10

Brazil: FTA or FTAA or WTO?

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Brazil is the great current question mark as US trade strategy moves toward implementing its current strategy of "competitive liberalization."[1] That phrase is a good description of current policy. It conveys the ultimate intent of liberalization but stresses that national policy, in a variety of forms, is needed to get to that end.

This process is not a sudden innovation. Rather, it has emerged with increasing clarity over the past decade. The United States has moved away from its former insistence on multilateralism and on the General Agreement on Tariffs and Trade (GATT), now the World Trade Organization (WTO), as the unique forum of trade negotiation. First, it fully embraced regionalism, after earlier experiments with Canada and Israel, when it accepted the North American Free Trade Agreement (NAFTA) in 1992 and, two years later, provided decisive support for the extension of free trade throughout the Western Hemisphere at the Miami summit. This was the state of affairs from the end of the Clinton administration to the beginning of bilateral negotiations. And despite finally gaining approval of new "fast-track" authorization—trade promotion authority (TPA), as it is now called—the Bush administration has committed itself much more fully to

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1. US Trade Representative Robert Zoellick has argued the case for bilateral agreements as "a speedy route to free trade" (*Financial Times*, November 19, 2002). Fred Bergsten (1996) had earlier argued the case for open regionalism—a mode that others have embraced, as this volume suggests. On the other side, WTO officials and other economists have continued to defend multilateralism.

such a bilateral strategy, moving actively in the direction earlier signaled by its predecessor in signing trade pacts with Jordan and Vietnam. Most recently, it has completed and signed bilateral free trade agreements (FTAs) with Singapore and Chile. Trade negotiations are under way with the Southern African Customs Union, Morocco, Australia, and Central America (to include in 2004 the Dominican Republic). That makes for quite a burden for US Trade Representative Robert Zoellick and company, in addition to the continuing Doha Round of multilateral negotiations.

To be sure, the United States is hardly the only FTA practitioner. The European Union has been even more prominently engaged in this process. It moved actively toward Eastern Europe after the fall of the Berlin Wall and toward the Maghreb and other parts of Africa; most recently, it has sought to make its influence felt in Latin America and Asia. Developing nations have been vigorously pursuing these negotiations in recent years. Overall, more than half of all regional agreements reported to the GATT and the WTO have emerged since 1995. Almost half of reported global trade emerges in such free trade groups.

Within that new international setting, Brazil now has a new government, and one unlike its predecessors. The victory of the Workers' Party, the PT (Partido dos Trabalhadores), has brought to power the Brazilian left. Luiz Inácio Lula da Silva won a stunning victory in the presidential election of October 2002, with some 60 percent of the popular vote—counted accurately, as Brazilians always like to note, within hours of closure of the polling booths. His party, although it controls only about a fifth of the seats in Congress, has succeeded in achieving a working majority in both the Chamber of Deputies and the Senate. This was the fourth time Lula had run, and many had anticipated that policy in Brazil—a country afflicted by limited economic growth, the persistence of extreme income inequality, and insufficient attention to social policy—would take a radical turn. That certainly was the expectation of the markets, as well as the fervent hope of many of Lula's supporters.

The immediate surprise has been the turn in the exact contrary direction. Six months into Lula's administration, the new finance minister, Antonio Palocci, and the new central bank president, Henrique Meirelles, have begun to regain the confidence of Brazil's lenders. As a consequence, the risk premium of Brazil has descended from about 2300 basis points after the election of Lula to something in the range of 700 points. In addition, the exchange rate has moved from a level close to 4 to about 3 reais to the dollar, where it seems to have stabilized. Trade finance, at least in the form of short-term capital, has begun to flow again, although foreign direct investment (FDI) still remains scarce, as investors have as yet failed to react positively. At current magnitudes of $4 billion in the first seven months of 2003, net FDI is well below inflows in recent years and now trails foreign investment in Mexico.

The International Monetary Fund (IMF) has reviewed and enthusiastically continued its pact with Brazil, hastily signed in August 2002 prior to the election. Indeed, the new government, early on, committed itself to an even larger and continuing fiscal surplus of 4.25 percent of GDP. Reserves have begun to creep upward: the trade surplus is projected to reach as much as $18 billion by the end of 2003. Under these circumstances, despite the hesitancy of foreign investors noted above, the current account deficit has rapidly declined to less than 1 percent of GDP; in previous years, this key statistic had often hovered above 4 percent and regularly climbed higher.

One inevitable consequence of Brazil's tight monetary and fiscal policy has been continued anemic economic performance. Growth continues to remain below acceptable levels, given the country's high, and increasing, rate of unemployment—almost 13 percent officially and higher in fact—and the social unrest manifested in the urban centers of Rio de Janeiro and São Paulo. The projections are not optimistic: the Central Bank recently reduced its estimate of GDP growth for this year to 1.5 percent, and it is even more cautious about the longer term. Next year growth is expected to improve, but to still remain below the target rates of 4 to 5 percent that had been promised in the election campaign.

A potential political struggle inside (and outside) the government has been avoided only because of Lula's unwavering support of Palocci's approach. But the stage has been set for those divisions to emerge more starkly as the Congress takes up constitutional amendments to address the recurrent deficit emanating from the social security system for public employees (now consuming more than 5 percent of GDP) and the complicated structure of taxes (now running at more than 35 percent of GDP). Lula must cope with disappointed federal workers and the judiciary, as well as with unhappy governors who resist the loss of their constitutionally guaranteed claim on resources. At this early stage, however, the results are quite favorable. The pension reform has gone through much as it had been initially presented. Future retirees will eventually be faced with a defined contribution rather than a defined benefits scheme.

