

SHALL WE SAMBA? Canada-Brazil Relations in the 1990s

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EXECUTIVE SUMMARY

The worst of the Brazilian financial crisis seems to have passed with no domino effect on the rest of Latin America, as some analysts had predicted in early 1999. However, considerable damage is expected to the economies of the region through a slower, less visible transmission channel: trade. Home to 45 per cent of Latin America's gross domestic product and to 35 per cent of its population, Brazil is a key trading partner for many countries in the region. Widespread economic slowdown and diminishing intra-regional trade is expected as a result of recession and shrinking demand in Brazil.

Brazil is also a valued trading partner for Canada. It is Canada's largest export market in Latin America and the leader of Mercosul (Mercosur in Spanish), with which Canada has been trying to increase links for some time. Moreover, after the United States, Brazil is arguably the second most influential actor in the hemisphere's economic integration process – a regional priority for Canada.

Despite an increase in high-level visits in recent years, political cooperation between Canada and Brazil remains weak, leading to misunderstandings and mutual misgivings. This may explain why the two countries have been unable to push beyond a certain threshold in bilateral relations. Deepening relations with Brazil has implications for Canada's trade policy in the region. This is important for Canada, which has identified Latin America as a huge untapped market (Canada's market share is only 3 per cent), thus the Canadian emphasis given to the Free Trade Area of the Americas (FTAA) negotiations. Meanwhile, the hemispheric integration process has exposed power relations in the Americas, a new terrain for Canada that calls for prudence. Given Brazil's relative weight in the region, the management of bilateral relations with this country is pivotal for Canada's Latin American strategy.

Understanding Brazil's concerns is a first step to addressing these problems to both countries' satisfaction. This will not only improve the bilateral relationship, but will allow Canada to advance in its attempt to gain access to Latin American markets. This paper suggests a few policy options for pushing beyond the existing threshold in relations.

RÉSUMÉ

Le plus dur de la crise financière au Brésil semble être passé sans avoir provoqué d'effet domino dans le reste de l'Amérique latine, comme certains analystes l'avaient prédit au début de 1999. Mais les économies de la région ne sont pas quittes pour autant; la crise peut encore les frapper à cause d'un canal de transmission plus lent et moins visible: celui du commerce. En effet, le Brésil, qui représente 45 pour cent du produit intérieur brut de l'Amérique latine et 35 pour cent de sa population, est un partenaire commercial clé pour plusieurs pays de la région. La récession et la contraction de la demande au Brésil peuvent donc entraîner un ralentissement économique généralisé et la diminution des échanges commerciaux intra-régionaux.

Le Brésil est également un partenaire commercial important pour le Canada. Il constitue le plus grand marché d'exportation de l'Amérique latine et le moteur du Mercosul (Mercosur en espagnol) avec lequel le Canada s'applique à intensifier les liens depuis un certain temps. De plus, après les États-Unis, le Brésil est sans conteste l'acteur le plus influent du processus d'intégration économique de l'hémisphère – un processus qui est une priorité régionale pour le Canada.

Malgré la multiplication des visites de haut rang ces dernières années, la coopération politique entre le Canada et le Brésil tarde à se consolider, laissant le champ libre aux malentendus et à la méfiance mutuelle. On peut certainement voir dans cette situation la raison pour laquelle les deux pays ne parviennent pas à accroître leurs relations bilatérales au-delà d'un certain seuil. Or, l'amélioration des relations avec le Brésil ne manquerait pas de stimuler la politique commerciale du Canada dans la région. C'est un objectif important pour le Canada qui voit dans l'Amérique latine un gigantesque marché inexploité (sa part des échanges commerciaux s'y limite à trois pour cent) et qui, de ce fait, est très attentif aux négociations sur la Zone de libre-échange des Amériques (ZLEA). En attendant, le processus d'intégration hémisphérique a fait ressortir au grand jour les rapports de force qui existent au sein des Amériques, un terrain relativement nouveau sur lequel le



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Canada devra avancer avec prudence. Étant donné le poids relatif du Brésil dans la région, la bonne marche des relations bilatérales avec ce pays constituera l'axe central de la stratégie du Canada en Amérique latine.

Pour s'attaquer aux divers enjeux à la satisfaction des deux pays, il est nécessaire de comprendre les préoccupations du Brésil. Non seulement la relation bilatérale s'en trouvera-t-elle facilitée, mais aussi le Canada pourra mieux cibler ses efforts pour accéder aux marchés de l'Amérique latine. Le présent rapport propose quelques solutions à explorer pour faire sauter le verrou qui semble bloquer les relations entre les deux pays.

RESUMEN

Lo peor de la crisis financiera en Brasil parece haber pasado y el efecto dominó sobre la región, que muchos analistas vaticinaban a comienzos de 1999, no se produjo. Sin embargo, se espera considerable daño a las economías de la región por una vía de contagio mucho más lenta y menos visible: el comercio.

Dueño del 45 por ciento del producto bruto interno de América Latina y del 35 por ciento de la población, Brasil es un socio comercial clave para muchos de los países de la región. Brasil también es un valioso socio comercial para Canadá. Brasil recibe más exportaciones canadienses que cualquier otro país de América Latina y es el líder del Mercosul (Mercosur en español), la unión aduanera con la que Canadá ya hace tiempo ansía estrechar vínculos. Más aún, Brasil es considerado, después de Estados Unidos, el segundo actor de mayor influencia en el proceso de integración económica continental – una prioridad regional para Canadá.

A pesar de las crecientes visitas de alto nivel de los últimos tiempos, la cooperación política entre Canadá y Brasil permanece débil, generando malos entendidos y aprehensiones mutuas. Esto en parte explica por qué los dos países no han podido cruzar cierto umbral en las relaciones bilaterales. La profundización de las relaciones con Brasil acarrea implicancias para la política comercial canadiense en la región. Canadá ha identificado a América Latina como un mercado de gran potencial hasta ahora subexplotado (Canadá solo tiene 3 por ciento del mercado latinoamericano), lo que explica el énfasis canadiense dado a las negociaciones del Área de Libre Comercio de las Américas (ALCA).

