsalt oil fields is hindered by excessive state intervention and local content requirements. To be successful, the investment opportunities opened up by the expansion of the middle-class, infrastructure updating, and subsalt oil exploitation need to be informed by the principle of "exportability" and not by that of protected import substitution.

The second consideration is that preferential trade agreements (PTAs) have become in recent years an important mechanism for trade expansion and an irreversible feature of modern regulated international trade. In the early 1990s, there were 70 PTAs in force. The proliferation of agreements intensified in the following years. In 2013, 546 PTAs had been notified to GATT/WTO, against only 123 notifications throughout the GATT era. Of these 546, 356 are in place today.

Apart from economic cooperation agreements with neighboring countries, Brazil, together with Mercosur, is a signatory to only five PTAs, of which only two with India and Israel are in place, both with a short-range[18]. Communities with much larger internal markets than Brazil's and at the frontier of world's technology, such as the US and the European Union, recognize that, in the globalized world in which we live, even they must join forces to accelerate their growth prospects. They are thus in the process of negotiating a deep free

[17] On these three growth areas, see Bielschowsky (2012).

[18] Information about the PTAs came from IEDI (2013).

trade area, the so-called Transatlantic Trade and Investment Partnership[19]. In early 2016, twelve Pacific Rim countries, including the US and Japan, signed the Trans-Pacific Partnership trade agreement. The impertinence of Brazil's protectionist trade position has become more blatant than ever, raising the urgency of an integration program to release the country from its economic isolation.

The integration program we propose has three pillars to be put in place over a number of years: fiscal reform, substitution of exchange rate protection for tariffs, and international trade agreements.

Fiscal reform. The goal of the first pillar of the program is to simplify and reduce the tax burden on businesses without an increase in the government deficit. This would require establishing a limit for the growth rate of government expenditures. The interim Temer government has recently proposed a new formula: to limit the federal government nominal spending growth to the value of last year's inflation. Provided inflation is on target, this is equivalent to freezing the real value of government spending. At first, this should create fiscal space for the debt to GDP ratio to stabilize, and in a second stage for a reduction of the tax burden. To make sure that this target will not be bypassed through parallel budgets, the proposed public spending limit should be supplemented by a limit on public debt growth. The construction of this pillar would require the approval of constitutional reforms as necessary to keep public spending expansion under control[20].

This first pillar would help to reduce the "Brazil cost", which is the main factor mentioned by Brazilian companies to explain why they cannot face international competition. Their second biggest problem is the exchange rate.

Replacing tariffs by exchange rate protection. This is the theme of the second pillar of the proposal, namely the replacement of tariff protection against imports by exchange rate protection. This would start with a credible announcement of a substantial reduction to be implemented over a number of years of tariffs on imports, domestic content requirements, government procurement preferences, customs and port entanglements, restrictions on professional

[19] For an introduction, see: OECD, *The Transatlantic Trade and Investment Partnership: Why Does It Matter?* In: http://www.oecd.org/regreform/facilitation/TTIP.pdf .

[20] Examples of these constitutional reforms are: a minimum retirement age, stricter pension inheritance rules, revised civil servants' tenure rules, deindexation of public employees' salaries and pensions, unearmarking of government revenues.

service imports, and technical specifications of products diverging from those adopted abroad.

The authorization for all interested parties to use the Express Customs Clearance/Blue Line, adopted by Brazil's IRS to streamline the tax procedures for foreign trade operations, would be among the measures for trade faciitation. This special speed lane currently applies to only a few large companies. As taxes on imports will drop with the program's implementation, they will no longer be important to boost federal revenues. This may facilitate Brazil's IRS to agree in reducing substantially the bureaucratic requirements for firms to use the Blue Line[21].

The trade facilitation measures should include a substantial improvement in port infrastructure and transportation facilities, through concessions and public-private partnerships. As shown by recent studies by the Inter-American Development Bank, plausible reductions in transport costs can generate significant increases in the country's exports[22].

The announcement of these antiprotecionist measures will presumably be made by a President convinced of their need and with Congressional support for their implementation. In this case, under a floating exchange rate regime this announcement should have the effect of devaluing the currency, as financial agents will want to buy dollars and sell reais previously to the program's implementation, to profit from the increased demand for dollars that will occur as imports are facilitated.

Reduced protection is a critical pillar because it will give Brazilian firms access to modern inputs, enabling them to integrate their activities to international trade flows, similarly to what occurs today with Embraer. Certainly, there will be losers as well as winners. Brazil (not unlikely the US) will continue to be a major commodity exporter, but macro sectors as a whole should not either benefit or be harmed by trade liberalization. The protection mechanisms that will be reduced or eliminated seem to be more important for manufacturing than for agriculture or mining (but not necessarily for tradable services). However, manufacturing will also be the major beneficiary of the tax simplification and reduction program as agriculture is relatively less taxed. In

[21] Kume et al. (2011) document the strong relationship of import duties evasion with the tariff levels.

