

The Geography of Brazilian External Trade: Right Option for a BRIC?

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I – Introduction

Words can make a difference sometimes. The five-letter BRICS acronym increased the focus on a specific set of countries. Brazil, in particular, is considered in a different way as it used to be: it has become for several analysts not only ‘another developing economy’, but rather one of the candidates to play a major role in the international scenario in the near future.

This change of perspective is not only a matter of semantics. Recent economic performance and macroeconomic indicators of these economies contribute to a more careful consideration of their possibilities. Large domestic market makes it more likely to obtain ‘growth-led exports’ rather than ‘export-led growth’, which implies a pro-active role in international relations.

It is no coincidence that in recent years Brazil has been invited to participate (even with a less-than-expected role) in meetings of the group of richest countries, in meetings of several groups of countries concerned with the multilateral negotiations at the World Trade Organization, at the same time that former Brazilian authorities often take part in selected groups of experts dealing with the intended reforms of the international financial system. Brazilian delegates often play an active role in the debates within multilateral agencies, aiming at contributing to change the ‘political economy’ of the decision-making process in these agencies.

This adds up to the peculiar characteristic of the country having been a founding member of the most important multilateral institutions, and traditionally having its diplomatic action concerned with the respect to the agreed rules and disciplines in each of these organisms.

From a Brazilian perspective, these movements have reinforced a desire to become a permanent member of the UN Security Council, as well as an aspiration to participate in a more active position at the meetings of the G-7 (to be expanded to a possible G-10, for that matter).

It is expected that a successful country in the set of ‘BRICS’ shall have a productive capacity corresponding to its economic potential, a relatively stable economy and a high profile in the international scenario. These are the conditions that qualify these countries to participate at the high-level forums.

* UN/ECLAC and Universidade de Brasília. The views expressed here are my own, and do not necessarily correspond to the official position of these two institutions. I thank Ricardo Bielschowsky and Carlos Mussi for comments on a preliminary version.

The Brazilian economy gets most of its dynamism (80%) from domestic demand (especially consumption, as the investment ratio to GDP accounts for only 20%). The weight of external demand has increased in recent years, and trade policy puts emphasis on regional trade, as one major source of dynamism for exports with higher value-added and higher technological content.

This emphasis has been the object of some fierce criticism. To start with, Latin America and the Caribbean account for only 6% of the World's Gross Domestic Product¹. Its potential for absorbing Brazilian products is, hence, limited.

The regional market is also rather vulnerable to variations in the terms of trade: recent drop in the price of commodities (most of the region's exports) have strongly affected Brazilian exports of manufactures to the region². This reduction in export revenue has stimulated some countries in the region to raise trade barriers, and several analysts expect this movement to gain momentum in the coming months, if there is no positive change in the international scenario³.

Half of total industrial exports from Brazil depend on subsidiaries of transnational companies. This means that the degrees of freedom for the authorities in re-designing the geographical orientation of trade flows is subject to internal decisions in those firms and to their control over sales channels. This imposes some limits for the country to explore the markets for products with high value-added and high technological content in industrialized countries. The regional market can, therefore, provide some space for improving the export structure.

The argument in favour of intensifying regional trade is based mainly on its contribution to the country's negotiating capacity in international forums⁴ and the 'quality' of trade flows, allowing for a significant share of industrialized exports with higher technological content. Critics would stress that the regional emphasis diverts efforts that could promote exports to larger, more promising markets, where fierce competition could stimulate the degree of sophistication of the export bill.

This discussion mixes the geographical orientation of trade flows with the sector concentration of incentives to export. In the 1980s some American economists⁵ worried about competition by Asian countries have developed several models providing a rationale for what was called 'strategic export policy'. In essence, the idea was to provide incentives to domestic firms in some sectors so as to provide them a competitive edge over foreign-owned competitors.

The analysis that follows differs from this approach in that it does not necessarily aim at biasing trade policy towards any specific sector. Instead, the argument concentrates on the

¹ According to the World Bank Development Indicators Online

² The increase in Brazilian manufactured exports to Latin America in the fourth quarter of 2008 was only 1/3 of the corresponding figure in 2007.

³ Including more pro-active policies adopted by Brazil to foster economic activity in neighbouring countries.

⁴ See, for instance, the statement by the Foreign Affairs Minister in Amorim (2008).

⁵ See, in this regard, Helpman/Krugman (1989) and Krugman (1990).

identification of gains that could accrue from trade relation with neighbouring partners. It is based on the assumption that the political will favouring regional integration will help to overcome recent protectionist trends. It is argued that there is a case for caring about regional trade, but also that there are a number of obstacles to further pursuing this option.

After a brief presentation of the major characteristics of recent economic indicators (next Section) the text shows (Section III) specific aspects of the relationship of Brazil and the main international agencies (its multilateral approach), as an indication that the multilateral dimension has always been present in the Brazilian perspective. The fourth Section discusses the regional option as a tool for improving the technological content of exports. The argument put forward here is that this option is to some extent inevitable, in view of geographical determinants and in face of the several regional groupings in other regions, but it presents a number of difficulties, discussed in Section V. Last Section presents some final remarks.