Mientras tanto, el proceso de integración hemisférica ha expuesto las relaciones de poder dentro de las Américas, un terreno nuevo para Canadá que requiere prudencia. Dado el peso relativo de Brasil en la región, el manejo de las relaciones bilaterales con este país es clave para la estrategia latinoamericana de Canadá. Comprender los intereses e inquietudes de Brasil es el primer paso para encontrar soluciones satisfactorias para ambos países. Esto no solo contribuirá a mejorar las relaciones bilaterales, sino que también permitirá que Canadá avance en su proyecto de ganar acceso a los mercados latinoamericanos. Este documento ofrece un menú de opciones de políticas conducentes a superar el actual umbral de las relaciones bilaterales.

SUMÁRIO

O pior da crise financeira brasileira parece ter passado sem qualquer efeito dominó no resto da América Latina conforme alguns analistas tinham predito cedo em 1999. No entanto, prejuízos consideráveis são esperados nas economias da região num canal de transmissão menos visível e mais lento: o comércio. Possuindo 45 por cento do produto interno bruto da América Latina e 35 por cento da população, o Brasil é o sócio mercantil chave para muitos países da região. Espera-se uma economia lenta e difundida junto com a diminuição do comércio intra-regional como resultado da recessão e de procuras contraídas no Brasil.

O Brasil também é um valioso parceiro mercantil para o Canadá. Brasil é o maior mercado de exportação do Canadá na América Latina e é o líder da Mercosul (Mercosur em espanhol), com a qual o Canadá, já por algum tempo tem tentado aumentar os vínculos. Além disso, depois dos Estados Unidos, o Brasil é indisputavelmente o segundo ator mais influenciador no processo de integração econômica do hemisfério – uma prioridade regional para o Canadá.

Apesar de um aumento de visitas de alto nível em anos recentes, a cooperação política entre o Canadá e o Brasil continua fraca levando a mal entendimentos e apreensão mútua. Isto pode explicar porque os dois países são incapazes de ultrapassar um certo limiar em relações bilaterais. Relações aprofundadas com o Brasil têm implicações para a política comercial do Canadá na região. Isto é importante para o Canadá, que já tem identificado a América Latina como um vasto mercado não penetrado, (o Canadá tem apenas 3 por cento da participação no mercado) conseqüentemente, explicando a ênfase canadense dada às negociações da Área de Livre Comércio para as Américas (ALCA). Entretanto, o processo de integração hemisférica tem exposto relações de poder nas Américas, um novo terreno para o Canadá, que requer a prudência. Dado o peso relativo do Brasil na região, a administração de relações bilaterais com este país é fundamental para a estratégia Latino Americano do Canadá.

Compreendendo os interesses do Brasil é o primeiro passo para resolver estes problemas à satisfação de ambos os países. Isto não só melhorará as relações bilaterais, mas permitirá o Canadá de avançar na sua tentativa de ganhar acesso aos mercados Latino Americanos. Este documento sugere algumas opções políticas para se ultrapassar o limiar em relações atuais.

Brazil: Why should Canada be concerned about recent developments?

Brazil is particularly meaningful to Canada on three fronts: as a destination of Canadian investment, as a trade partner, and as a regional power. Recent developments in Brazil may alter the investment environment, the demand for Canadian goods and the continuation of the regional economic integration process. With a population equal to that of Russia, the area of the continental United States and a GDP similar to Canada's, Brazil shares borders with thirteen countries, many of which are highly dependent on the Brazilian economy. Therefore, the fate of South America is closely tied to that of Brazil.

There are then circumstantial as well as structural reasons why Canada should be concerned about where Brazil is headed. The purpose of this paper is twofold:

- to examine recent developments in Brazil and to explore how new realities may affect Canadian interests there and in the region as a whole;
- to discuss the prospects for Canada-Brazil relations and suggest a menu of policy options.

This policy paper draws on discussions at the FOCAL workshop "Whither Brazil? Implications for the Hemisphere and bilateral relations with Canada" held in March 1999 in Ottawa. The workshop brought together approximately thirty expert commentators from the public, private and non-governmental sectors of Canada, Brazil and the United States. This document also reflects FOCAL's own policy analysis on the subject.

I. BRAZIL: CURRENT SITUATION

Political Outlook

"The indomitable democracy" was the title of a recent article by Brazilian political scientist Mónica Hirst ("La democracia indomable", Clarín (Buenos Aires), February 1, 1999, p.12), in which she finds in Brazil's peculiar institutional and political structure the roots of the country's current financial distress. Indeed, Brazil's highly fragmented political system, strong regional interests and volatile political loyalties are often blamed for the slow pace of reform. There is widespread consensus that structural reforms are needed in order to restore economic health.

Brazil is a demographic giant that sent 106 million citizens to the polling stations in October 1998. Brazilians express their political preferences through two main channels: a federal regime organized around 26 states – most of them jealous of their autonomy –, and a party system made up of 22 political parties.

In October 1998, President Fernando Henrique Cardoso was re-elected with 54 per cent of the votes. Governors of the opposition were elected in three of the four most powerful states – Minas Gerais, Rio Grande and Rio de Janeiro –, only São Paulo remaining in the hands of the governing Social Democratic Party (PSDB). The 513-seat Chamber of Deputies was left divided among seven national parties,

some of which are federations of provincial parties, and numerous smaller groups.

Since no party has a clear majority in Congress, coalition building is the indispensable condition for governing. This is often aggravated by fast changing political loyalties, forcing the President to renew his coalition for every policy issue. An incident involving the governor of Minas Gerais, former President Itamar Franco, illustrates this well. In January 1999, he announced a moratorium of the debt that his state held with the federal government, even though his Brazilian Democratic Movement Party (PMDB) is a member of the five-party coalition that backs Cardoso in Congress. Franco's move unleashed the now familiar sequence of events: capital flight, devaluation and, finally, the free float of the *real*.

