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The Mechanics of Brazil's Auto Industry

By Helen Shapiro, in NACLA's *Report on the Americas*, Jan/Feb 1996

In April, 1994, the vice-president of General Motors of Brazil (GMB) made a special appearance on prime-time television. Instead of the standard sales pitch, he asked viewers to stop buying the Corsa, GM's hottest-selling car. GMB was forced to make this unprecedented appeal by the overwhelming response to its new compact. Only two months after appearing on the market, waiting lists for the Corsa already approached 130,000, nearly all of planned production for 1994. If Brazilians did not wait until local production caught up to demand, GM feared that the illegal 30-50% markups being charged by disreputable dealers and in the burgeoning black market would rise even further.

After more than a decade of stagnation, Brazil's auto market has been booming. Total vehicle production grew by 30% in 1993 and another 14% in 1994, making 1994 the most profitable year in GMB's 69-year history. Optimistic about the future, GM Brazil is planning to invest US$2 billion over a three-year period, all from locally generated profits. Brazil has moved to the forefront of GM's global strategy, a far cry from when GM's Chief Executive Officer from the 1980s, Roger Smith, disparagingly referred to Brazil as a "black hole."

GM is not alone in its renewed enthusiasm for Brazil. Ford, Fiat and Volkswagen, which, together with GM, dominate the local industry, are also planning to invest US$9-12 billion in modernization and new capacity. They will be joined by Renault, Hyundai and Asia Motors, the first new entrants into the car market since the early 1970s. Mercedes, which previously produced trucks and buses, will start assembling passenger cars. Toyota has expressed similar interest in entering Brazil's passenger car market. While Brazil was the world's ninth largest producer in 1994 with an annual output of 1,581,381 vehicles, some predict that by the year 2000, it will produce two million cars. This would move Brazil into sixth place, surpassing England, Canada and South Korea.

The recent recovery of Brazil's auto industry coincides with the reduction of trade barriers

and deregulation, leading many to conclude that market liberalization is driving the boom. This conclusion is unwarranted, however. While selective reforms have been critical, the revival of the auto industry is not the result of free trade and a noninterventionist state. In fact, despite the overall liberalizing trend since 1990, the Brazilian state has developed specific sectoral policies aimed at promoting the industry's recovery, including organized negotations between the government, the auto companies and labor. It is these deliberate state policies in concert with a changing industry and international economic context that explain the auto industry's recent boom. Indeed, Brazil's auto industry has been largely shaped by the dynamic interaction between state policy and the global auto industry since its beginnings in the 1950s.

The auto industry has many of the attributes of a classic oligopoly. It is capital intensive with large economies of scale. To be cost-effective, an integrated auto plant must produce about 250,000 units a year. Its requirements of large fixed investments, distribution and service networks, and brand-name recognition create enormous barriers to entry for newcomers. As a result, it is dominated by a handful of transnational corporations whose strategies are interdependent. A firm's decision about where to produce, for example, may have more to do with its market position relative to a competitor than with simple short-term profit or cost calculations.1

Despite images conjured up by the development of the "world car," in which models are standardized for world markets and car components come from different locations around the world, auto companies do not randomly survey the globe in search of low-wage production sites. This may be an accurate portrayal of firm strategy in labor-intensive industries such as textiles that can easily relocate to exploit low wages and government incentives, and where low-entry barriers allow new competitors to challenge firms operating from high-cost locations. By contrast, capital- intensive industries like auto depend on an industrial infrastructure for parts and components, skilled labor, and a sizeable domestic market. Wage rates, while important, are only part of the story.

In Latin America, auto production is concentrated in the larger, more industrially advanced countries of Brazil, Mexico and Argentina. Though tiny in terms of global market share--3%, 2%, and 1%, respectively--the auto industry dominates manufacturing in each country's economy. In the past five years, these Latin American markets all experienced booms in demand, in contrast to almost nil growth in the developed countries. Given the low rates of car ownership--1 to every 11.6 people in Brazil, 1 to 8.5 in Mexico, and 1 to 5.5 in Argentina, as compared to 1 to 3 in the United States--transnational auto companies were attracted to the huge growth potential of these overseas domestic markets.