II – Recent Trade Trends

Brazilian economy presents a trade performance equalled by few other developing economies. Exports have systematically surpassed imports in the last three decades. In the 34 years from 1974 to 2008 in only 12 a trade deficit obtained: from 1974 to 1979, and more recently between 1995 and 2000.

External prices do play a role as an explanatory factor. In 1974-1980 the dependence of Brazilian economy upon oil imports was a binding constraint, at a moment when oil prices reached by then record levels. This (plus strong import repression) explains why export growth was far more intense than imports in terms of volume and yet trade deficits obtained. The same is true for 1995-2000, as illustrated by Table 1. As a matter of fact it was only between 1991 and 1995 and more recently, after 2005, that the growth of imports surpassed exports in volume.

Table 1 - Brazil – Trade Growth in Volume – 1975 – 2007 - (Yearly Average (%))

| | Exports | Imports |
|-----------------|---------|---------|
| 1975-80 | 7.3 | -0.0 |
| 1981-85 | 6.1 | -0.1 |
| 1986-90 | 5.9 | 2.2 |
| 1991-95 | 6.9 | 28.9 |
| 1996-2000 | 8.1 | 3.7 |
| 2001-2005 | 13.1 | 1.3 |
| 2006-2007 | 1.4 | 19.8 |
| Total 1975-2007 | 6.6 | 5.3 |

Source: FUNCEX

Export performance – a more than fivefold increase in value between 1990 and 2007 (from US\$ 31 billion to US\$ 160 billion) – was accompanied by the intensification of trade relations with other Latin American and Caribbean countries, as shown in Table 2. Relative weight of exports to the region has more than doubled between 1990 and 2006, and remained constant in recent years, when total export value boomed.

Table 2 – Brazil - Relative Importance (% of total exports) of Exports to Latin America & the Caribbean – 1985 – 2006

| | 1985 | 1990 | 1995 | 2000 | 2006 |
|----------------------------|------|------|------|------|------|
| Latin America & Caribbean | 9.2 | 11.4 | 22.5 | 24.6 | 25.5 |
| of which: South America | 7.8 | 8.6 | 20.4 | 20.1 | 19.4 |

Source: ECLAC/BADECEL

Efforts to stimulate regional trade are often justified on the grounds that the regional market allows for: i) developing dynamic comparative advantages, since most of the exports are industrialized products; ii) these comparative advantages stem not only from the higher value-added of the export bill, but also from the easier market access for technologically more elaborated products; iii) a 'learning process' in the exporting activity, allowing domestic producers to acquire expertise by exploiting initially less sophisticated markets and qualifying themselves to subsequently face more demanding consumers in industrial economies; iv) geopolitical arguments that stress the higher negotiating capacity in international forums of joint positions held by neighbouring countries.

As Table 3 shows, exports to Latin America and the Caribbean have a higher share of industrialized products than exports to other regions. For instance, in 1990 most⁶ of total Brazilian exports to other Latin American & Caribbean countries were industrialized products. The same picturing obtains, sixteen years later. As is well known, this corresponds to the typical Latin American standard of industrial exports being concentrated in the US and other Latin American countries. As the degree of technological intensity is considered, exports of products of medium and high technology are more intense in trade with Latin America and the Caribbean than with any other market. Presence of these products in regional trade is almost twice as high as their participation in total exports.

This is a totally different pattern than that observed in exports to Europe or to Asia, where primary products are dominant.

The scenario Table 3 indicates is one where Brazilian producers and traders exploit the regional market so as to take advantage of the comparatively higher degree of industrialization and the more intense R&D activity in Brazil (as discussed in following sections) to exploit neighbouring markets. A good deal of these trade flows takes place on the basis of preferential access condition⁷.

⁶ As indicated by 14.0% of low technology products, 48.3% of medium technology products and 8.5% of high technology products.

⁷ See, in this regard CEPAL (2006): in 2005 2/3 of regional trade took place under preferential agreements.

Table 3 - Percentage of Selected Products of Brazilian Exports to Specific Markets – 1990-2006

Industrialized Products – Low Technology

| | Latin America* & Caribbean(33) | USA | European** Union (27) | Asia-*** Pacific (16) | China | Japan | Others | World |
|------|-----------------------------------|------|--------------------------|--------------------------|-------|-------|--------|-------|
| 1990 | 14,0 | 20,6 | 10,7 | 23,5 | 17,3 | 5,3 | 14,0 | 14,7 |
| 2000 | 16,8 | 16,2 | 9,0 | 11,6 | 4,5 | 3,3 | 5,7 | 12,1 |
| 2006 | 11,6 | 13,9 | 8,6 | 9,6 | 5,5 | 2,4 | 3,9 | 9,2 |