Equally relevant, but until now subordinated to the central problem of economic performance, is the question of Brazil's foreign policy—more specifically, its position on negotiations about the Free Trade Area of the Americas (FTAA). Brazil is now co-chair, along with the United States, of the final phase of the negotiations. Like the Doha Round, these regional talks are also scheduled to terminate by the beginning of 2005. Time is beginning to run out on both.

Unlike Lula's economic policy, the issue of freer trade has yielded no dramatic surprise. Indeed, regarding international relations, from the very beginning Lula and the PT had defined a rather straightforward anti-American, antiglobalization policy. After all, it was the PT that had organized the World Social Forum in Pôrto Alegre to counteract the World

Economic Forum in Davos, Switzerland. During his most recent campaign, Lula was not alone among the candidates in directly opposing Brazilian accession to the FTAA. In December 2002, he provided petroleum to a Venezuela racked by the strike of the national oil producer, PDVSA (Petroleos de Venezuela). And his breakfast meeting on inauguration day with Fidel Castro and Hugo Chavez hardly went unnoticed by the American right. But that initial position, too, has shown considerable moderation, adding to the unhappiness of the Brazilian left. Lula has met twice with President Bush in Washington, most recently in June 2003, along with joint sessions held by 10 cabinet ministers. The final communiqué hinted at a new special relationship.

But the trade issue still remains unresolved. USTR Zoellick held meetings in Brasília in May, preparatory to the Bush-Lula meeting on June 20. The next FTAA ministerial meeting is scheduled for November in Miami; by then, only a year away from the negotiation's scheduled conclusion, it will be clearer whether there will be a hemispheric agreement or merely a wider series of bilateral initiatives. In the interim will be held the Cancun WTO ministerial meeting, and in such forums Brazil has already taken a leadership role. It may give a much better idea of how Mercosur (Mercado Comun del Cono Sur) negotiations with the European Union are evolving, as well as an indication of how much progress Brazil has made with its South American neighbors. Already, the European Union has indicated some greater responsiveness, and Lula's recent visit to London emphasized Brazil's longtime connection with Europe.

The intent of this chapter is to anticipate the consequences of these important events now unfolding. The structure is a play in three acts. In the first section, I elaborate the historical Brazilian position on international trade, emphasizing the strong, and continuing, Brazilian preference for advance at the multilateral level. There I also discuss the parallel strategy of strengthening Mercosur and of extending it to a South American Free Trade Area. The latter was designed as the logical counterpoint to NAFTA, and as a venue in which Brazilian leadership could play a leading role. Building on this discussion, I then elaborate on some of the additional elements introduced by the Lula administration. Necessarily, because it looks ahead, this analysis can hardly be definitive. And I conclude, even more speculatively, by examining the possibility of a bilateral arrangement between Brazil (or Mercosur) and the United States, adding to the regional spaghetti bowl—a result that might appear attractive in the midst of continuing delays in progress on the broader multilateral agenda.

The Past

Brazil has long pursued its destiny as an important component of the international environment. Since the end of World War II, Brazilian foreign

Table 10.1 Brazilian income and trade, 1950–2002

	GDP			Exports		
	Total (billions of dollars)	**Per capita** (dollars)	**Growth** (percent)	**Growth** (percent)	**Percent of world trade**	**Percent of GDP** (2000 base)
1950–64	66.4	1,033	6.6	2.7	1.5	4.6
1965–73	152.4	1,694	10.0	8.3	0.9	5.4
1974–80	318.1	2,885	5.8	8.1	1.0	5.4
1981–94	388.1	2,778	2.0	6.0	1.1	6.9
1995–2002	595.1	3,594	2.3	5.7	0.9	9.1

Sources: Comisión Económica para América Latina y el Caribe (CEPAL); and Brazil's Ministério do Desenvolvimento, Indústria e Comércio Exterior.

policy has evolved in five consecutive stages. Table 10.1 provides information on the performance of the economy during each stage.

In the first of these periods, the country, under civilian leadership from 1950 to 1964, progressively moved away from closely paralleling the United States to actively participating in the nonaligned movement in the early 1960s. Initially, Brazil anticipated strong US external support for its development efforts as a response to its aid during the war, both with its military and with a supply of raw materials. But that was not to be, and Brazil drifted away as the Cold War monopolized US attention. The economy's rapid growth through import substitution enhanced Brazil's independence. At the initiation of the Alliance of Progress that pattern was broken, but only briefly. Janio Quadros's more independent foreign policy—he awarded the Cruzeiro do Sul to Che Guevara in 1961—was followed by João Goulart's explicit appeal to internal nationalism and populism as well as his active engagement with the nonaligned nations.

A second, and intense, relationship with the United States ensued after the Brazilian military intervened in March 1964. The new foreign minister defined the objectives clearly: "to defend the security of the continent against aggression and subversion, whether external or internal; to strengthen all the ties with the United States, our great neighbor and friend of the North; to broaden our relations with Western Europe and the Western community of nations."[2] This new policy of concentricity replaced the internationalism of the earlier flirtations with nonalignment with a focus on the hemisphere. But above all, the strategy once again saw the United States as a close and ongoing ally.