The roots of the modern Brazilian auto industry can be traced back to 1956, when the government of Juscelino Kubitschek (1956-1961) implemented a five-year plan initially motivated by balance-of- payments concerns and the desire to protect local-parts producers that had emerged during World War II. The Kubitschek administration came to see the auto industry as the quickest, most effective way of promoting Brazil's industrialization: "fifty years (of development) in five" was his campaign slogan. By attracting foreign capital and technology and generating linkages to complementary sectors, the auto industry was to be the leading sector in a broad import-substituting

industrialization push.

The plan's basic approach was to restrict imports and force transnational automotive companies to choose between abandoning the Brazilian market or producing vehicles with 90-95% Brazilian- made content within five years. Until that point, Brazil's auto industry consisted of foreign subsidiaries or licensed domestic firms that assembled vehicles locally from imported completely or semi-knocked down kits. Transnational corporations expressed little interest in shifting from assembly to full manufacture. As a Ford representative put it at the time, the idea of producing engines in the "tropics" was "utopian."

But a combination of factors made full-scale car manufacturing in Brazil more feasible. At the international level, as the postwar boom came to an close, profits on domestic operations fell in both the United States and Europe, pushing firms to place greater emphasis on overseas expansion. International competition intensified as a result, and aggressive European firms began to challenge the U.S. Big Three (GM, Ford and Chrysler) in their traditional markets including Latin America. When one firm took the first step by deciding to invest in Brazil, other firms followed in order to defend their potential market shares.2

The dynamics of oligopolistic competition were not the only factor, however. The resulting shake-up in the global auto industry gave the Brazilian government greater leverage vis--vis the auto transnationals. By issuing a credible threat that the Brazilian market would be closed to imports, the government was able to pressure the transnationals to engage in full-scale local production. The government also offered extensive subsidies that significantly reduced the cost of capital investment and guaranteed a return even if profits did not materialize. Since most of these financial incentives were available for only the five years of the plan, the government set the timing of firm investment by increasing the barriers to entry for firms that wanted to delay investing. By compelling large investments, the government increased the exit costs as well. Eleven firms signed up. Three (Willys-Overland, Vemag and the National Motor Factory) were controlled by Brazilian capital, and two (Mercedes-Benz and Simca) were joint ventures. The rest were controlled by or were wholly owned subsidiaries of foreign firms.

The early 1960s marked a period of economic instability and labor unrest in Brazil, culminating in the military coup of 1964. For the auto industry, this was a period of crisis. Firms had built ahead of demand, and the industry became plagued with overcapacity. The auto sector was further hard hit as the market shrank with the 1963-64 economic downturn and the military's post- coup austerity program. Smaller, financially weaker firms did not survive these lean years. By 1968, the original eleven firms had shrunk to eight. Only those controlled by transnational capital remained, of which three--Volkswagen, GM and Ford--controlled 89% of the total vehicle market.

Workers were brutally repressed during the military regime, and ultimately forced to shoulder the costs of its austerity program. Workers' real wages fell drastically during this period, and their share of total income was redistributed to the top income brackets. This income concentration, along with the military's easing of tight credit policies after 1967, paved the way for an economic boom based on consumer durables such as automobiles

and household appliances. Brazil's GDP grew 10% annually between 1968 and 1974. The auto industry was key to jumpstarting this so-called "economic miracle" by sustaining 20% annual growth rates between 1968 and 1973. Excess capacity, once a liability, now allowed firms to meet rising demand. By the early 1970s, production capacity couldn't keep pace with demand, leading firms to initiate a new wave of investments.

Changing international conditions made it difficult to maintain the high "miracle" growth rates. The oil shock in 1973 came down heavily on Brazil, which imported 80% of its oil needs. The conservative military government, concerned about the growing trade deficit, sought--in addition to heavy foreign borrowing--to move the auto industry towards exports as a way of obtaining needed foreign exchange. For the transnational subsidiaries, which had invested heavily in the domestic market with the expectation of continued rapid growth, exports served as a temporary outlet for excess capacity.