Industrialized Products - Medium Technology

| | Latin America* & Caribbean(33) | USA | European** Union (27) | Asia-*** Pacific (16) | China | Japan | Others | World |
|------|-----------------------------------|------|--------------------------|--------------------------|-------|-------|--------|-------|
| 1990 | 48,3 | 28,7 | 16,1 | 39,3 | 28,9 | 18,1 | 19,6 | 25,7 |
| 2000 | 44,9 | 26,6 | 14,8 | 26,8 | 9,0 | 8,0 | 12,8 | 25,1 |
| 2006 | 46,9 | 32,0 | 17,5 | 18,9 | 7,8 | 10,1 | 14,5 | 26,4 |

Industrialized Products - High Technology

| | Latin America* & Caribbean(33) | USA | European** Union (27) | Asia-*** Pacific (16) | China | Japan | Others | World |
|------|--------------------------------------|------|--------------------------|--------------------------|-------|-------|--------|-------|
| 1990 | 8,5 | 7,7 | 2,9 | 1,8 | 0,3 | 0,9 | 1,7 | 4,3 |
| 2000 | 12,6 | 22,3 | 9,2 | 2,6 | 5,1 | 10,6 | 5,4 | 12,5 |
| 2006 | 12,3 | 11,0 | 5,0 | 4,0 | 1,4 | 0,4 | 5,5 | 7,7 |

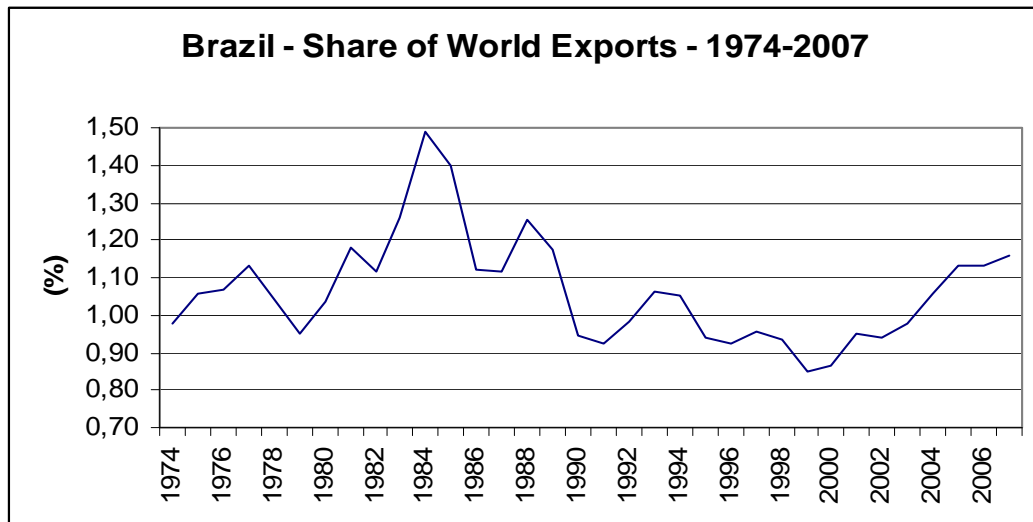
(*) Antigua & Barbuda, Argentina, Bahamas, Barbados, Belize, Bolivia, Chile Colombia, Costa Rica, Cuba, Dominica, Ecuador, El Salvador, Granada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Venezuela, Dominican Republic, St.Kitts&Nevis, St.Vincent & Grenadines, St.Lucia, Surinam, Trinidad & Tobago

(**) Germany, Austria, Belgium, Cyprus, Denmark, Slovakia, Slovenia, Spain, Estonia, Finland, France, Greece, Hungary, Ireland, Italy, Leetonia, Lithuania, Luxemburg, Malta, Netherlands, Poland, Portugal, United Kingdom, Czech Republic, Rumania, Sweden

(***) Australia, Brunei Darussalam, Cambodia, Philippines, Hong Kong, India, Indonesia, Lao, Malaysia, Myanmar, New Zealand, Korea, Singapore, Thailand, Vietnam, other nes.

Source: CEPAL, 2008.

From the mid-1980s to about year 2000 a number of factors have affected Brazilian export dynamism. High domestic inflation (until 1995), reduction of incentives to exports, less investment stemming in part from the process of adaptation of firms to a new scenario with less presence of the State and higher import competition, lower real exchange rate and other elements all have contributed to a sharp reduction in the Brazilian presence in the international market: from a maximum of 1.49% in 1984 the participation of Brazilian exports fell to only 0.85% in 1999 (Graph 1).



Source: Ipeadata

Since 2000 change in the exchange rate regime with significant devaluation, plus the understanding that some more active trade policy is needed, so as to avoid the negative effects of external shocks (as experienced in the second half of the 1990s), coupled to the benefit of higher commodity prices, have led to more pro-active trade policies and a higher profile in the international trade scenario, but the share of Brazilian products in total world exports still remains below the 1.2% level.