Another complicating feature of Brazil's political landscape is the electoral system that gives a disproportionately large representation to voters in states with small populations (a deputy from the state of São Paulo needs 200,000 votes to be elected, whereas a representative from the Amazonian state of Roraima requires only 5,000); effectively, the system favours rural states. Often the most developed and populous regions are ill-represented, and less sophisticated politicians, mainly driven by local or personal interests, possess excessive power.

Despite the political challenges, Congress has managed to pass several key reforms in recent months. They include laws for pension reform (increase in public sector workers' contributions and the new collection from retired workers) and on raising the financial transaction tax (from 0.2 per cent to 0.38 per cent, which is expected to yield \$8 billion (U.S.) in revenue a year). The next step is to implement these reforms, and to move from an emergency fiscal adjustment to structural reform of public spending at the federal, state and local levels.

Pending reforms for the short-term include the fiscal responsibility law (it would punish politicians who exceed their spending limits) and reform to the tax system (clearly establishing the responsibilities of the different levels of government, among other things). There is also a proposal under study to reform the political system, introducing parliamentary districts and greater party discipline, and a blueprint for improving the efficiency and transparency of the judicial system. Obtaining support for these reforms, however, may prove to be difficult considering the recessionary context of 1999, rising unemployment, falling real wages, and President Cardoso's plummeting popularity (seven months after the devaluation popular support is at a historical low of 16 per cent).

On the other hand, even though public support at home has declined, President Cardoso still commands international support from the international banks and the United States government, in particular. He has strong presidential levers at his disposal to push for reform implementation when negotiating with resistant State Governors. Equally important, Cardoso has four more years as Brazil's President, and while some Governors may try to

position themselves for the next elections by challenging the President's policies, there is no real contender to Cardoso at this point. Finally, while the lengthy negotiations between the Executive and Congress have earned Brazil a reputation as a slow reformer, this fact may ensure that there is widespread consensus for reforms thus making them, not only democratic, but also enduring.

Financial Prospects

While there is consensus on the political factors behind the Brazilian financial crisis, economists are divided on the economic factors that caused it. In February 1999, only weeks after the *real* was left to float freely, the annual meeting of the World Economic Forum in Davos found renowned economists split into two groups. "This is the best foretold crisis in recent history", said George Soros, blaming primarily domestic factors – notably the overvalued *real* and huge fiscal deficit — for Brazil's financial turmoil. Sebastian Edwards and Milton Friedman also share this view. They recommend further fiscal austerity and structural adjustment for Brazil and other emerging markets to prevent crises of this nature in the future.

A second group of economists believes international factors – international financial market volatility, poor advice from the International Monetary Fund (IMF) and late reaction from the international community – played a stronger role in the crisis. In keeping with this view, nothing short of the reform of the international financial system can avoid future crises. Paul Krugman and Jeffrey Sachs are two of the economists who advocate this view.

The first challenge facing Brazil immediately after the January devaluation was to prevent an outbreak of inflation. The fear of an across-the-board price hike has now abated with inflation numbers over the past six months having been remarkably low. This has allowed the Central Bank to lower interest rates ten times since March 1999. Current rates have been reduced by more than half: falling from 45% to 19.5%. The *real* has stabilized and has been trading in the range of 1.68 to 1.87 to the U.S. dollar. Indeed, the threat of a return to the old practice of indexation – automatically adjusting prices and wages to past inflation rates – seems to have receded.

A second challenge was Brazil's domestic public debt. There were doubts about the capacity of Brazil to service its debt in dollars following devaluation. Since the debt is subject to variable interest rates, the cost of servicing grows sharply as interest rates rise. Nonetheless, seven months after the devaluation, the possibility of debt default receded because of the drastic drop in interest rates. Investors are aware of the debt problem and will be cautious about further involvement in Brazil. Indeed, restoring investor confidence is another challenge facing the Brazilian government.

Restricted access to international capital markets, were denting consumption and investment in Brazil. Towering credit costs were also hurting exporters and offsetting the advantage of a devalued *real*, thus undermining Brazil's strategy of exporting its way out of the crisis. Since April 1999, access to financing has improved, resulting in a faster

than expected economic recovery. Yet Brazil must raise taxes, as well as carry out deep spending cuts under conditions of the \$41.5 billion (U.S.) multilateral aid package (IMF and other donor agencies and countries), first negotiated in November 1998. Major steps towards this goal were taken with the privatization of the state-owned telecommunication sector (Telebras), energy and mining companies (Valle do Rio Doce) in the last two years. It is likely that the three largest state companies remaining: the state oil company (Petrobras), Brazil's largest bank (Banco do Brasil), and the second largest financial entity (Caixa Economica Federal), will be privatized in the near future.

Notwithstanding the consensus that Brazil will continue to have negative economic growth (forecasts range between a 1 and 2 per cent drop in GDP in 1999), there is room for optimism in the country's long-term performance. Grounds for hope include:

- the support of the IMF and other international financial institutions (IFIs);
- the return (albeit slow) of some investors to Brazil;
- the containment of inflation in the months after the devaluation;
- the drop in interest rates from 45% to 19.5%; and
- the proven willingness of Congress to pass necessary reforms.

In addition, the fact that Finance Minister Pedro Malan has been confirmed in office for a second term sends a clear message of continuity in Brazil's overall economic policy. Finally, new Central Bank governor Arminio Fraga's strategy of defending the *real* by initially increasing interest rates (and lowering them shortly after) is proving to be more credible and sustainable than that of selling reserves.

Social Reality

President Cardoso gained tremendous popular support in 1994 when, as Minister of Finance, he implemented the *Real Plan*. The plan increased the purchasing power of millions of Brazilian consumers by taming inflation, which hit the poor hardest, and by raising minimum wage by 40 per cent. Price stabilization undeniably benefited the poor, lifting an estimated 13 million above the official poverty line. Since 1994, access to basic services like electricity, garbage collection, and drinking water increased markedly. Infant mortality fell and illiteracy had a significant drop. However, Brazil remains one of the most unequal countries in the world.