For a time thereafter, Brazil's engagement with the United States was obvious: it was the second-largest site of official American foreign presence in the world. External investment was welcomed. Rising inflation gave way to stabilization, participation in the euro-dollar market, mushrooming exports, and the eventual Brazilian "miracle," with rates of ex-

2. Foreign Minister Vasco Leitão da Cunha, as quoted in Fishlow (1978–79, 393).

pansion in the early 1970s of more than 10 percent a year. In that world, still another tack was taken in international policy: to assert a new independence, an opposition to any impediments that would limit the attainment of the *grandeza* that finally appeared within reach. After all, as such rates of expansion continued, Brazil would soon be the envy not merely of its Latin American neighbors but even of Spain and Portugal. Lending flowed after the first oil crisis of 1973; thus, even in its aftermath, Brazil's economy managed to expand at a still-significant though diminished rate of 6 percent a year. Yet the country was substantially dependent on imports of petroleum, and when the second shock came in 1979, a growing nightmare soon replaced the previous dreams.

The debt crisis of the early 1980s was the decisive factor in the next period. Thereafter, the military government, even after Delfim Netto was recalled to manage the economy, could not restore the expansion. By that time, internal matters—the return to civilian government in 1985 and a search (alas unsuccessful) for a new, noninflationary basis for economic growth—had become dominant. External policy fell somewhat by the wayside, with the important exception of a new emphasis on regionalism. Mercosur and the new focus of engagement with neighbors in a democratizing South America date to this period in the later 1980s, when the Reagan administration had little time for Brazil. How little was displayed in the presidential trip to Latin America in 1986, when Reagan stood in São Paulo and erroneously referred to the country he was visiting as Bolivia! On the other hand, it might as well have been. After failed attempts at controlling spiraling inflation, poor economic performance, and finally, in 1993, impeachment of the president, Brazil saw the first period in a century when per capita income failed to increase.

A fifth phase began when Fernando Henrique Cardoso, after being elected as president, successfully implemented the *Real* Plan. Brazil had finally confronted and halted its inflationary upsurge. This time, unlike the failed Cruzado Plan of 1986, macroeconomic policy worked correctly, as income rose and price increases slowed dramatically. But all was not to be sweetness and light. Despite the extensive privatization, mounting government deficits—together with severe recurrent international crises—necessitated sharp devaluation of the *real* in early 1999. That potentially positive adjustment, too, was subsequently confounded in 2000 by the Argentine crisis, an internal energy shortage, and a recession in the United States.

As a consequence, in Cardoso's second term Brazilians saw little progress on fundamental reforms in taxation, social security, the financial system, and so on. The average annual rate of growth declined from 2.5 percent in the first four years to just 2 percent in the second. What had started so gloriously turned into utter political rejection in the campaign of 2002.

These increasing internal macroeconomic difficulties had external consequences. Brazil's strong commitment to Mercosur was complicated by

Table 10.2 Mercosur trade (percent of total exports)

	1990	1995	1999	2000	2001	2002[a]
Argentina	14.8	32.1	30.3	31.8	28.4	22.4
Brazil	4.2	13.2	14.2	14.0	10.9	5.4
Paraguay[b]	39.5	57.4	41.5	63.4	52.4	50.4
Uruguay	35.1	46.2	44.0	42.9	39.1	33.3
Mercosur	8.8	20.6	19.9	21.1	17.2	11.4

Mercosur = Mercado Comun del Cono Sur

a. Data are for first nine months of 2002, except for Paraguay, where they refer to first six months.

b. Data for Paraguay have been corrected to exclude reexports.

Source: CEPAL (2002, 159).

the devaluation of the *real* and the increase in protection required to reduce the burgeoning Brazilian trade deficit. The Argentine recession and eventual financial crisis struck another decisive blow. But much earlier, in 1997, actual intrazonal trade had peaked, and the absence of continuous advance had led to increasing dissatisfaction. For that reason the regional experiment, despite the strong current political commitment, demands closer attention.

The experience of more than a decade of relationships among Argentina, Brazil, Paraguay, and Uruguay may be quickly summarized.[3] From Mercosur's formal start in March 1991 with the Treaty of Asuncion up to the present time, three separate periods may be distinguished (see table 10.2).

The initial phase was one of preparation: an attempt to establish a zone of free trade before the later move to a common market scheduled to occur at the end of 1994. Given the mounting problems in Brazil—this was the era of Fernando Collor de Mello's impeachment and of the inability of his successor, Itamar Franco, to control raging inflation—we can hardly be surprised that relatively limited progress was made toward actually achieving free trade. But it was also the period when intrazonal exchange expanded greatly relative to trade with the outside world. Indeed, from its low starting values, such commerce grew more rapidly in this first interval than subsequently. And the number of products liberalized was substantial, even though the countries retained control over key areas—automobiles, textiles, sugar, and the like—not to mention the areas of capital goods and information technology, which were treated separately. The exceptions, excluding automobiles and sugar, totaled about 25 percent of trade by the end of this initial period.

3. A number of general discussions of Mercosur and its evolution are now available. See IDB (2002), which offers an analysis as well as an extensive bibliography.

Alexander Yeats of the World Bank was quick to criticize this first period of expansion as inefficient (Yeats 1998).[4] His point was that much of the growth in intrazonal trade occurred in uncompetitive, capital-intensive products. In other words, the rise in exchange between Argentina and Brazil, a good part of it in the protected automobile sector, was trade diverting rather than trade creating. Had trade occurred on a nondiscriminatory basis, the Mercosur countries could have purchased more from those outside the region and would have wound up better off.

