Global Counsel

Trade trumps solidarity for Brazil and China

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Summary

- This week the Institute of International Finance warned that Latin America and Brazil in particular were not prepared for a possible slowdown in Chinese growth in 2012. This is a sign of a trade relationship that has been transformed over the last decade. President Lula Da Silva of Brazil went to China in 2004 promising a new geography for world trade. Brazil's exposure to China has risen sharply since.

- However, the new geography has not worked out the way Lula intended and the disappointment underlies important shifts in Brazil's foreign commercial policy. Brazil may run a trade surplus with China, but not on terms that are politically acceptable to most of its manufacturers.

- Under Lula's leadership this growing tension was suppressed in favour of the pursuit of a grand political vision of South-South solidarity. The administration of Lula's successor, Dilma Rousseff, has implicitly broken with this strategy since taking office in January 2011, aligning more openly with the US in its criticism of Chinese currency policy and supporting the complaints of Brazilian industry more vocally. The shine has well and truly come off Lula's vision of BRIC solidarity.

- The growing strains between Brazil and China are emblematic of the economic forces and conflicting priorities that are likely to deepen tension between the large emerging economies over the next few years. China's own desire to diversify its export markets away from the developed world will make this worse, not better.

This week the Institute of International Finance warned that Latin America and Brazil in particular were not prepared for a possible slowdown in Chinese growth. This exposure is a sign of a trade relationship that has been transformed over the last decade. Before he left office at the end of 2010, President Lula da Silva of Brazil spent the best part of a decade setting out a foreign policy based on the idea of South-South solidarity and the common interests of the emerging economies. With China in particular, Lula imagined a political alliance between the parallel rising powers of the West and East as the centre of a revision of global political power. Heading to China in 2004, Lula said that Brazil and China were poised to "define a new geography of trade".

Since taking office in January last year, Brazil's new President Dilma Rousseff has not been in any particular hurry to pick up the baton. By aligning more closely with the US on the question of the Chinese currency and taking a tougher and more vocal line on cheap Chinese imports, her administration has crossed political lines Lula would have regarded as off limits. While it is easy to put this down to the effects of a new President seeking to differentiate herself from her predecessor, or even the straightened economic circumstances of the downturn, it also reflects something more fundamental about the way in which Lula's new geography has played out.

Understanding this is key to understanding why interventionist voices like Brazilian Finance

Minister Guido Mantega have demanded and been given such political latitude to speak publically on 'currency wars', and why many in Brazilian business are starting to feel that they are winning a debate about protection that they lost under Lula because of his wider political ambitions. This Global Counsel Insight note looks at those deeper trends and asks what they tell us about the BRIC coalition more generally.

A not so new geography of trade

Lula's prediction of booming trade relations between China and Brazil has been borne out in purely numerical terms. Trade flows have risen sharply over the last five years, boosted by rising commodity prices and growing Chinese demand for natural resources. In 2011 Brazil ran an $11bn trade surplus with China (Chart 1).

Chart 1: Evolution of Brazilian trade with China 2000-2011; Total trade (LH) Import/export share (RH)

Source: SECEX Brazil 2012

However, for Brazilian critics the problem lies in the underlying structure of Brazilian trade, which has something depressingly familiar about it. On paper Brazil's trade with China increasingly looks less like a partnership of equals and more like a typical North-South trading relationship. Brazil exports chiefly raw materials and commodities to China and imports increasingly sophisticated manufactured goods in return. China's inward investment in Brazil and wider Latin America is focussed almost solely on securing energy and commodity supplies.

The level of co-dependence in the relationship is also badly skewed. Although China is Brazil's largest market and its second largest source of imports, Brazil does not even feature in China's top ten export markets. By one government estimate at the start of 2011 for every Brazilian company exporting to China there were ten importing from it.

In many respects the Lula that went to Beijing in 2004 had some grounds for hoping for something different from Brazil's trade relationship with China. Manufactured goods accounted for 22% of Brazil's exports to China and 26% of China's exports to Brazil in 2003. Embraer's investment in aircraft manufacture in Harbin seemed emblematic of the new synergy.

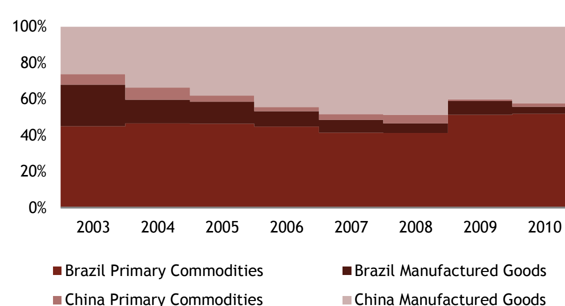

Chart 2: Evolution of the structure of Brazil-China trade 2004-2011.

Source: UNCTAD 2012, Global Counsel calculations

Most of a decade later, the balance in the relationship looks very different. Although Brazilian exports of manufactured goods to China have grown marginally in real teams over that period, they have been dwarfed by the expanding trade flows in Brazilian commodities and Chinese manufactured goods, which now account for double their 2003 share of trade flows (Chart 2).

Brazil also finds its advanced manufactured goods exports to key markets like US, which account for a quarter of its export trade, increasingly under pressure from Chinese competition (Chart 3). In Mexico, for example, Brazil's share of imports market went from 1.3 percent in 2002 to 1.4 percent in 2010. China's went from 2.6 percent to 13.9 percent in the same period. As if to make the point, Embraer seriously considered pulling out of China altogether in 2010 when it became clear the Chinese government would block its attempts to move into the market for larger small jets.