According to a 1996 United Nations Development Program (UNDP) report, the richest 20 per cent of the population enjoy 65 per cent of the total income, while the poorest 50 per cent receive only 12 per cent. The income gap has grown in the last four decades; in 1960 the relationship was 54 per cent to 18 per cent. To put it differently, the average per capita income of the richest 10 per cent is nearly 30 times greater than that of the poorest 40 per cent, as opposed to 13 times in Costa Rica, 10 in Argentina and 5 times in France. Brazil's poor, currently around 50 million

people (30 per cent of the population), live mostly in the Northeast, especially in rural areas, and in the metropolitan areas of São Paulo and Rio de Janeiro. Race and gender are significant factors influencing inequality.

Having dedicated his first term in office to economic reforms, President Cardoso had conceived his second term as the time for social reform. The combination of budget cuts and recession may make implementation of social reform an elusive task, however. High unemployment (the official rate is currently 8 per cent) will continue to pressure Brazil's social fabric. The current economic situation is likely to cause poverty to rise further and exacerbate chronic problems such as, inequity, institutional violence and rural landlessness. Already, even moderate inflation (relatively lower than in the past) is eroding the purchasing power of Brazilians and contributing to their disillusionment with the Cardoso government.

Foreign Policy

In March 1999, Foreign Minister José Felipe Lampreia explained Brazil's foreign policy for the next four years as a series of concentric circles:

the consolidation of Mercosul;

the integration of Chile and Bolivia;

the establishment of a South American Free Trade Area (SAFTA);

the extension of the SAFTA into Mexico;

a free trade agreement between Mercosul and the European Union (E.U.);

the Free Trade Area of the Americas (FTAA).

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- the extension of the SAFTA into Mexico;
- a free trade agreement between Mercosul and the European Union (E.U.);
- the Free Trade Area of the Americas (FTAA).

Other important issues include active participation in the millennium round of the World Trade Organization, and in the reform of the United Nations, including expansion of the Security Council (Brazil has long indicated a desire for Security Council status). Strengthening of Mercosul, the customs union of Argentina, Brazil, Paraguay and Uruguay is the first priority of Brazilian foreign policy. Intensifying relations with Argentina, which Brazil considers a "strategic ally" is key to that goal. The integration process between the two countries, initiated with the re-establishment of democratic governments in the 1980's, transformed the subregion into an integrated market and a pole of attraction for investment, which Paraguay and Uruguay joined shortly after. Deepening relations with Chile and Bolivia, currently associate members of Mercosul, and increasing links with Mexico are also priorities in Brazil's hemispheric strategy.

Brazil's hemispheric strategy consists of consolidating its regional power base by expanding its Mercosul links to create a Brazilian-led South American Free Trade Area (SAFTA), and only then negotiating trade liberalization with North America on a stronger footing. The SAFTA initiative was born in 1993 and has been pushed by Brazil ever since as the prime instrument to achieve its trade objectives. These are twofold:

- to develop while continuing to protect its internal market until its domestic companies are ready to compete internationally, and
- to improve access for Brazilian products to its main markets, especially the United States.

A SAFTA would enable Brazil to achieve its objectives in two ways. In the South American scenario, Brazil can easily throw its political and economic weight around and make sure that the opening of its own economy is selective and gradual. Additionally, South American countries' exports, because of their composition and quality, are not seen as a threat to Brazilian products, while these countries provide a growing market for Brazilian manufacturing products (farm machinery, cars). A SAFTA led by Brazil is also seen as instrumental to the second goal of strengthening Brazil's negotiating power vis-à-vis the United States in hemispheric trade talks.

Finally, leadership of a SAFTA not only serves Brazil's trade policy aims, but also its overall foreign policy objectives. Essentially these are to win Brazil a stronger leadership role in shaping the course of world affairs. Itamaraty, Brazil's Foreign Ministry, bases these aspirations on Brazil's vast geography and population, and most recently, economic opening and growth, modernization and regional leadership. A successful South American bloc headed by Brazil would buttress this country's credentials as the major world player it feels it should be.

Brazil-E.U.

The European Union is of great importance to Brazil's economy: it is the main market for Brazilian exports and the first foreign investor in the country. In the early 1990's, however, relations with the E.U. soured due to friction in a

number of areas including the European Union's Common Agricultural Policy (CAP), E.U. bias toward protectionism, Brazilian legislation on intellectual property, investment and services, and environmental effects of the occupation and development of the Amazon. Relations have improved, and Mercosul and the E.U. are set to begin talks on an economic association agreement in late 1999, although negotiations for tariff reductions will not begin until July 2001. The timetable was agreed on the margins of the Rio Summit (June, 1999), the first E.U.-Latin America/Caribbean full gathering, that launched a plan for biregional economic and political cooperation initiatives. Improving market access of agricultural products to the E.U., and gaining leverage against the United States-sponsored FTAA, are Brazil's main expectations for a Mercosul-E.U. economic association.

The Free Trade Area of the Americas (FTAA)

The FTAA, cornerstone of Canada's policy for the Americas, is not only of little interest to Brazil, but according to the current schedule, it is at odds with its trade strategy for the region. Indeed, the FTAA if implemented, would threaten the Brazilian plan of gradual, selective market opening and consolidation of its regional base before negotiations with North America. The FTAA would also threaten Brazil's ability to de-link trade from domestic policies on labour and environment.

In keeping with this, Brazil has been the most reluctant Latin American country during preparatory negotiations for the FTAA. Through Brazilian-led Mercosul it has taken positions regarding the speed and the scope of negotiations that clearly conflict with U.S. and Canadian aims. Canada would like negotiations to proceed as fast as possible and to begin implementing commitments as they are negotiated ("early harvest"). Brazil prefers to wait until 2005 and implement them as a single undertaking. The two North American countries also favour using NAFTA as a benchmark for the FTAA, although a "WTO-plus" arrangement would be better still. This would involve the inclusion of issues insufficiently covered or not covered at all by the existing multilateral and regional regulations: labour and environmental standards, services, foreign investment and more rigorous intellectual property regulations.