This of course means that there are 98.8% of the international markets as potential opportunities to improve Brazilian export share, and a number of recent trade measures reflect this perception. On the import side, in recent years there have been renewed concerns regarding the inflow of products, in particular of Asian origin.

Both movements (bigger exports and imports) influence Brazilian positions in international negotiations: it is convenient that a country searching for new markets stick to the basic WTO rules, so as to avoid new barriers. At the same time, intense import growth often leads to the initiation of legal procedures against accusation of dumping practices.

A good deal of the efforts to foster exports in recent years has been concentrated in regional markets, as well as exploiting new, non-traditional markets in Asia, Africa and Eastern Europe. Diversification of the geographical destination of exports has become a central issue in trade policy: in 2000 the ten major Brazilian trade partners corresponded to some 70.4% of total exports, whereas in 2006 the ten major partners imported only 59.2% of total Brazilian exports.

The share of the US as a destination for Brazilian exports has fallen from 24% in 2000 to 15% in 2007⁸. This is not to say, however, that there has been a withdrawal from the US

⁸ CEPAL (2008).

market, since in volume terms Brazilian exports to the US presented the following indexes⁹: 43.0 on average in 1990-1995, 54.8 in 1991-2000 and 94.0 in 2001-2007¹⁰.

A similar result obtains for exports to the European Union. In 2000 the EU absorbed some 28% of Brazilian exports, falling to 24% in 2007. Yet in volume terms the corresponding indexes were: 43.8 on average in 1990-1995, 53.7 in 1996-2000 and 89.1 in 2001-2007.

At the same time the share of Asia in total Brazilian exports increased from 15% in the 1990s to about 18% in 2007. For countries in Eastern Europe those shares were 3% and 4%, respectively. The three major African Brazilian partners (Angola, South Africa and Nigeria) taken together account for less than 3% of total exports¹¹.

This means that the actual results were not only an outcome of the quite favourable evolution of export prices in this period¹², but rather the noticeable increase in the share of the regional market was an actual gain in a period of overall good export performance with market diversification.

Brazilian economy has become more intensely related to the international market also in relation to capital flows. The gross inflow of foreign direct investment ranged between US\$ 1.0 and 3.0 billion a year between 1980 and 1995. Since then the amount has increased systematically, reaching fairly high levels in 2000 (US\$ 40 billion) and 2007 (US\$ 50 billion). In recent years Brazil ranked second among developing economies in attracting FDI, being surpassed only by China.

Brazilian gross foreign direct investment abroad was marginal (averaging less than US\$ 800 million per year) until 1994. In more recent years it has shown quite impressive amounts, although with sharp variation in yearly figures.

Gross inflow of portfolio investment has also been remarkable. Until 1993 the typical yearly figure would be less than US\$ 25 billion (taking into account the non-resident resources invested in stock exchange, fixed interest rate bonds and other investments), largely affected by legal restrictions on non-resident investors. The annual figure increased very sharply in recent years, up to a total of US\$ 210 billion in 2007.

What these figures indicate is that the Brazilian economy has become more exposed to the international markets for goods, services and capital. The intensity of the changes and the magnitude of the flows are not irrelevant. As a consequence, they have led to an intensification of the traditional Brazilian approach to multilateral institutions, centred on a) the concern with the application of institutional rules and b) the worry with differential treatment to developing economies, as briefly discussed in the next Section.

⁹ 2006=100. Data from FUNCEX.

¹⁰ Data from FUNCEX.

¹¹ Trade with other BRICS is also rather limited: in 2007 only Russia (2.3%) and China (6.7%) absorbed significant shares of total Brazilian exports.

¹² Export prices increased on average 2.3% in 1009-1995, fell on average by 3.1% between 1996 and 2000, and then increased at a yearly rate of 6.1% from 2001 to 2007.

III – Multilateral Approach

Brazil was among the 23 founders of GATT in 1947. Why a developing economy has joined what was originally seen as a 'rich boys' club', is an issue in itself. In any case, this early adhesion is symptomatic of one of the characteristics of Brazilian diplomacy: having frontiers with nine other countries and no significant conflict a good deal of Brazilian diplomatic activity has concentrated over time on economic issues. From the perspective of a weaker player in the international market it is important to preserve the existence and efficiency of disciplinary rules and supervision. Among other initiatives, Brazil has been one of the active defenders of the 'special and different' treatment that the WTO provides to developing countries¹³.

This explains in part the pro-active role Brazil has played at the GATT and more recently at the WTO. Since the creation of the WTO in 1994 Brazil has a high profile in numbers of dispute cases: 24 cases as complainant, 14 cases as respondent and 49 cases as third part. Overall the outcome has been positive to the country, with mostly favourable decisions.

If at previous negotiating rounds Brazil and other developing economies typically presented a low profile, benefiting from the negotiations among other members on the grounds of the MFN clause, since the Uruguay Round and particularly in the process of trying to foster a Doha Round Brazil is without doubt one of the developing economies ranking among the major players, participating in a number of countries groups, from the Group of Cairns to the several Gs (G-77, G-20, G-4, etc).