[22] See: Moreira Mesquita, M. et al. (2008) and (2013).

addition, at the edge of trade expansion manufacturing will benefit from economies of scale and specialization that are not present in agriculture, which operates under rising costs as its expansion requires the occupation of less productive or more distant lands. Also, albeit selectively, the industrial sector will benefit the most from access to imported inputs that are cheaper and of better quality.

Particularly for large and diverse countries like Brazil international trade is no longer based on macro-sectorial specialization as in the famous example of David Ricardo, in which Portugal specialized in wine and England in textiles. Modern trade in the global value chains is predominantly intrasectoral rather than between sectors; it is prominently intrafirm rather than between firms; and it is mostly of inputs and components rather than of final goods[23]. The principle of comparative advantage remains valid in the global value chains, but it needs to be reinterpreted in terms of stages, activities, and tasks rather than of final products or whole industries[24]. Trade liberalization may result in little change from the point of view of final products or the relative sizes of major sectors of activity. Also, there may be no major shifts in the productive structure of the economy, that is, that the distance will be small in terms of geography, activities and processes, that firms and workers will need to travel to adapt themselves to a greater integration to international trade.

The sequencing of liberalization is a complex issue. On one hand, it would facilitate the acceptance of the program by industrialists if the lowering of tariffs were to start with inputs to reach final products only later. But this would mean for instance that the absurdly high rates of effective protection enjoyed by trucks and automobilies in Brazil would become even higher. It is better to consider a program that, at the end of a number of years, unifies the effective rate of protection of all goods and services, except possibly for those produced by technologically advanced infant industries. Given this principle, the sequencing of liberalization could be determined by considerations of

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[23] For a masterful analysis of the new trade patterns, see Helpman (2011).

[24] For an analysis of the impact of global value chains in international trade, see OECD (2013).

political economy, related to the maximization of the program's support among entrepreneurs, workers and consumers at large.

It is not simple to design a mechanism for the proposed substitution of exchange rate protection for tariff protection, especially because of the volatility of the capital account and its importance in determining the exchange rate. One can imagine solutions for this dilemma, but they would all start from the recognition of the importance of a competitive exchange rate for the program's success. Before his recent appointment as Central Bank's president, Ilan Goldfajn (2016) proposed to shift the responsibility for the definition of the exchange rate policy from the Central Bank board to a committee of the Monetary Policy Council, composed of members from the Central Bank and the Finance Minister[25]. The objective would be to make clear that the exchange rate is a critical price that is important not only for inflation control but also for resource allocation and Brazil's growth strategy. This would be a welcome policy initiative to facilitate the implementation of the second pillar of the integration program.

Trade agreements. The third pillar of the program are international trade agreements. Given the large domestic market that it will open to exports from the rest of the world, Brazil will be able to make valuable negotiations for the liberalization of their trading partners' markets. The range of possibilities is broad, involving multilateral, regional and bilateral agreements. The country will need freedom of movement and thus may need to bend the Mercosur rules of a common list of negotiation with third parties.

The suggested integration program is unilateral; therefore it is not conditional on the fulfillment of trade agreements. However, in the sequencing of import liberalization there will be room to do it first for countries that sign trade agreements with Brazil. Faster access to the Brazilian market should be a sufficient stimulus to induce the country's trading partners to enter into such agreements. One cannot stress sufficiently that trade liberalization is an advantage in itself for Brazil. Trade gains that come from agreements are in addition to those generated by this proactive policy to reactivate Brazil's economic growth.

[25] The Monetary Policy Council, composed of the Ministers of Finance and Planning and of the Central Bank President, exercises oversight over the monetary policy conducted by the Central Bank.

Conclusions

This text developed four points in favor of a greater integration of Brazil to international trade. The first is that the country has been for thirty-five years a prisoner of the middle-income trap, unable to develop a growth model based on productivity gains and not just on labor transfers from rural to urban activities. The second point is that the country's isolation from the rest of the world--with exports of only 11.2% of GDP, which represent no more than 1.1% of world trade--stands proeminently among the reasons for this poor performance. The third point is that in the postwar period only a few countries succeeded in overcoming the middle-income trap and became fully developed--but they all did so with a strong integration to the international community, exporting either manufactures, services, or commodities. Thanks to its large and diverse economy, Brazil has the possibility of developing an integration process incorporating all three sectors of economic activity.

The fourth point relates to the components of a gradual and pre-announced integration program. It would have three pillars: a fiscal reform to reduce taxation and bureaucratic hudles on productive activities; a progressive but substantial reduction of tariffs and other protectionist measures, partly offset by a more depreciated exchange rate; and the implementation of bilateral, regional, and multilateral trade agreements.

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