The Brazilian government adopted a go-slow approach in the first phase of FTAA preparatory negotiations (1994-1996) and has employed dilatory tactics since 1996. Brazil has also opposed the NAFTA template, especially the inclusion of labour and environmental standards in the hemispheric trade agenda. The North American scheme established for the first time an explicit link between trade sanctions (through the withdrawal of market access benefits) and nonobservance of national labour or environmental laws. The rationale for Brazil's position is twofold: first, because of the prevailing gap between Brazilian labour codes and practice, Brazil would most likely be a target for sanctions; second, Brazil is committed to the principle of national sovereignty and is averse to any potential infringement on its domestic policies.

Brazil's position at the FTAA talks responds to a complex web of incentives and defensive motives. The paramount incentive for Brazil's involvement in the hemispheric economic integration process is also shared by its Latin American counterparts: further opening of the U.S. market. On the other hand, Brazil also worries about the risk of being marginalized from preferences negotiated under the FTAA umbrella, and the potential erosion of existing preferences that Brazil enjoys with other Latin American countries by extension of NAFTA (as a bloc or by country).

Understanding

that trade policy serves wider political objectives of the Brazilian government is a first step to understanding Brazilian bargaining positions in multilateral fora.

Another fear underlying Brazil's lack of enthusiasm towards the FTAA is that of locking itself into a scheme heavily influenced by the United States, thus losing political and economic manoeuvrability. Brazil takes pride in being a global trader, not dependent on any single market. Brazil sends approximately 27 per cent of its exports to the E.U., 23 per cent to Latin American countries —70 percent of which goes to Mercosul partners —, 19.5 per cent to the United States, and the remaining 30.5 per cent to Asia, Africa and the Middle East. Canada receives approximately 1 per cent of total Brazilian exports. The composition of Brazilian exports is diversified: manufactured products account for 55%, semi-manufactured goods for 22% and commodities make up for around 23% of total exports. Relations with each of the aforementioned countries and blocs of countries are conceived as "options that reinforce and increase Brazil's bargaining power and strengthen our diplomatic triumphs" (Brazilian government policy paper "Brazil's external policy", April 1997). Understanding that trade policy serves wider political objectives of the Brazilian government is a first step to understanding Brazilian bargaining positions in multilateral fora.

Multilateralism

Brazil is an active member of the regional and international communities. At the regional level, Brazil is an involved member of the Rio Group, the Iberoamerican Conference, and to a lesser degree, of the Organization of American States (OAS). Brazil is not a true believer in the OAS; it tends to see the organization more as a bilateral forum where countries settle their scores with the United States, rather than as a multilateral forum. Brazil is a chronic debtor to the OAS, currently \$19 M in arrears in its quota payment. This said, Brazil is currently involved in the negotiation and implementation of measures related to hemispheric security, anti-drug initiatives and arms traffic. Brazil was also guarantor of the Peru-Ecuador peace process. Human rights are another item in the hemispheric agenda of interest to Brazil. Jointly with Canada, Brazil has

co-chaired the Working Group on Democracy and Human Rights since 1995, a proposal stemming from the Plan of Action of the Miami Summit of the Americas. Brazil has ratified the inter-American Convention on Human Rights, and has also ratified most of the additional protocols, whereas Canada has not even signed the Convention.

On the international scene, Brazil is a committed member of the United Nations and it continues to work to obtain a permanent seat at the U.N. Security Council. In 1998, Brazil was elected to nonpermanent seats at the U.N. Security Council (until December 1999) and at the Economic and Social Commission (ECOSOC) (until December 2000). Brazil participates in peacekeeping missions to Angola, Mozambique, Guatemala, Bosnia and Cyprus. Partly due to its African heritage, Brazil is particularly dedicated to promoting peace and development in Africa where it has sent military and policy observers, medical units and electoral experts. Brazil was instrumental in the establishment of the Community of Portuguese Speaking Countries. Brazil is also an active player at multilateral trade negotiations, privileging the fight against protectionism and subsidies of developed countries.

II. SPILLOVER TO MERCOSUL AND THE REGION

Brazil's financial volatility and devaluation have caused considerable economic as well as political damage to Mercosul. Argentina, Paraguay and Uruguay were the hardest hit by economic turbulence in Brazil as it accounts for a large share of the foreign trade of the three countries. The importance of the Brazilian market in Argentine and Uruguayan foreign trade has doubled since the start of the decade; in 1998, both countries sent one third of their exports to Brazil. In turn, Paraguay sold nearly half of its exportable goods to Brazil. In 1998, the four members traded \$20 billion (U.S.) of goods and services. Given the relevance of the Brazilian market for three Southern Cone countries, widespread economic slowdown is expected as a result of a contraction of demand in Brazil.

Certain industries and products are being particularly affected. Most serious is the case of the auto industry in Argentina that has seen many plants closed down and thousands of workers laid off because they are not able to compete with cheaper Brazilian cars. There is concern that this may spell the end for the Argentine auto industry, the greatest source of Argentine exports to Brazil. Provinces of Argentina, Paraguay and Uruguay bordering Brazil suffer even more as in most cases 70-90 per cent of their production goes to Brazil. In addition to transmission by way of trade, there are investment effects. It is likely that many decisions on whether to make capital investments in manufacturing are influenced by expectations regarding the regional market.

Prospects for Mercosul are unclear at this point. While the political will to overcome the current crisis of the arrangement is there, the commercial imbalances caused by the devaluation of the *real* are imposing a high economic and political cost and protectionist demands are mounting in Argentina and Uruguay. For the first time in the history of Mercosul, the two larger members are in recession at the

same time, leaving little room for significant concessions. On the other hand, the financial crisis exposed the weaknesses of the Mercosul scheme, in particular the lack of provisions to deal with temporary imbalances, its insufficient institutional structure and the partners' excessive dependence on the Brazilian market ("Brasildependencia"). Should Mercosul survive this critical juncture, this may prove to be an opportunity to strengthen the institutional structure of the integration arrangement and to increase macroeconomic coordination.