The higher exposure in trade and the parallel initiatives that this brings about in different forums have, of course, stimulated Brazilian policy-makers for quite some time now to try to make part of the group of the most important nations in the international scenario. This has led to the by now recurrent and long standing candidacy to become a permanent member of the UN Security Council, as well as to frequent signalling of Brazilian desire to be invited to the meetings of the G-7, the group of the richest countries.

Improved economic conditions, better access to the international capital market and changes in investment priorities have also led to changes in the relations with multilateral agencies in charge of providing foreign exchange liquidity (IMF) and long-term capital (World Bank).

Brazil was one of the signatories of the Bretton Woods Agreement, in 1944, and as such its relation with the IMF and the World Bank goes back to the very beginning of the operations of these institutions. The first operation with the Fund dates from 1954, when the Fund provided support for a loan by the US Eximbank. The first loan dates from 1958.

¹³ The GATT has since its very beginning accepted that developing economies present specific economic problems. This has led to Article XVIII of the GATT and the idea gained momentum in the 1950s-1960s. Part IV of the General Agreement – dealing with Trade and Development – was a political achievement by developing countries. Later on, the adoption of an Enabling Clause reinforced the GSP mechanism. Brazilian diplomacy was very active in fostering these instruments.

Relations with the Fund have not always been friendly, as in the 1959 bilateral conflict. In the 1980s Brazil signed a set of six Letters of Intentions with the Fund, and most of the commitments were not achieved. The next decade was also one of difficult relations. In 1994 the Fund decided not to give support to the Real Plan, on the basis of considering the fiscal adjustment not sufficient to sustain low inflation levels, as well as revealing scepticism with regard to the exchange rate policy.

International shocks hit Brazilian economy hard in the second half of the 1990s. In November, 1998 Brazil signed an agreement with the IMF, the World Bank, the IDB and a few countries, in order to stabilize the public debt ratio to GDP. In 2001 and again in 2002 and 2003 new agreements were signed. In 2005 Brazil decided to stop renewing the credit lines with the Fund and actually returned the amount of credit available from the several agreements which had not been used.

A member country can have access to resources in a given proportion to the quotas the country deposits at the Fund. In four occasions, however (1992, 1998, 2001 and 2002), Fund loans to Brazil were well above its quotas (respectively 103%, 600%, 400% and 902%). No other Latin American country has ever drawn such high percentage in relation to its quota as Brazil did in 2002.

Relations with the World Bank also come a long way. The first loan (US\$ 75 million) dates from 1949 (energy) and from then on the Bank has played a major role in financing the country's infrastructure. During the 1950s Bank loans to Brazil were concentrated in infrastructure projects, especially energy and transportation. In the 1960s while energy remained as the most important absorber of the Bank funds, agriculture and manufacturing industry also captured a good deal of resources. This diversification was intensified even further in the 1970s.

The most significant changes took place from the 1980s onwards, when the Bank changed its policy, giving increasing emphasis to foster governance and finance policies, apart from projects, with an increasing concern with poverty, environment and gender issues. At the same time Brazilian government reduced its public investments in infrastructure and productive activities.

Be it for the changes in the approaches both from the viewpoint of the Bank and Brazilian government or for other elements, the fact is that the net inflow of resources from both the Bank and the IMF became negative for many years.

The experience with these multilateral agencies, plus the increased access to international market both for sovereign and private debt since the 1990s, and even more so in the 2000s have led the country to adopt a more cautious approach. As a matter of fact Brazilian authorities have often argued in favour of changes in the way the IMF deals with liquidity crises, by demanding the creation of additional credit lines and a more preventive role by the Fund. Brazil has also often emphasized the need for changing the political economy of the institution, by increasing the share of developing economies in the decision process.

Increased possibilities to access international capital markets actually stimulated domestic efforts to adjust regulation and norms so as to facilitate Brazilian firms to benefit from these improved credit conditions. A number of Brazilian firms have been able to take advantage of this liquidity to finance themselves by issuing ADRs at increasing proportions: total transactions in 2004 were worth US\$ 434 million; in 2008 that amount had increased almost fivefold, reaching US\$ 1.9 billion¹⁴.

Brazil is also one of the founders of the Interamerican Development Bank, has often relied on its resources for the financing of infrastructure projects and – since the mid-1990s – also for projects in social areas, environment and public sector governance. As similar to the IMF and the World Bank, however, in recent years the net inflow of resources from IDB became negative, calling for an adaptation of bilateral relations.

The country has recently increased its share in the capital of CAF (Corporación Andina de Fomento), a regional institution that mobilizes resources from international markets to Latin America, in order to provide multiple banking services to both public and private agents. Many of the projects financed by CAF aim at fostering regional integration. This is one of the reasons why Brazil has adopted a higher profile as a stockholder.