The appearance of this piece motivated a range of responses,[5] but there were two basic criticisms. First, Yeats's focus was on member country exports rather than imports, which show much less difference between the rate of expansion of regional and external trade. This was a period of reduction of tariffs and the beginning of a new policy of openness, when import growth was viewed as important in curbing inflation. Second, the potential economies inherent in the new patterns of specialization would take time to be fully realized. To some degree, as a result of much slower subsequent growth—and indeed a reversal in Mercosur expansion—this debate became irrelevant. But it revealed a sensitive issue that has never quite disappeared. Later works continue to deal with this question, in different ways.

As the Protocol of Ouro Prêto successfully concluded in December 1994, a second phase of movement to a common external tariff was supposed to proceed, building on the expansion of trade that had taken place during the first period. But this new stage encountered real problems: the decline of Argentine national income in 1995 with Mexico's Tequila crisis and, more significantly, the effect on Brazil of the Asian and Russian financial crises. One result of these disturbances was the decision to increase Mercosur's common tariff in December 1997 from 14 percent to 17 percent. Additionally, the lists of national exceptions grew as each of the four members added more. As table 10.2 reveals, intrazonal trade advanced much more slowly after 1995. Nevertheless, formal efforts to liberalize services and other areas of commerce continued.

The devaluation of the *real* in January 1999 and the subsequent slowing of growth within the group set in motion a reversal. Not only did trade among the countries of the group decline but also relations between Brazil and Argentina became progressively more difficult. When Domingo Cavallo resumed his position as finance minister of Argentina in 2001, he both called for a return to the initial idea of a free trade area instead of a common market and unilaterally raised Argentine tariffs on consumer goods to 30 percent and reduced those on capital goods to zero. Even in the

4. A version of this article appeared a year earlier as a Policy Research Working Paper.

5. For a summary of the dispute from the standpoint of Yeats's critics, see IDB (2002, 41); for a treatment that extends the basis for questioning Mercosur, see Schiff and Winters (2003, 212, 217–20).

midst of such problems, however, Mercosur hosted its first meeting with the chiefs of government of Europe in 1999, seeking to secure an agreement that would parallel the negotiations of the FTAA. And President Cardoso invited the presidents of all the South American countries to Brasília in the following year to discuss the potential advantages of coordinating their policies.

Mercosur is currently in crisis, a situation made much worse by the domestic difficulties faced by its members. Argentina (and Uruguay) experienced an extraordinary 10.5 percent decline in income in 2002; that same year, Argentina, Uruguay, and Brazil had to resort to the IMF for extensive additional resources. Yet the member states are faced with impending, and important, trade negotiations with deep consequences for Mercosur. Already the new Brazilian and Argentine presidents have begun to grapple with this reality. Early indications, such as the grouping of the countries in other negotiating forums (e.g., those of the Doha and FTAA meetings), are that this regional focus is far from irrelevant. Indeed, given skepticism about possible results in the Cancun and Miami meetings, Mercosur appears to have taken on a new priority.

Historically, Brazil has regarded the multilateral track as more important. That circumstance in part reflects a distribution of trade with the major world markets that has always been fairly well balanced. It also results from the preferences of Brazil's Foreign Office. That leadership role has hardly gone unchallenged. Finance has objected in the past, and successfully. But most recently, the victory over Canada in the WTO dispute between the aircraft manufacturers Bombardier and Embraer provided a new forward impetus. So, too, did the significant Brazilian role in achieving a successful launch of the Doha Round after the WTO failure in Seattle.

In particular, Brazil's positions on three major parts of the WTO agenda were quite important to the final document that emerged in Doha. First, and ever more important as Brazilian exports of agricultural products have been recently increasing, was its insistence on a major reduction of the barriers to such trade faced by developing countries. Here there was apparent consistency with the United States, which like the other developed countries provides its own farmers with agricultural subsidies but of relatively smaller size. Moreover, as the European Union expands toward the east, the issue is not merely French resistance but also the anticipated entry of such important agricultural producers as Poland, Hungary, and others. In Asia, Japan and South Korea are equally hesitant to burden their diminishing agricultural sectors.

Table 10.3, which provides a measure of the international distribution of support to agriculture and the size of that support relative to national income before and after the Uruguay Round, suggests two important points. First, the expenditures of the European Union are comparatively large but have declined relative to those of the other countries included. In particular, the United States' total support increased even while its

Table 10.3 Total agricultural subsidies

	1986–88		2000	
	Total (billions of dollars)	**Percent of GDP**	**Total** (billions of dollars)	**Percent of GDP**
European Union	109.7	2.6	102.4	1.4
United States	68.1	1.4	92.1	0.9
Japan	58.2	2.4	68.2	1.4
South Korea	14.2	10.0	22.8	5.0
OECD	302.1	2.3	321.1	1.3

Source: OECD, *Agricultural Policies in OECD Countries 2002*, 176.

share declined. Second, the outlays by both Japan and South Korea exceed the relative contribution of their agricultural sectors to national income. While the corresponding barriers to free trade are now relatively smaller than they were before the Uruguay Round, they remain large enough to severely limit international trade. Agricultural subsidies now total $1 billion a day, a sum far exceeding the amount available for economic development assistance.[6]

The major reduction in trade-distorting subsidies proposed by the United States would accelerate their relative decline following the Uruguay Round agreement. Europe has been reluctant to accept, but has recently begun to shift its position. Brazil and the United States would be more closely allied on this issue were it not for the subsidy increases voted by the US Congress in the 2002 Farm Bill and the American quotas and high tariffs that directly handicap key Brazilian exports such as sugar, orange juice, and tobacco.