The financial crisis exposed the weaknesses of the Mercosul scheme, in particular the lack of provisions to deal with temporary imbalances, its insufficient institutional structure and the partners' excessive dependence on the Brazilian market ("Brasildependencia").

Finally, economic slowdown in the largest country of the region and rising unemployment will create more poverty in Latin America, ending a decade marked by under-performance, according to Peter Hakim, President of Inter-American Dialogue. Political and economic reforms undertaken in the late 1980's created high expectations for the region, but the 1990's failed to deliver the expected results. The region has seen a general rise in its poverty levels and many people are worse off than they were at the beginning of the 1980's. Moreover, developments on the international scene have further reduced the ability of the region to cope with existing problems of poverty and inequality. Lastly, hemispheric cooperation has progressed much slower than expected a decade ago. At the turn of the decade, the "Washington Consensus" remains the model of choice for Latin America. Moreover, recession across the region is likely to deepen the process of economic reform and privatization as countries compete over scarce foreign investment. To prevent further pauperization of Latin America, the implementation of second generation reforms – educational, judicial and social – to follow economic reform, is urgently needed. While there appears to be consensus to undertake these reforms, some call it a "false" consensus and point to an apparent absence of real commitment to allocate funds to that end.

III. U.S. RELATIONS

The Brazil-U.S. relationship is rather complex and has been punctuated by periods of cooperation, but most recently, friction and mistrust have dominated. A tense dispute over Brazil's information technology sector in the late 1980's, the growing number of restrictions on Brazilian imports to the United States (steel, shoes, orange juice and Brazilian chickens among other products), and the creation of Mercosul – which the U.S. sees as a stumbling bloc to concluding a FTAA by 2005 – are some of the most recent sources of friction. Brazil's misgivings also stem from the fact that the United States is the only challenger to Brazil's hegemonic position in Latin America.

There are also strong economic interests linking both nations. Brazil is the U.S. second export market in the region; moreover, Latin America is the only region in the world with which the U.S. enjoys a trade surplus, most of which is with Brazil. In addition to trade, there are other reasons why the U.S. has an interest in containing the financial crisis: the investments of 450 of the 500 largest U.S. businesses; the exposure of major U.S. banks such as Citibank; and the possibility of a further fall in commodity prices. The latter would most likely trigger U.S. farmers' demands for agricultural subsidies, which could depress prices even more. The aforementioned U.S. concerns may explain the Clinton Administration's unambiguous support of the Cardoso Administration and decisive coordination of the rescue package.

IV. CANADA-BRAZIL RELATIONS: INTERESTS AND PRIORITIES

Implications of Brazilian financial instability for Canada

Direct effects of the Brazilian financial crisis on the Canadian economy are bound to be minor, since Brazil is not a significant market for Canada. Brazilian demand for Canadian products probably will decrease in 1999, but this will not compromise Canada's prosperity in a meaningful way. As with the Asian crisis, the most serious effects would likely occur indirectly through the United States. A serious downturn in Brazil would, nevertheless, harm the prospects of some individual Canadian companies that have chosen to advance further into Latin American markets than the norm.

Canadian interests in Brazil

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The Canadian private sector has been engaged in Brazil for nearly a hundred years. The longest-established Canadian company, today known as Brascan (former Traction, Light and Power) was set up in Brazil at the turn of the century and helped lay out much of the country's basic infrastructure for the provision of electricity, water and gas. Although Canada's profile has diminished – before World War I Canada competed for the first position as top foreign investor with the United Kingdom and the United States –, today it ranks seventh with cumulative investment around

\$4 billion (Cdn). Figures are low, however; Canadian investment in Brazil represents 4 per cent of total foreign investment in Brazil and approximately 2 per cent of overall Canadian direct investment abroad.

The most rapidly growing markets are telecommunications, information technologies, mining and energy. Major investors include Alcan Aluminium Ltd., Bell Canada International, Moore Business Forms, Nortel and Seagram. Canada has a Double Taxation Agreement with Brazil, and signed a Trade and Investment Cooperation Arrangement (TICA) with Brazilian-led Mercosul in 1998. It has also been actively pursuing a Foreign Investment Protection Agreement (FIPA) for some time.

Canada's exports to Brazil over the past five years have traditionally exceeded \$1 billion (Cdn). In 1997, Canada's exports to Brazil even surpassed those to Mexico, a NAFTA partner at \$1.56 billion (Cdn). However, in 1998, Canadian exports were \$1.39 billion (Cdn) to Mexico against \$1.25 billion (Cdn) to Brazil. This tendency is likely to continue in 1999 due to the recession in Brazil. While wheat, newsprint, mineral fuels and potash accounted for most of the exports, there is a rising demand for products with higher value-added such as mobile cellular systems, telecommunications, information technology and environmental equipment. Brazil is one of five priority markets for the Export Development Corporation (EDC). Currently the EDC offers financing programs for Canadian companies investing in Brazil as well as lines of credit to companies in Brazil.

As trade links grew so did political ties and bilateral assistance. The frequency of bilateral visits from different levels of government has increased markedly, producing various bilateral agreements. Accords on the establishment of a joint economic and trade council, nuclear cooperation, joint training of peacekeeping forces and an extradition treaty are among the most recent commitments linking the two countries. The Canadian International Development Agency's (CIDA) budget for bilateral assistance to Brazil doubled in the last three years with the development of a new program framework focusing on equality, environment, public sector reform, health, education and human rights. Canada's current development cooperation program with Brazil amounts to \$7.4 M (U.S.) per year, representing approximately 2 per cent of Brazil's total official development assistance.