Last but not least, Brazilian external policy has put increasing emphasis in the support the country can provide to other developing economies, the so-called South-South cooperation¹⁵. This is a process where the basic criteria are still being gradually defined. In any case, it can be said that there are two broad patterns: a) cooperation with closer neighbours (Mercosur partners in particular) reflect the efforts to overcome difficulties in the integration process, with joint action in areas such as sanitary policies, technical norms, institutional strengthening, consumer rights and others; b) cooperation with third countries, comprising a broad range of subjects.

Cooperation with non-Mercosur countries include actions in labour training, basic education, prevention of AIDS, transfer of agricultural technology, exchange of experiences in the combat to hunger and poverty, and other subjects. The countries with which Brazil sustains cooperation programs comprise Portuguese speaking countries in Africa, East Timor, other South American countries, Haiti and others. Apart from a genuine support to populations dependent upon external help South-South cooperation is also a means for the country to maintain a higher profile in the international scenario.

At the same time that Brazilian external policy maintained an active role in the international setting, with an increasingly higher profile (as expected from a major player), however, it has clearly given priority to intensifying regional ties. This, of course, corresponds to favourable expectations with regard to the gains from regional markets, as discussed in the next Section.

¹⁴ See www.cvm.gov.br for data.

¹⁵ For detailed information see www.abc.gov.br.

IV – Is the Regional Option a Mistake?

External political commitments notwithstanding, the important question from the strict viewpoint of the Brazilian economy is whether the regional market is able to provide dynamism to domestic producers and exporters, as well as to improve the technological content of domestic production.

Regional trade in primary products is by and large determined by commodity prices determined elsewhere. It is a matter of specific negotiation if bilateral trade can provide these products at lower costs than in the international markets.

Trade in services is still rather limited in scope and importance, so the argument with regard to the regional market is largely concentrated in manufactured goods. The question is, therefore, whether the regional option can be a tool to provide sustained manufactured exports and market for technologically high-level products. Latin America and the Caribbean account for 6% of the World's Gross Domestic Product)¹⁶. Concentrating efforts in a market with comparatively limited potential as this might be seen as a myopic bet.

The answer depends on: a) the income level and pattern of demand of the other countries in the region; b) the comparative advantage of Brazilian products versus local production in those countries, as well as in comparison to competing imports from third countries into those markets; and c) local consumer's preferences for Brazilian products.

The pattern of demand that has allowed for Brazilian exports to other Latin American countries in recent years has clearly benefited from the wealth effects stemming from terms of trade effects¹⁷, from labor market improvement (increase in formal employment and higher wages¹⁸) and social policies. This has helped to enlarge the medium class in the region and as a consequence broadened the regional market for manufactured goods, especially vehicles and other durable consumer goods.

Lower export prices are likely to affect income and thus reduce regional trade. This is one of the major threats (apart from protectionism) that might affect regional demand for Brazilian manufactures. Acceptance of traditional Brazilian brands and preferential access to markets might contribute to sustain a certain level of export activity. And as discussed later, there are specific mechanisms that could be adopted so as to maintain regional trade when liquidity of foreign currencies is limited.

Also, agents matter. Transnational subsidiaries are important players, for they account for half of total industrial exports and for most of the exports of products with medium to high-technology. Their policy so far has been to use Brazil as an export platform to the regional

¹⁶ In constant dollars (base year – 2000). Figures from the World Bank (World Development Indicators Online).

¹⁷ Latin American countries as a whole have benefited from terms of trade gains equivalent to 1% of GDP in the present decade (CEPAL (2008)).

¹⁸ CEPAL 2008a.

market¹⁹. This is an outcome of the internal policies of these firms but also a reflection of the still limited competitiveness of Brazilian production. There is hardly a significant indication of these companies planning to move their plants to other countries in the region²⁰. If anything, the movement in recent years has been towards concentrating activities in Brazil.

Furthermore, exporting to the regional market has proved to be an important issue for small and medium firms: regional trade flows show a higher presence of these firms than total exports. There are, hence, additional arguments favouring the regional option, on the grounds of domestic distributive effects.

Most of the R&D activity in the region takes place in Brazil. Its domestic market allows for large-scale production, at unmatched dimensions in the region. Brazil also presents a more varied set of sector policy instruments than most countries in the region.

These peculiarities are indicative that Brazilian producers are more likely to benefit from gains from scale and technical progress than their local competitors in neighbouring countries. This shall provide comparative advantage in an extensive spectrum of products for quite some time.

Sustaining or improving market share for Brazilian products will depend on at least three elements: i) competitiveness of Brazilian brands; ii) differentiated access to markets provided by cost differentials and trade preferences; iii) lack of repudiation to Brazilian products on political grounds. Performance of specific brands is a microeconomic issue that depends on the performance by each firm. More relevant to the present argument are the other two elements.