Once again, changes in the global industry reinforced the government's objectives, this time toward exports. Powerful new competitors from Japan, whose revolutionary production technique produced low-cost, high-quality vehicles for export, challenged the existing international market structure. GM and Ford, for example, sought to catch up by automating at home. They also adopted "world car" strategies, which allowed them to produce at higher volumes and lower cost by increasing product standardization worldwide.3 Such global production networks allowed the companies to increase economies of scale, spread research and development costs over more vehicles, and use low- wage production sites as export platforms for engines and components. Some European firms also looked to developing countries, such as Spain and South Korea, as low-cost export bases for finished vehicles for other low-income countries with similar demand profiles.

The military government in Brazil promoted the development of cars for export by launching the Special Fiscal Benefits for Exports (BEFIEX) program in 1972. The government granted generous incentives, including tax exemptions on imported machinery, equipment and other parts, and waived federal and state value- added taxes on exports. In exchange, firms had to commit to long- term export contracts and comply with minimum domestic-content requirements (85% for vehicles sold in Brazil).4 Firms were also allowed to import a certain number of parts and components that had previously been banned because they were produced domestically.

The Brazilian government was able to leverage privileged access to its large and growing domestic market to pressure the auto transnationals to produce cars and components for export in Brazil. For example, Fiat, which until then had no presence in Brazil, was allowed to enter the domestic car market only in exchange for exporting 155,000 engines annually. In terms of auto firms already in Brazil, the state had greater clout since, in contrast to the 1950s, these firms had to protect not only their access to the Brazilian market, but their prior investments as well.

For example, GMB wanted to introduce the J car, one of GM's "world cars," to Brazil. However, the size of the domestic market did not justify the investment needed to build the J car's new engine, which had to be made in Brazil in order to comply with domestic-content requirements. GM decided to absorb the excess capacity while the domestic market

grew by exporting the engine to the U.S. Pontiac division. Exiting a market can be costly, as can reentry. The fact that firms were forced to consider Brazil as a production site for export, when they otherwise might not have, speaks to a successful dynamic outcome of import-substituting policies from the 1950s and early 1960s. Over the course of the 1970s, Brazil's total automotive exports had increased from virtually zero to US$1 billion.5

By 1980, the industry was churning out over a million vehicles a year, making Brazil the world's eighth-largest producer. There was also a surge in trade-union activity during this period, as workers' protests against declining wages and authoritarianism in the workplace grew and eventually linked up to broader opposition to the military government. Although exports had grown to 14% of production, firms continued to focus on domestic demand, which was predicted to hit two million by 1990. With volume up and new investment coming on stream, costs were declining. Even the World Bank concluded that the industry was a successful "infant" on the verge of maturity.6

The debt crisis of the early 1980s snuffed out these optimistic projections. Once again confronted with domestic market contraction and macroeconomic uncertainty, the industry stagnated over the 1980s. Firms looked to exports as an alternative, and by 1990, when the BEFIEX program was phased out, Brazil's car exports reached US$8.2 billion.7 Exports came to substitute for, rather than complement, domestic sales.

The direction of these exports began to shift as Brazil's Third World markets also contracted in response to debt-driven austerity programs and increased protectionism. In the early 1970s, nearly 90% of Brazil's finished-vehicle exports went to other Latin American countries. By 1984, 40% of Brazil's vehicle exports were being shipped to the U.S. and Europe, and by 1989, this share had increased to 60%. Brazil's biggest success stories were the Volkswagen Fox in North America and the Fiat Duna in Europe. For a brief time, it seemed that Brazil might be able to duplicate South Korea's strategy of exporting cheap cars to these profitable markets.8 However, the increasingly overvalued Brazilian currency pushed these cars out of their price-sensitive market niche.

By decade's end, Brazil produced less than a million vehicles annually. New investment had ceased, and many firms' profits were increasingly derived from the lucrative financial market rather than car sales. Within the global industry, Brazil was eclipsed by Spain, South Korea, and even Mexico, which outproduced Brazil for the first time in 1991.