Much more fundamental has been the United States' insistence that such farm subsidy issues be treated only in the multilateral setting and not in the FTAA negotiations. Brazil's rapid current growth in agricultural exports—a class of goods, basic and processed, that accounts for almost 30 percent of the country's total sales abroad—makes this issue an especially important one, and not only in its dealings with the United States. Europe, which receives a larger share of such products from Brazil, is also a major current target in the Doha Round and in the Mercosur-EU negotiations.

A second advance at Doha had been US acquiescence in discussion of antidumping and similar protective provisions enacted by sections 201 and 301 of the Trade Act of 1974. This acceptance stands in dramatic contrast to the continuing imposition of these sanctions. Data compiled by the WTO show that the United States has brought 257 actions against imports

6. To be sure, these gross data do not differentiate between consequences of domestic policies that distort trade and those that redistribute income. But they do measure the extent to which agricultural interests make their voices heard.

since 1995, more than any other country, and that steel products account for one-third of the measures taken by all members (WTO, *Annual Report* [2003], 23). The increased protection imposed by the United States in 2002 for the benefit of the steel industry—recently ruled illegal, in a decision now under appeal—especially riled Brazil, less because of the severity of its effects (Russia, Europe, and South Korea felt them much more) than because it involved an industrial sector in which Brazil had gained a comparative advantage. If export emphasis, not agriculture alone, is to be an important part of future Brazilian policy, then such additional sectors as steel, automobiles, cell phones, and the like become central.

Here, too, the US position is clear as far as the FTAA is concerned: there is no need to take up this issue during those negotiations; only at the multilateral level can any progress occur. Brazil's reaction is to argue that such matters as government purchases and foreign investment should similarly be excluded from FTAA concern and left exclusively to the multilateral arena. This position, of course, goes very much counter to United States efforts to ensure that any FTAA treaty be WTO-plus in its provisions in these areas. In this matter, unlike in agriculture, Brazil's interests appear to clearly differ from those of the United States, leaving no easy solution.

Such difficulty is especially characteristic of the third issue addressed at Doha: the exemption of certain medicines from the rules that have applied to intellectual property rights since the Uruguay Round. Brazil and South Africa were quite eager to substitute generic alternatives for the treatment of AIDS; India, as a potential supplier, was equally interested. Drugs targeting malaria and tuberculosis were also included. Needless to say, pharmaceutical firms in the United States (and Europe) were appalled. But this dramatic gain was essential to the satisfactory conclusion of the Doha meeting, and it was a source of great Brazilian satisfaction. Indeed, in subsequent negotiations, international firms, faced with the threat of generic substitutes, have agreed to significantly reduce the price of AIDS medications. Brazil's approach to AIDS has received wide and quite favorable notice.

Ironically, events in the world's wealthiest country helped to shift the balance toward relaxing patent protection. The US anthrax scare in the aftermath of the terrorist attacks of September 11 caused a huge demand for Cipro—and supplies of the patented drug were inadequate as well as expensive. The United States quickly secured a major reduction in price from Bayer. That decision, so soon after Doha, provided dramatic support for the position of the developing countries. Similar gains are now being sought in other fields where important health advances have occurred. And as reimbursement for prescription drugs under Medicare has suddenly emerged as a major issue in the United States, their high costs—particularly in contrast with the prices for the same drugs under the national Canadian system—have become a matter of daily comment. That may help to explain the recent agreement to allow exports of generic drugs to poor countries, as Brazil has sought.

Such substantial Brazilian gains at Doha, although widely promoted nationally, did little to help the political ambitions of the government's candidate, former minister of health José Serra, in the presidential elections of 2002. Worried about rising inflation and internal debt, reduced access to foreign capital, and slower growth, as well as increasing crime in urban areas and mounting unemployment, Brazilians wanted change. As noted earlier, in the runoff Luiz Inácio Lula da Silva, the candidate of the Workers' Party, won a convincing victory; at the same time, the PT gained a leading but far from a majority position in congressional elections.

The Present

In the run-up to the election and immediately after, Brazilian markets reflected the worries of the domestic and the international business communities. The exchange rate dropped considerably, moving to a value of 4 reais to the dollar; to counter the uncertainty, domestic interest rates were progressively raised in the last months of the Cardoso administration to 26 percent; inflation rose, especially prices of international goods; and there was even much talk of the inevitable rescheduling of the domestic debt that would have to take place.

To the surprise of many, the new government, guided by Finance Minister Antonio Palocci, has responded to the crisis by imposing even tighter monetary and fiscal policies. Simultaneously, the Workers' Party has taken on the task of pushing through Congress many of the needed changes that they had earlier opposed: greater independence of the central bank, reform of the social security provisions for public employees, revisions in the tax system, and modernization of the labor laws. The results have included impressive real appreciation of the exchange rate and the beginnings of interest rate reduction that should accelerate over coming months.

Such continuity in domestic economic policy has been accompanied by continuity in the foreign sphere. We therefore can focus on the three elements that define current international economic policy.[7]

The first is the strengthening of Mercosur and the continuation of efforts to extend it to a free trade area within South America. It is essential to appreciate that the benefits of this relationship, seen from the context of Brazil, go beyond simple economics.