Most regional trade takes place on the basis of preferential trade agreements. Yet, preferential margins in the region are still rather limited and there is a long way to go in order to make regional trade really free from barriers. This is a pressing issue, as a means to deal with increasing competition of imports from third countries²¹, as a step towards fully benefiting from regional integration, and as an instrument to protect regional trade from trade diversion imposed by the multiplicity of preferential agreements signed between other Latin American countries and some industrialized competitors.

This is, of course, a very sensitive issue. Given the disparities in size and potential competitiveness among countries, further concessions can only be achieved if economic agents identify clear gains in this process. Systematic trade imbalances, investment diversion favouring the larger partners and job creation at a slower pace than expected tend to act as a centrifugal force on regional integration exercises. It is by now generally

¹⁹ See, in this regard, Baumann/Galvão (2002).

²⁰ Except, perhaps, a few investors in Chile, taking advantage of the bilateral preference agreements signed between that country and several others, such as the US, European Union and some Asian countries.

²¹ As illustrated, for instance, by the recent Brazilian market-share in Argentina: imports from Brazil fell from 36% in 2005 to 31% in 2008; at the same time Chinese products tripled their share, from 4% to 12% (CNI (2008)).

accepted that at least within Mercosur the smaller members have little motives to celebrate²².

As Venable (2008) suggests, the way to go with lack of factor price equalization, trade diversion penalizing the smaller economies and re-location of firms increasing the income gap among countries is “to extend both the width and the depth of economic integration”. This calls for more active measures to reduce disparities.

The argument here is not to think in terms of Brazil becoming a ‘regional hegemon’. Instead, emphasis shall be given to the fact that the sustainability of a regional integration process depends on the specific conditions that allows all the participants to benefit from the specific concessions they make.

To what extent can one expect that exploring the regional market instead of, say, that of industrialized countries, might affect the technology intensity of the export products?

By and large most of the dynamism for manufacturing and hence the margin to absorb gains from scale and the stimuli to improve the technological content of Brazilian production is provided by the domestic market. Export coefficients in most sectors account for about one-fifth of output.

Considering the share that is actually exported, it is an empirical issue to determine whether there are differences between the products that go to regional markets and those shipped to OECD countries. The concern with regional trade harming technological incorporation would only make sense if the differences were significant, with sophisticated products being destined to high-income markets. In any case, changing this scenario is not only a matter for domestic policy, as trade in most of the medium and high technology products corresponds to market strategies by subsidiaries.

In summary, there are potential gains stemming from the regional market, which should not be disregarded by policy-makers. Absorbing these gains (and even more, making them sustainable over time) is not a trivial matter, though. There are a number of obstacles to intensifying regional trade, as shown in the next Section.

V – The Challenges involved in the Regional Option

Emphasis in the economic and political relations with other Latin American countries and even more so with South American neighbours is one strong characteristic of recent Brazilian external policy. Approximation with neighbouring countries has intensified since the mid-1980s, and gradually gained momentum in the diplomatic agenda.

²² For instance, Baumann/Mussi (2006) shows some indicators that the gains have not been evenly distributed among the four founding members of Mercosur.

The basic scepticism with regard to the emphasis on regional trade has to do with the relatively low share of regional trade when compared to other regions. Intra-regional trade among Asian countries corresponds to some 35% of total exports, whereas in Western Europe that figure surpasses 60%. In Latin America as a whole, intra-regional exports are close to 20% of total exports.

This raises the question as to what could be a reasonable level of importance for regional trade, given the actual conditions of the economies and a number of other determining elements. Is a 20% share of regional trade on total exports a reasonable level? Is there an ideal, alternative figure? There is probably no immediate answer to these questions, and it goes beyond the purposes of this paper to discuss whether the regional market is able to provide a significant dynamism to Brazilian manufacturing sector, both in terms of production growth and in reducing its technological gap.

Be that as it may, it is argued here that however justifiable in terms of the geographical proximity and potential achievements, the regional option is not free from difficulties, demanding far more decisive action than has been recorded so far. The argument is presented in taxonomic form, as five challenges involved in the intensification of regional relations.

V.1. Challenge # 1: Dealing with Different Actors

One basic characteristic of Brazilian economic and political diplomacy has been to preserve its characteristic of a global player in the international scenario. The expression 'global player' applied to a Brazilian perspective means not only that the country cares about sustaining and improving trade flows with most other countries in the world, diversifying both the commodity structure of its trade flows and the geographical destination of its exports. It also means that the country maintains positive diplomatic relationship with every country, with no conflict or interruption of bilateral relations.

Clearly the United States and Western Europe are the traditional partners in terms of economic and political matters. Long-standing ties in terms of trade relation as well as investment flows, the sheer importance of these markets and the weight of these economies in the international scenario all make it inevitable that most of the economic and political relations be related to these countries.

Asia is the new economic frontier, given the dynamism of the largest economies in that continent and the close (and increasing) links among Asian countries.

Africa is an important potential partner, given the historical roots that link Brazil to most countries in Western Africa, the still low share of Brazilian products in the regional market, the high proportion of African-descendents population in Brazilian society (which in principle might help create specific economic links, based on affinity of interests) and the economic potential of some African economies, such as South Africa.