In the 1990s, an intensive restructuring process has reshaped the global auto industry. As markets become more open and brand-name loyalties weaken, firms are less likely to design unique car models for particular national markets. Companies are integrating their global operations in an attempt to eliminate duplication and cut costs. This has reshaped the transnational auto manufacturers' relations with their parts suppliers, for example. Firms are now turning to outside suppliers to do some of the processes that they once did in-house. In imitation of the Japanese, they are also reducing the number of parts suppliers they work with in an attempt to collaborate more closely on product design and development. The pressure on these firms to meet international standards with respect to cost, quality, and delivery time has increased.9

Recent Brazilian governments have taken steps that reinforce the industry trend of global

integration. The failure of heterodox economic policies of President Jose Sarney (1985-90) and subsequent bouts of hyperinflation paved the way for the implementation of neoliberal economic policies in Brazil. President Fernando Collor de Mello (1990-92) initiated neoliberal reforms, including his campaign promise to open the Brazilian market to imported cars for the first time since the late 1950s. Competition from imports was meant to jump-start the stagnating domestic auto industry by forcing firms to invest in new technologies and update locally produced models, which Collor said resembled "horse-drawn buggies." The Collor administration reduced domestic-content requirements from 90% to about 70% and loosened other regulations protecting domestic suppliers in an effort to give firms more flexibility with respect to sourcing and reduce the time required to introduce new models.

The removal of the ban on imports represented a sea change in Brazilian policy. In order to compete against imports, the auto transnationals have been forced to modernize their plants. They are moving towards state-of-the-art technology, automated more processes, and introduced new models in an effort to improve both quality and productivity. Longer production runs, made possible by increasing sales, have also helped improve efficiency. This, in turn, has reduced the number of main suppliers and forced those remaining to cut costs.

Nevertheless, while import competition has disciplined Brazil's auto firms, the industry's rebound cannot be characterized as a simple consequence of liberal reform. Other state policies implemented over the past five years that go against the grain of the general liberalizing trend have played a key role in reshaping and revitalizing the Brazilian auto industry in the 1990s. For example, despite orthodox policy recipes to the contrary, firms must still satisfy high domestic-content requirements. Likewise, tariffs remain higher than in other industries and are being reduced only gradually. Far from pulling back, the Brazilian state continues to actively manage trade through industry-specific trade accords such as Mercosur, a customs union linking Brazil, Argentina, Paraguay, and Uruguay. That accord facilitates the use of Brazil as an export platform for cars for the region.

Perhaps the most important policy initiative designed to promote the auto industry's recovery was the creation of sectoral chambers that bring together the state, the auto firms, and labor unions. The chambers were convened by the Collor administration, which feared that the negative impact of neoliberal economic reforms on the industry would lead to plant shutdowns similar to the one carried out by Ford in early 1992. In the initial agreement, signed in 1992, in exchange for government promises to reduce state and federal taxes, the auto firms agreed to reduce costs and profit margins--and ultimately, prices--and to invest approximately $20 billion by the year 2000. The firms also agreed to increase employment and to guarantee a real wage increase of 20% from 1993-95 in exchange for labor's implicit agreement to engage in collective bargaining before going out on strike. The agreement led to a 22% reduction in retail prices.10

The chambers, which started as an emergency measure to save the auto industry from collapse, evolved into an ongoing forum in which the state, business and labor attempted to negotiate realistic policies that all three sides could agree to. In 1993, the sectoral chamber expanded to include a plan to develop "popular cars," so named because their

small size (engines less than 1000 cc) and low price (around $7,200) made them affordable to Brazil's middle class. Itamar Franco's government (1992-1995) agreed to tax reductions for these small cars in exchange for commitments from firms to invest and from labor to moderate its demands.

This combination of liberal and interventionist policies reshaped and revitalized the auto industry in Brazil. The popular car program shifted demand toward small cars, to 47% of overall car purchases, compared to 30% in 1993. Exports to Argentina have skyrocketed to 69% of total vehicle exports Surprisingly, the market recovered and firms planned new investments in 1993, despite a 2,700% inflation rate. A 5% economic growth rate that year was more compelling than the lack of price stability or fiscal reform.