> Mercosur is a fundamentally *political* decision that is realized as a consequence of *economic* actions. . . . Mercosur emerges as an exercise of convergence of interests between countries situated, in general terms, at the *same level of economic and social development*, despite differences in their size. . . . In sum, Mercosur is a modest con-

7. In a recent speech Celso Amorim, the minister of foreign affairs, sets out the current Brazilian position in greater detail; see Amorim (2003).

> struction of integration that functions as a condominium, with relative permeability and association between its present few members.[8] (Almeida 2002, 31; emphasis his)

There is little doubt that Lula's election has led to even greater Brazilian commitment to this objective than had been seen earlier. The recent election of Néstor Kirchner as Argentine president—defeating Carlos Menem, who earlier had argued for direct Argentine economic integration with the United States—reinforces the Brazilian position. There has been a new emphasis on the four members of Mercosur presenting a unified front in negotiations, first with the Andean countries, then with the European Union, and finally with the United States. And, not least important, Brazil is able to exercise leadership in this venue.

The second element is negotiations within the WTO. Here, as with the FTAA and the pact with the European Union, the focus is primarily economic. But these forums now are drawing greater Brazilian interest as a result of the rapid increase in exports achieved in the past year. For the first time in some 30 years, it is genuinely possible that exports may spark a domestic recovery. The agricultural sector is making a strong contribution as well. And in such a world, in the words of Foreign Minister Celso Amorim, the "policies and practices of the developed countries with their billion-dollar subsidies and arbitrary recourse to measures of commercial protection penalize the more efficient producers instead of recognizing them" (Amorim 2003, 2).

Clearly the Brazilian preference is to focus on the WTO, particularly given the recent entry of China and potential accession of Russia, as the source of the real benefits. The WTO's importance has been heightened by its recent finding that US safeguards on steel products were illegal, a case in which Brazil was among the complainants. In this forum, Brazilian skill and knowledge have begun producing results. As a consequence, the role of the Foreign Office has been enhanced; at the same time, the claims of Brazil for a permanent seat on the UN Security Council have been strengthened.

The Doha Round offers an opportunity for more than progress on the questions of agricultural subsidies and antidumping restrictions; it also may make possible a revision of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) reached in the Uruguay Round—and not merely, as the United States insists, as it pertains to drugs used to treat HIV-AIDS, malaria, and tuberculosis. Additionally, Brazil, in conjunction with other developing nations, seeks a modification of the Trade-Related Investment Measures (TRIMs) accord to permit a national policy of greater industrial promotion, particularly in high-technology spheres. Finally, it strongly prefers to negotiate on such matters as services, invest-

8. Translations are mine throughout.

ments, governmental purchases, and intellectual property rights within the WTO rather than to open these subjects to the United States' WTO-plus strategy in negotiating the FTAA.

The FTAA, accordingly, comes last in Brazilian priorities—behind even the negotiations with the European Union. In those, at least, Brazil sees itself making no additional concessions beyond those already under discussion in the Doha Round. And there as well, Brazil sees the possibility of applying a little "competitive liberalization," in the manner of the United States. In the discussions surrounding the FTAA, Mercosur has already responded to the US decision to differentiate among CARICOM (the Caribbean Common Market), the countries of Central America, the Andean Community, and Mercosur by refusing to submit offers for tariff reductions in services; nor have any of the four countries in the group presented a formal position on investments or governmental purchases. Increasingly, Brazil seems to favor a minimal FTAA rather than any strategy that foresees replication of the NAFTA and US-Chile agreements.

This stance has great domestic appeal, and not merely to the supporters of the PT. Much of the industrial sector (though not all) concurs. Brazilian calculations of the benefits that could be anticipated from successful conclusion of the FTAA negotiations seem consistently to indicate limited, and unequally distributed, benefits. In particular, Brazil is not a clear beneficiary. Thus Marcelo de Abreu reports computable general equilibrium results showing Brazilian exports to the United States increasing 9 percent while corresponding imports rise 23 percent, figures consistent with other partial equilibrium estimates by himself and others (Abreu, forthcoming).

But a review of other recent quantitative models demonstrates a lack of consensus (see Castilho 2002). Much depends on the specific conditions imposed—dynamic versus static, inclusion of nontariff barriers, degree of disaggregation, demand elasticities utilized, base year of the study, and so forth. The selection reported here in table 10.4—limited to the 1999–2001 period—contains five studies. All presume full liberalization, either within the FTAA or with the European Union, and some with both. They thereby provide apparent upper-bound estimates of the practical consequences of trade integration. On the other side, comparison of the initial calculations and actual results of NAFTA show a tendency toward understatement of the changes in trade that resulted, because such advances in commercial policy have been associated with new reasons for gains in investment and productivity.

The results presented in table 10.4 clearly suggest that the FTAA should not lead to Brazilian imports exceeding exports. Only one study predicts such an outcome, and there the deviation is virtually zero. Second, and somewhat surprisingly given that Brazil exports relatively more agricultural products to Europe than to the United States, the orders of magni-

Table 10.4 Results of econometric studies of the impact on Brazil of the FTAA (percent change)

	FTAA					FTAA and European Union	
	Study 1	Study 2	Study 3	Study 4	Study 5	Study 1	Study 5
Total imports	12.7	7.0	29.5	6.2	8.0	25.9	10.9
Total exports	17.5	14.0	38.0	10.0	7.3	35.7	8.4
GDP	7.0	n.a.	0.5	4.0	4.5	13.3	4.5

Studies: 1. Wanatuki and Monteagudo (2001); 2. Carvalho and Parente (1999); 3. Roland-Holst and van der Mensbrugghe (2001); 4. Diao, Diaz-Bonilla, and Robinson (2001); 5. Tourinho and Kume (2002).