Current Priorities

In 1990, Canada became a full member of the Organization of American States (OAS) paving the way for closer political and commercial links in the hemisphere. The 1994 North American Free Trade Agreement (NAFTA) was Canada's first such agreement with a Latin American nation. Three years later, a free trade agreement (FTA) with Chile demonstrated Canada's commitment to forging stronger ties with the region. The next logical step in the Canada-Latin America "crescendo" was to fashion closer links with Canada's largest trade partner in South America: Brazil. This, however, has proven to be an arduous proposition.

Despite an increase of high-level visits in recent years, political cooperation between Canada and Brazil remains weak, leading to misunderstandings and mutual misgivings. Indeed, there is a widespread sense that there is a threshold in the bilateral relationship that both countries have been unable to cross. To begin with, current Canadian exports to Brazil are comparable to those in the 1970's. Brazil's last-minute decision not to sign the Trade and Investment Co-operation Arrangement (TICA) as scheduled during Team Canada's visit in 1998 also illustrates the lack of readiness of the bilateral relationship. Another example is the still fruitless effort of the Canadian government to conclude a FIPA with Brazil. These realities beg the question: what is holding the relationship back?

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During most of the 1990's two irritants dominated the bilateral agenda: the Lamont-Spencer case and the dispute on aircraft subsidies. The transfer of the two offenders to a Canadian prison in 1998 put an end to one of Canada's longest consular cases. The conflict over aircraft subsidies, involving Canadian aircraft maker Bombardier and the Empresa Brasileira de Aeronautica (Embraer), dates back to 1996. The two companies have been involved in a fierce competition over the regional jet market, in which they succeeded in involving their respective governments. First, Canada took the case to the WTO alleging violations to the Subsidies Agreement and GATT 1994 on the part of the Brazilian government. This led to a counterclaim by Brazil of similar violations on the Canadian side. In August 1999, a final WTO ruling found both parties at fault and recommended bringing export support programs in line with the rules of the multilateral organization. While compliance is likely to take time, the ruling may help to close a difficult chapter in Canada-Brazil relations by transferring jurisdiction on the matter to the WTO. While minor irritations still remain in the bilateral trade agenda, the elimination of the two major hurdles should allow for more fluid relations.

To ensure that is the case, Canada and Brazil should now turn their attention to underlying, less tangible irritants in the bilateral dynamic. These have to do with mutual perceptions and with the position of both countries on key hemispheric issues. Of particular importance are Brazilian suspicions of Canada's relationship with the United States, the two countries' diverging views on the Free Trade Area

of the Americas, and Brazil's perception that Canada has insufficiently recognized the importance of the South American country as an international actor.

While Canada views Brazil as a lucrative destination for its goods and investments, the latter's perception of Canada is more complex. Canada is a U.S. ally, a NAFTA partner and its economy is tremendously dependent on the U.S. economy. As such, Brazil's perception of Canada is tightly linked to that of the United States. Brazil-U.S. relations are rather intricate and they have been quite strained in recent times, as reviewed in section III. Moreover, Brazil does not clearly see Canada as playing the role of counterweight to the U.S. within the hemisphere, as expected when Canada joined the OAS.

One other reason for Brazil's discomfort is that Canada may be using its pursuit, outside of the NAFTA and FTAA frameworks, of increased trade links with the Americas – namely Chile and Mercosul – to press the U.S. Congress for fast-track approval. Approval of fast-track is most likely to accelerate the hemispheric process, something Brazil has been trying to avoid ever since the FTAA initiative was announced in 1994. Meanwhile, Canada has become the keenest advocate of the economic integration hemispheric process, taking stands that are clearly at odds with Brazil's. Essentially, Canada has worked to speed up a process that Brazil is trying to slow down and has pushed for commitments that Brazil clearly does not want to make. Conversely, Brazil's dilatory tactics at FTAA negotiations and its reluctance to cooperate with a process supported by the majority of Latin American countries have led to growing frustration among Canadian government officials.

The fact that Canada's position on key FTAA issues coincides with that of the United States is also a source of suspicion for Brazil. Moreover, Canadian emphasis on "new" (intellectual property protection, services) and "brand new" issues (civil society, trade and environmental standards) in trade negotiations diverges from Brazil's restrictive approach to trade agreements. Brazil's overriding concern when negotiating trade agreements is to improve access for its products; in light of this, Canada's trade policy is sometimes perceived by Brazil as hazy and less than committed to the core aspects of trade.

A further cause for malaise relates to Brazil's concern with its self-image and its place in the pantheon of nations. In its perennial quest for recognition on the world stage, the Brazilian government expects other governments to take into account its economic weight and regional leadership. There are questions whether the Canadian government has been sensitive enough to this Brazilian expectation. There is also an issue of competition between Canada and Brazil as the second and third economies in the hemisphere. Both countries share similar gross national products – in 1997 Canada's was \$607.74 billion (U.S.) and Brazil's was \$820.381 billion (U.S.) –, although per capita incomes differ considerably (in the same year it was \$19,640 and \$4,790 respectively). Finally, Brazil has traditionally seen itself as the bridge between the United States and Latin American

countries; any attempt by Canada to play the role of intermediary may be perceived by Brazil as a threat to its regional leadership.

V. OPTIONS FOR PUSHING BEYOND THE EXISTING THRESHOLD IN RELATIONS

The following options and recommendations for Canada are built around some basic assumptions on Brazilian foreign policy:

- Brazil's foreign policy serves the consolidation of the Brazilian state (consolidation of its regional power, control of its own territory, management of the Amazon basin);
- Brazilian foreign policy is built around the traditional concept of national sovereignty characterized by the principle of nonintervention;
- Although an ally of the United States in the broad sense, Brazil is wary of the U.S. hegemonic influence in the region;
- Brazil sees itself as a regional power and potentially as a global power.
- Brazil's trade policy serves the aforementioned foreign policy objectives.

These assumptions have implications for how Brazil will tend to perceive Canada: the Brazilian government will take a close look at how Canada positions itself vis-à-vis the United States; Brazil will be suspicious at any attempts made by Canada to intervene in what it considers Brazilian domestic politics; Brazil will want to be considered by Canada as an equal, not as a less-developed country; and Brazil will be extremely careful when negotiating trade commitments.