Contrary to what might be expected, the boom in auto production has not strengthened labor's hand. As a result of increased automation and subcontracting--and lots of overtime put in by auto workers on the factory floor--the industry has been able to produce almost 80% more vehicles with 11% fewer workers compared with 1990.11 Not only has employment not increased, as the sectoral chamber promised, but wage increases haven't been forthcoming either. With the adoption of tight credit policies by the new administration of Fernando Henrique Cardoso, sales fell sharply after mid-1995, further undermining labor's bargaining position. Some 150,000 workers were laid off in Sao Paulo's automotive industry between June and November, 1995.12

The state has, on occasion, sidestepped the sectoral chamber in the interest of larger macroeconomic concerns, to the dissatisfaction of both auto firms and trade unions. For example, in October, 1994, the exiting Franco government unilaterally reduced the import tariff on cars from 35% to 20% several months earlier than planned. The move was motivated in part to make it harder for auto transnationals to carry out their promised wage increase. The government feared the firms would pass the cost on to car buyers, thereby refueling inflation. By the end of 1994, imports accounted for 25% of car sales.

While the Cardoso administration continues to promote the sectoral chamber as a way of managing industrial policy, it too has sacrificed negotiated settlements to macroeconomic concerns. Now troubled by the "orgy" of car imports, which was fueling growing monthly trade deficits, Cardoso put tariffs on imports back up to 32% in February, 1995. Likewise, an increase in popular car taxes was motivated at least in part by the government's fear that it was losing needed revenue. The recent slowdown of the economy has been engineered to shore up the stabilization plan, which had reduced monthly inflation to less than 2% and was threatened with the very fast growth rates of early 1995. In the shadow of the Mexican financial crisis in December, 1994, the Brazilian government worried that the combination of an appreciating currency and widening trade deficits would lead investors to withdraw funds in anticipation of a currency devaluation. Imports continued to surge, however, leading the government to increase the tariff drastically to 70% in April. Some firms were hit harder than others, particularly those that depended on imports to supplement their domestic product line.

Government planners in the 1950s expected that forging an auto industry made up of transnational firms would make it easier for a country like Brazil to access technology and foreign markets. Due to political and economic conditions, financial constraints, and the

nature of the global industry at the time, building a national industry with domestic firms was never seriously considered. Domestic parts producers expressed little interest in expanding into vehicle production and the one state-owned firm was ill- suited to the task. Moreover, the U.S. Big Three were unwilling to license technology at that time.

The Brazilian strategy contrasts to that of South Korea, which actively promoted domestically owned firms in the 1970s.13 While that approach allows for more national control, it required huge investments and access to licensed technology. The Korean government's control over foreign-exchange allocation and access to cheap financing gave it more leverage over domestic firms. Korean firms also had access to foreign technology. The quickening pace of technological change and competition is making it difficult for even established auto transnationals to go it alone nowadays and could make them more reluctant to license technology, upon which the Korean firms are still quite dependent.

Explicit industrial policies promoted by the Brazilian state to address varying development objectives and macroeconomic concerns have fundamentally shaped the investment decisions of the auto transnationals. In the future, the state's industrial policy will no doubt continue to affect the extent of new investments, the level of imports allowed into the country, and the orientation of these firms towards domestic or export markets. The state's capacity to pressure the industry to comply with its domestic development objectives, however, is becoming increasingly tenuous. The currently high tariffs effectively force the auto firms to supply the Brazilian market through local production rather than imports. But these measures are only temporary, given the government's free-trade commitments and its fear that without import competition, the auto firms will engage in the cartel-like behavior of the past--jacking up prices and maintaining out-dated technology. Moreover, the General Agreement on Tariffs and Trade (GATT) limits the government's ability to impose export requirements as it did in the past.

Most importantly, without a buoyant domestic market, Brazil has nothing to leverage. Ultimately, therefore, the industry's future depends on the growth prospects of Brazil's domestic market and that of its South American neighbors. Brazil's income distribution, already the worst in Latin America, makes car ownership within the reach of only a small percentage of the population. If the government wants to see the firms' much-heralded plans for new investments materialize, it will have to manage the economy in such a way that macroeconomic growth and stability do not come at the expense of higher unemployment and increasing income concentration. Otherwise, Brazil--despite its population of 150 million--may once again be seen as a "black hole" by the transnational auto companies.

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