Source: Castilho (2002, 23).

tude of benefits are quite similar in both markets. While the size of total trade is similar, one would expect the differences in composition to have had greater effect. Third, the consequence of liberalization of trade both with the European Union and with the United States appears dramatically different in the two relevant studies (Wanatuki and Monteagudo 2001; Tourinho and Kume 2002): in one, the addition of the European Union makes little difference; in the other, the changes caused by each liberalization separately are in effect added to create a much larger total.

Thus it is not obvious that the reduction of Brazilian protection under the FTAA will lead to especially great difficulties. Certain sectors will be harmed initially, but many of these have already adjusted to the much greater level of imports that have flowed into Brazil in recent years as tariffs have been lowered. The reality will likely be far different from what those violently opposed to the agreement envision. This, of course, brings us to the central point. Policymakers in Europe have been far more willing than those in the United States to support Brazil politically, and to accept Lula. Bush's recent efforts at conciliation represent a major change in US policy, and they may lead to much better relations than have been experienced in the past few years. But more than rhetoric will be needed to achieve any gains.

We may therefore conclude that Brazilian policy on international trade has changed little. Its domestic economic recovery has enabled Brazil to express its external preferences more effectively now than in the past, and much of the current restatement of policy reflects that new ability. The foreign minister makes this case clearly when he maintains that

> the route of credibility that the Brazilian economy has entered, the commitment to fight poverty and hunger, the attention given to human rights, and the consolidation of democracy are factors that trace a picture of international respectability and enormously help the external action of the government in its various directions, including that of foreign trade. (Amorim 2003, 5)

The Future

Brazil has thus far performed well as the final phases of its three separate trade negotiations approach. All—the Doha Round, the FTAA, and the Mercosur treaty with the European Union—are scheduled to conclude at the beginning of 2005. Moreover, its international position has been much strengthened by the effective leadership demonstrated over the first six months of Lula's presidency. His acceptance reaches far beyond the domestic sphere: abroad in Europe he has been equally effective, most recently winning Tony Blair's open support for a permanent Security Council position.

In the Doha Round, Brazil has had an opportunity to clarify its position over the past year.[9] Agriculture has been chosen as the premier area for significant concessions, and recent export performance only enhances its importance. But beyond that, there is a well-defined Brazilian stand on industrial products, services, review of the TRIPs and TRIMs agreements, and so on. On the Singapore issues, which include discussions on investment, government purchases, competition policy, and easing of commercial restrictions (i.e., trade facilitation), Brazil is neutral. It wishes to see what gains can be achieved before announcing potential concessions here.

The still-tenuous European and US agreement on agriculture seemingly had provided the impetus at the WTO ministerial in Cancun in September 2003 to avoid what all would regard as disaster. Alas, it contributed to breakdown and one directly confronting the United States and Brazil. That inability to reach consensus left the Doha Round in total disrepair, awaiting further negotiations in Geneva.

That conclusion was directly responsible for a different resolution at the FTAA discussion in Miami in November, where Brazil and the United States agreed to a short statement postponing any substantive decision until continuing rounds of meetings in 2004. The compromise signaled stalemate. The United States is free to negotiate bilaterally with a number of additional countries in the region, those that are prepared to accept FTAs equivalent to the earlier agreement with Chile. Brazil and Mercosur were deliberately not among the chosen. They will await the continuing FTAA meetings to see whether any minimal regionwide framework evolves.

This lack of consensus has occurred despite the apparently closer relationship with the United States that Brazil has achieved in recent months. Lula and Bush have met twice, the last including separate sessions between 10 Brazilian ministers and their US counterparts, and the final joint statement was very positive; it began, "The United States and Brazil resolve to create a closer and qualitatively stronger relationship between

9. For a good summary, see Filho (2003, 6–7).

our two countries. It is time to chart a newly purposeful direction in our relationship . . . in order to promote hemispheric and global cooperation" ("Joint Statement" 2003). American Ambassador Donna Hrinak foresaw such an outcome before the meeting itself: "Brazil and the US are jointly assuming responsibility for leading the hemisphere toward free trade and integration" (quoted in *Brazil News*, June 2003, 2).

Yet in reality, Brazilian enthusiasm about the FTAA seems not quite to match this positive news emanating from Washington. First of all, the current second-ranking figure at Itamaraty, Ambassador Samuel Pinheiro, is well known for his negative views on the FTAA; they had led, after all, to his demotion by the previous foreign minister, Celso Lafer. Before Zoellick's visit to Brazil in May, Pinheiro wrote, in an article on the PT Web site, "Brazilian society ought to mobilize in defense of preserving the sovereign right of Brazil to have a development policy . . . that a future FTAA would come to prevent definitively and legally" (quoted in *Estado de São Paulo* Web site, May 28, 2003).