Weak political cooperation may have led to an insufficient understanding of Brazil's concerns on the part of the Canadian government, and to misconceptions and suspicions about Canada's intentions towards Brazil, on the part of the Brazilian government. These flawed mutual perceptions may be largely responsible for the existing threshold in bilateral relationship. Therefore strengthened political cooperation should be conducive to dispelling misapprehensions and heightening mutual collaboration. Based on these assumptions and on the findings of our study, policy-makers from both Brazil and Canada may wish to consider the following areas as fertile ground for renewed political cooperation. Deepened political cooperation will require action at different levels:

Multilateral Cooperation

United Nations

- In keeping with its ambitions of being recognized as an important international player and obtaining a permanent seat at the Security Council, active engagement and leadership in U.N. initiatives is key to the Brazilian government. Conflict resolution and peacekeeping activities in Africa, U.N. reform, Iraq's compliance with U.N. resolutions, and the promotion of

nuclear weapons-free-zones, are some of Brazil's main issues of concern at the U.N. Many of these priorities are also shared by Canada. Furthermore, Brazil and Canada currently hold non-permanent seats at the Security Council (until December 1999 and December 2000, respectively) and are members of ECOSOC (until December 2000 and December 2001, respectively). The Canadian government should explore these and other avenues for working together at the U.N.

World Trade Organization

- Continue to work on issues of common interest such as the removal of agricultural export subsidies affecting trade, in the lead up to the Millennium Round in the year 2000.

Hemispheric Cooperation

- **On the human security approach promoted by Canada:** Based on the assumptions on Brazilian foreign policy made in this paper, Canada may want to focus in areas where the Brazilian government needs help and which do not represent a threat to national sovereignty. For example, illegal drugs are not a big issue for Brazil but the country has to endure criminality partly related to the drug problem, and it is also a turntable for drug trafficking. Police reform is another issue that fits well in the human security agenda and it is an area where the two countries have already started to work together. Other issues of concern to Brazil include human rights and poverty, violence and firearm control. Deepened political dialogue on existing Summit of the Americas agenda issues may lead to joint work on new and emerging issues such as urban poverty, citizen insecurity and environmental security.
- **Leadership:** Given Brazil's relative weight in the region, we recommend that Canada be prepared to share leadership with Brazil, as it has done on the Human Rights Chapter of the Santiago Summit Plan of Action, on some issues of mutual interest such as judicial reform and corruption, or on some new issues of the human security agenda as it applies to the hemisphere. Helping smaller countries in the region may be another opportunity for joint initiatives.
- **On the FTAA:** A major reason for Brazilian unenthusiastic behaviour towards the FTAA is that it regards it a process ultimately dominated by the United States. Therefore, a first step is to convince Brazil that hemispheric cooperation can be more balanced and that Canada can help to redress the existing imbalance. A second step is to show Brazil that, while sharing many concerns and interests with the U.S., Canada has independent foreign and trade policies for the Americas. The Canadian government is encouraged to make an effort towards stronger differentiation from the United States, particularly in those issues that matter to Brazil (e.g. labour and environmental standards).
- **FTAA and civil society:** Brazil is not a true believer in civil society participation in the negotiating process. Brazil is reluctant to see civil society involved because it fears that labour and environment issues will be put in

the forefront of the trade agenda. It also fears the domination of U.S. civil society actors, more numerous and better organized than local NGOs, likely to push for labour and environmental issues. Therefore Canada will find it difficult to convince Brazil on more civil society engagement unless it serves other purposes of the Brazilian government. For example, civil society involvement might prove to be acceptable to Brazil if it indirectly slows the pace of negotiations. Brazil might also be more open to civil engagement if the environmental and labour issues are not included in trade negotiations but dealt with at the International Labour Organization.

Bilateral Cooperation

One of the realities emerging from this paper is that trade dominates the Canada-Brazil bilateral agenda. This has been mainly driven by Canada, although outcomes have failed to meet Canadian expectations. One possible strategy to push beyond the existing threshold in relations is to treat trade as a political issue; in other words, to deal with Brazil on its own terms. Considering that Brazil's trade policy is an instrument to the service of wider foreign policy objectives, Canada may want to capitalize on the non-trade agenda where Brazil and Canada share common values and vision. Canada can then build in trade issues into a wider foreign policy agenda. Human security is an area of potential interest to Brazil as it encompasses many Brazilian concerns such as human rights, peacekeeping, urban violence and firearms control.

- There is a need for continued academic and cultural ties. Exchange programs for Canadian and Brazilian students and professors, cultural and language scholarships, are some of the activities conducive to improved mutual knowledge and appreciation. An exchange program of foreign service officers, like Canada currently has with Mexico, would also enhance mutual understanding.

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The Canadian Foundation for the Americas (FOCAL) is an independent, non-governmental organization that fosters informed and timely policy debate and dialogue on issues of importance to decision-makers and opinion leaders in Canada and throughout the Western Hemisphere. Established in 1990, FOCAL's mission is to develop a greater understanding of important hemispheric issues and help to build a stronger community of the Americas.

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Additional copies of this report may be obtained from the FOCAL web site (www.focal.ca).

What is in it for Brazil?

- The Brazilian government could find a resourceful and willing partner in Canada. As a member of the G-7, Canada could offer valuable support to some of Brazil's initiatives and aspirations at the international level. In addition, Canada's credentials as an honest broker, peaceful, humanitarian and therefore a highly respected member of the international community, could give clout to any joint initiative that Brazil may undertake.
- Through CIDA, the Canadian government could continue to assist Brazil to meet its domestic challenges in the areas of poverty, environment and urban violence, to mention some.

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This section is built on the premise that weak political cooperation between Canada and Brazil may explain the existing threshold in bilateral relations. The suggestions contained herein are meant to offer a menu of options for deepened political cooperation; by no means it is exhaustive.



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