While the Foreign Ministry in particular puts a positive spin on high levels of Chinese inward investment such as Sinopec's $7.1bn 40% stake in Repsol Brazil in 2010, officials privately express concerns that there are few positive technology spillovers from such investments. The Brazilian government has considered restrictions on FDI in mining, including minimum domestic supply quotas and screening of transactions based on 'investor profile'. Brazil's preference for attracting European and US inward investment in areas with greater potential for spillovers such as services and high technology is clear.

The Chinese squeeze

The effect of this Chinese squeeze on Brazilian business and political attitudes has been pronounced. Although the boom in commodity prices and commodity exports has been a huge windfall for exporters like Petrobras and Vale, defensiveness among manufactured goods producers in 2004 has become acute anxiety in 2012. Beneath the surface of Lula's attempt to build a new high politics among the BRICs, Brazilian industry has been increasingly strident in arguing that China is both a direct competitor for Brazilian markets, and is gradually locking Brazil into a version of 'Dutch Disease' by stymieing its attempts to diversify away from commodity trade.

They also argue that Brazil's relatively earnest attempts to meet liberal prescriptions on privatisation, open trade and transparent governance are backfiring in the face of a competitor that manages to attract inward investment and grow explosively while insisting on its own state capitalist terms. The new mood of *dirigisme* in Brasilia - from central bank activism to limit hot money flows into the real to a more concerted focus on consolidating, developing and directing state champions and taking a minority stake in a wide range of Brazilian firms - can be traced back to the perception that Brazil needs to play more by a variation of China's own rules.

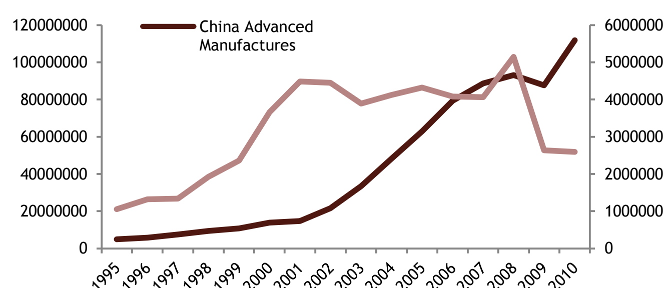

Chart 3: US imports of advanced manufactures from Brazil and China 1995-2011 ($)

Source: UNCTAD 2012

Aside from a more interventionist mindset in Brasilia, this internal tension also helps explain a number of outward strategies. Brazil may have been a last minute convert to the idea of a WTO world trade deal in Geneva in 2008 when it saw growing market access for its agricultural exports in the EU and the US slipping away, but it had spent much of the previous year blocking progress under political pressure from domestic manufacturers.

Finance Minister Guido Mantega's sympathetic public hearing for the US's complaints about Chinese currency policy, his year-long campaign for tougher G20 or WTO action on currency manipulation, and Dilma Rousseff's new pragmatism are just symptoms of the same new scepticism. Brazilian politicians are now more aligned with Brazilian business, which even in 2004 publicly opposed Lula's initial offer to recognise China's 'market economy status' under WTO rules. While the perceived imbalance in their economic relations remains, there is little business support for rapprochement, and tensions between Brazil and China can be expected to worsen.

One possible strategy for Brazil will be to seek deeper preferential trading links regionally both to drive regional economies of scale and a deeper local market. While Brazil has negotiated a number of free trade agreements in the region, an aligned trading bloc for Latin America (based, perhaps, on the Union of South American Nations) or a revived Free Trade Area of the Americas, remain unlikely. The US has invested much of its political capital in its Trans Pacific Partnership (see Global Counsel Insight 23 Feb 2012), and

many of its neighbours, such as Argentina, seem more interested in pursuing more aggressive protection of their own industries at the expense of Brazil.

The growing gaps in the BRIC wall

The first signs of this tension between Brazil and China were already clearly visible in the stalling of the WTO Doha Round of trade negotiations in 2008, not just between Brazil and China but between the emerging economies more widely. Although the failure of the Doha Round was widely perceived to be the result of a standoff between the global North and the global South, in reality Indian sensitivity on Brazilian agricultural exports and Brazilian and Indian sensitivity over China's growing manufacturing strength were as much to blame.

With trade barriers in the developed world now at historic lows in contrast to the emerging economies, all the signs suggest that if the rules based multilateral trading system survives, future Trade Rounds will be dominated by the debates between the BRICs rather than with them. Of the BRICs only India has thus far taken the significant step of challenging a fellow BRIC (Brazil) in a WTO dispute, but it is only a matter of time. All of the BRICs have, however, begun making active use of protective anti-dumping duties against each other. After what looks suspiciously like a political lull between 2005 and 2007, Brazil has now imposed 20 new taxes on Chinese imports, including five in 2011.

China's BRIC peers are unlikely to have any more success in changing Chinese policy than their developed country counterparts. Indeed, in the short term, Chinese policy is actually likely to exacerbate the problem, for the simple reason that China's perception of its own exposure to developed world demand after the banking crisis has led to an aggressive strategy of diversifying its export markets among its emerging economy peers. Of the fourteen renminbi swap agreements that the People's Bank of China has agreed since 2008 in order to facilitate easier trade settlement, almost all have been with other emerging economies, including the Brazilian central bank.

The growing tension between Brazil and China is a reminder that the half decade at the start of the current century was a brief window when the economic and political interests of the BRICs might have constituted a shared agenda. Even then, that agenda was largely negative: the BRICs shared and continue to share a revisionist worldview on global economic governance and agenda-setting. They individually want more say. They collectively agree on little beyond that. Lula's grand vision was predicated on the idea that economic relations would reinforce his high politics and push for solidarity in the face of the developed world. They appear to be doing the opposite.

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