In an interview published in *Isto É* on July 5, 2003, Rubens Barbosa, currently Brazil's ambassador to Washington, was almost as disapproving, declaring that the FTAA could not be concluded without the simultaneous conclusion of the Doha negotiations. Moreover, he directly criticized the United States for the failure to allow discussion of antidumping legislation and subsidies, indicating that Brazil's response was to eliminate intellectual property and investment from the FTAA. And finally, Foreign Minister Amorim, in an article appearing in the *Fôlha de São Paulo* on July 8, 2003, wrote:

> President Lula approved the blueprint of the Brazilian position on FTAA negotiations. . . . [It] can be described as follows: 1) the substance of the themes of access to the goods market, and in limited form, for services and investments, would be treated in a 4 + 1 negotiation between Mercosul and the United States; 2) the FTAA process would focus on some basic elements, such as resolution of controversies, special and differential treatment for developing countries, compensation funds, sanitary rules, and commercial trade facilitation; 3) the more sensitive themes that would represent new obligations for Brazil, such as the normative part of intellectual property, services, investments, and governmental purchases, would be transferred to the WTO[.][10]

This was exactly the position subsequently put forth by Brazil at the vice ministerial meeting in El Salvador held shortly thereafter. There was, as a consequence, little advance. Indeed, in the words of one newspaper, "On one side, there is Brazil, which, with the support of the Mercosur countries, disagrees with the present structure of the negotiations. On the other, there are the other 30 beneficiaries of the project, who did not see any benefit in the adoption of the new Brazilian architecture" (*O Estado de São Paulo*, July 16, 2003).

10. "Tendencias e Debates," *Fôlha de São Paulo*, July 8, 2003.

This does not sound as though there is much prospect of a definite advance. The positions that have been taken are unlikely to shift in a brief span of time.

The same statement also applies on the US side of the negotiations. Trade issues generally move slowly in presidential election years. NAFTA was an exception that came about as a consequence of Mexican insistence in moving forward. And with the electoral loss of the incumbent 1992, one may doubt the capability even of USTR Zoellick to push matters along in 2004. Given all the bilateral discussions already on the US agenda, a more realistic assessment is that both the Doha Round and the FTAA will have their deadlines extended. That very much seems to be the expectation in Washington, and a decision will be made very soon.

In these circumstances, why not a bilateral pact between the United States and Brazil, or, much more probably, with Mercosur? In principle, this arrangement would suit Brazilian interests quite well. It would allow Brazil to bypass the WTO-plus requirement that the United States currently insists on in its FTAA negotiations; it is consistent with the differentiation of tariff offers among groups of Latin American countries thus far made by the United States; and it provides greater leverage in the simultaneous discussions under way with the European Union to permit initial concessions—to be extended in the Doha Round—in agriculture. Not least, it enables the Lula government to extract an important, and early, diplomatic victory in its international trade negotiations that equals its earlier advance in domestic economic policy.

The more difficult problem is to provide a rationale for US compliance, which would seemingly contradict the basic tenets of its current policy, as reiterated most recently at the El Salvador meeting. But that negotiating position does not take into account the probability that an additional delay will occur. By embracing a strategy of bilateral advance with Brazil and Mercosur, the United States would transform the postponement of the FTAA and the Doha Round from a negative to a positive signal, indicating that the present policy of continued growth of trade is alive and well.

Such a strategy is consistent with the many additional discussions now in progress. A separate agreement with Central America is certainly likely to emerge, adding those countries to NAFTA; why not a more limited advance with Mercosur at the same time? Moreover, to the extent that such an advance enables Mercosur to achieve some agricultural concessions from the European Union, that step would signal potential future gains for the United States in the multilateral discussions.

The cost—added complication in the existing spaghetti bowl of trade associations—is minor relative to the benefits of achieving a real, closer US relationship with Brazil and South America. That achievement could later turn out to be a very positive element in the ongoing Doha discussions, as well as in addressing the broader hemispheric agenda involving drugs, money laundering, immigration, corruption, judicial standards, and so forth.

Such an arrangement, moreover, preserves and indeed enhances Mercosur's identity, which is very much in need of updating. Earlier expectations have gone unmet. The new leaders of Brazil and Argentina both see this relationship as central to their foreign policy. A partial agreement with the United States could provide a positive impulse to renegotiation among the four countries. After the devaluations of Brazil's and Argentina's currencies, and the great reduction in trade among them, a new basis is required if the commercial relationship is to keep pace with the closer political interactions of the last year.

At root, continuing Brazilian expansion over the next decade requires substantial revision in the role of foreign trade. For too long, rhetoric about the need to take advantage of surging international commerce—which has grown at about twice the rate of national product over the past half century—has been accompanied by far too little action. The immediate interests of the domestic market have always dominated, translating into protection and subsidies in one form or another. Brazil should now be exporting just about twice the percentage of GDP—10 percent—it has currently achieved. If it is to attain that goal, it will have to be just as aggressive in the range of internal economic policies it follows as in the international policies it promulgates.

Though there seems to be virtual consensus in Brazil at the present time favoring such an increase in exports, two challenges remain. First, Brazil must be able to sustain an emphasis on the external market once domestic demand recovers. Second, it must be able to match the regular rise in exports with corresponding increases in imports, rather than seeking to protect the internal market. Meeting these challenges would irrevocably alter the future.

Logic, internal economic policy, and foreign relations do not always intersect. Here at last is an issue where they do. Brazil has already defined its conditions in a way that makes such a bilateral, or 4 + 1, arrangement a natural approach to continuing progress toward freer and greater trade. What remains to be seen is the ultimate US response. It would seem far better to incorporate Brazil within expanding and freer, hemispheric trade than to punish it with isolation.

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