What is industrial policy for oil and natural gas? and what are its costs and benefits? The government seems to favor deepening the sector’s productive chain with the exploration of the Pre-salt oil field, as evidenced by initiatives already underway within the National Bank of Economic and Social Development (BNDES) and Petrobras, the government-owned oil company. But no government policy is yet to be found on paper. It should only become a reality after studies by the Brazilian Export Promotion and Investment (Apex), the Institute of Applied Economic Research (IPEA), BNDES, and Petrobras are completed.

The early signals in terms of what is already being practiced raise fears that Brazil may face the same problem as other countries that discovered large oil and gas reserves: Dutch disease. That is the risk of deindustrialization resulting from the concentration of investments in the oil sector to the detriment of others, and of exchange rate appreciation resulting from the large inflow of foreign currency from oil exports, which makes imports very competitive relative to domestic industrial production.

It happened in Holland (hence the name), where the discovery of oil in the late 1950s, when international prices were high, channeled all public funds into oil production and export. As a result, other industrial segments contracted and the Dutch began to import a lot, so the share of industry in GDP fell from 23% in 1970 to 17% in 1990.

Diagnostics
The economist Regis Bonelli, a researcher at the Brazilian Institute of Economics (IBRE / FGV), says that for deindustrialization to occur, Brazil would have to alter the structure of production in favor of mineral commodities, and this would have to coincide with a period of exchange rate appreciation. That, he says, is not currently the case. In fact, industry is recovering after the problems caused by the international crisis. Moreover, he points out, “our economy is still relatively closed, which increases import costs.”

The current existence of factors that defend against deindustrialization, however, does not guarantee the country immunity from Dutch disease. That will depend primarily on a combination of factors. Bonelli notes that “Oil and gas from Pre-salt are simply a promise of new com-
modities; we still do not know when they will be sold, in what quantities, and at what price. Another unknown is whether all the technological innovation effort will actually be directed to this segment, as some think.”

According to the economist Mansueto Almeida Junior, director of Research and Innovation of the Institute of Applied Economic Research (IPEA), the fear that Brazil — and BNDES — will focus industrial policy on oil and gas and forget other segments of the economy has arisen because the government has not yet made its policy clear. Public investments are reportedly being channeled to the oil sector. “The government has defended a change in the law to increase the BNDES loans to Petrobras, resulting in substantial financing to the Petrobras group,” Almeida said.

**Current policy cost**

BNDES provided US$25 billion to Petrobras in 2009. “Since the Bank did not have that money, these operations have a cost, which is the interest differential between what the Treasury pays to borrow and the rate the BNDES pays the Treasury,” Almeida explains. “We cannot do everything.”

Almeida thinks the government has another option in mind. He cites the Program for Modernization and Expansion of the Fleet Transpetro (Promef), established to revive shipbuilding in Brazil:

“We know that the construction of oil tankers is a large-scale, capital-intensive activity. Here we are trying to create the industry, which is risky. Building the whole production chain could result in a slower pace of oil extraction from the Pre-salt, and the country would miss the opportunity to use oil revenue in education, health, innovation, and even industrial policy for other sectors.”

He also points out that industrial policy is not changing the production structure — nor Brazil’s comparative advantage:

“Today, measured by the trade balance, Brazil has a trade structure very similar to that of the mid-1990s, in which primary products and low technological content have considerable weight in total exports. Our industrial policy seems to be consolidating this structure.”

**Currency appreciation**

When the wells of the Pre-salt fields are up and running, oil exports will bring in a large flow of dollars. For the economist Samuel Pessoa, head of the Center for Economic Growth (IBRE / FGV), a consequence will be increased demand for imported goods and domestic services. “Relative prices will change, making domestic services, which cannot be imported, more expensive and imported manufactured goods cheaper,” he says.

Pessoa adds that Pre-salt will require huge investments in a country that saves little (less than 20% of GDP). “If we opt to attract foreign savings and buy everything abroad, this will not interfere with other domestic industrial sectors. But if we opt to do everything with local production, it will be necessary to mitigate the appreciation of the exchange rate would be to increase domestic savings to avoid having to use foreign savings to finance domestic investment.”

**One way to mitigate the appreciation of the exchange rate would be to have more competition because the only buyer is Petrobras, and national suppliers will have priority.**

Samuel Pessoa
(Center for Economic Growth IBRE-FGV)

Adriano Pires
(Brazilian Center for Infrastructure)
use local currency, Brazilian reais. So foreign savings will have to be exchanged for local currency to buy domestic supplies and hire employees. This will make prices go up and the exchange rate appreciate.” One way to mitigate appreciation of the exchange rate, says Pessoa, would be to increase domestic savings to avoid having to use foreign savings to finance domestic investment.

**Competitiveness**

Adriano Pires, director of the Brazilian Center for Infrastructure (CBI), a private consulting firm, has a negative view of what will happen. While agreeing with the policy of national content that has been practiced for some time in the oil and gas production chain, he believes it could make domestic industry less efficient. There will be no competition because “the only buyer is Petrobras, and national suppliers will have priority,” he says. According to the policy of local content, goods and services in the oil and gas production chain must be produced by Brazilian companies, with targets for nationalization indexes.

However, Sérgio Gabrielli, CEO of Petrobras, is adamant that the nearly US$174 billion in investment needed to explore the Pre-salt fields will not cause problems: “The major limitation on Pre-salt exploitation is the capacity of suppliers to deliver equipment — rigs, pipelines, support ships, etc. — at reasonable prices and on time.”

The policy of national content reflects the goal of producing in Brazil to generate employment and income, Gabrielli says. “If the cost of the first ship built by a shipyard contracted by Petrobras is not in line with international prices, the cost of the tenth ship will be,” he emphasizes.

**Partnerships**

Another way to enhance competitiveness is to encourage Brazilian companies to associate with foreign companies to install plants in Brazil. The scale and diversity of investments in the Pre-salt fields would thus stimulate local industry. Roberto Zurli Machado, superintendent of the Basic Inputs Area of BNDES, said the role of the BNDES in financing the development of national industry will increase with the Pre-salt, enabling national industry to compete in the global market.

Efforts will be directed to development of the production chain, with emphasis on promoting manufacturers of electric motors and generators, support systems for all platforms, and construction of ships on a much larger scale. This will facilitate emergence of a national basic engineering cadre to strengthen local projects.

“With a bigger market Brazilian industry has become to view oil and gas as a great opportunity. Industry is starting to diversify its product portfolio to meet the needs of the oil industry,” Zurli says. To prevent Brazilian loss of competitiveness because of a flood of dollars and currency appreciation, he says, “The secret is to increase oil exports from the Pre-salt accompanied by investment in local production.”