Eastern Europe is seen as a promising potential market, in view of the still low participation of Brazilian products in those markets. Trade with transitional economies has increased, even though from very low levels.

But Brazilian diplomacy has for quite some time now looked for a more intense relationship with other Latin American economies, South Americans in particular. This region has concentrated a good deal of Brazilian diplomatic efforts in recent years.

A systematic and sustainable approximation with other South American partners is a challenge in itself. Not only there are significant natural barriers to a more intense economic relationship, such as the Amazon jungle and the Andean Mountains, all of which call for heavy infrastructure projects to facilitate transportation, as there are also cultural, institutional and sociological peculiarities that differentiate Brazil and Spanish-speaking America. In any case, lack of bilateral conflicts in more than a century is an important asset in fostering proximity with neighbouring countries.

The economic and geographical distance among the different economies is also decisive. Brazil has 190 million inhabitants; the next largest population in South America is Colombia's, with 46 million inhabitants, the third Argentina's, with 39 million inhabitants, and these are followed by much smaller countries.

The argument in favour of a more intense relationship on a regional basis follows from the several aspects already listed in previous Sections but also to the fact that South America is a very rich continent in terms of natural resources (Brazilian iron, soy and sugar, Argentina's wheat and beef, Venezuela's oil, Bolivia's natural gas, Chile's copper, Surinam's bauxite, etc), so that there are large potential gains stemming from the systematic exploitation of these results. Furthermore, South America has the largest tropical forest with the highest biodiversity of the world, as well as the largest reserve of non-salt water.

An indication of the increasing interest in South America is that Brazilian exports to the region increased 17% between 1995 and 2000, and 140% between 2000 and 2006, when it corresponded to some 19% of total exports.

Brazilian economy accounts for approximately half of the total production value of South America (60% of total manufacturing value and about half of the agricultural production). This differential has a number of implications, ranging from the better supply conditions – which have led to recurrent trade surpluses with neighbouring countries – to more intense R&D activities: 80% of R&D activities in South America take place in Brazil, and this is likely to lead over time to higher competitiveness vis-à-vis other countries in the region.

In the last decade or so there has been an increasing disequilibrium of the regional trade balance in technologically advanced products, favouring Brazil. As a consequence, intra-regional trade is comparatively more dynamic for Brazil in medium and high-technology products than its trade with other regions, as shown in Table 3.

Regional capital flows are still limited, but FDI flows from Brazilian firms have been active in the acquisition of firms from neighbouring countries, in as varied sectors as cement, financial services, steel, food, auto parts, gas, textiles and footwear.

The way to deal with these discrepancies is to pursue joint programmes leading to more intense productive complementarities among countries, as well as joint research activities. In recent years there have been a few initiatives in these directions. Mercosur's FOCEM (Fund for Structural Convergence and Institutional Strengthening) is only one example. Far more intense action is needed in this regard.

Regional infrastructure constraints among South American countries are to be dealt with by a number of projects related to the so-called Infrastructure Initiative in South America. These should help overcome the strong existing limitations in energy supply, transportation, and communication.

Physical barriers are a major characteristic and a binding constraint to integration among South American countries. Difficulties go beyond the inadequate infrastructure in transportation and communication. Several countries face serious difficulties in energy supply, and even though a number of proposals have been put forward this remains a major constraint to growth. The Amazon region – a political web comprising nine countries and nine Brazilian states – correspond to a large share of the regions' territory (60% of Brazilian territory), has clear comparative advantages in a number of areas, but the efficient, sustainable and systematic exploitation of its potential remains undetermined.

Inadequate infrastructure and difference in supply potential are only part of the difficulties conditioning Latin American regional trade. Limited trade preference margins among neighbouring countries and the multiplicity of agreements both within the region as well as with countries elsewhere further contribute to a rather complex scenario.

V.2. Challenge # 2: Regionalism in a World of Preferential Trade Agreements

Due to several factors – not least the disenchantment with multilateral negotiations after the failure of the Seattle meeting, in preparation for the Doha Round of the WTO – the number of bilateral and plurilateral agreements has boomed in recent years. They establish trade preferences but often comprise also disciplines regulating issues that are often not directly related to trade issues. Property rights, government procurement policies, competition policies, environmental issues, labour policies and others are often part of the commitments required for the signing of these agreements.

Latin American and Caribbean countries are no exception and in fact have been quite active in participating in this new wave of agreements. An increasing number of countries have negotiated agreements with countries in other regions as well as with neighbouring partners. The parallelism between the several integration initiatives and a number of extra-regional agreements might affect the outcome of regional integration schemes. Table 4 illustrates the situation in Latin America and the Caribbean.

Table 4 - Variable Geometry in Latin America and the Caribbean (2006)

| | Signed Agreements | Present Negotiations |
|-----------------------|---|---|
| Intra-Regional | LAIA, MERCOSUR, ANCOM, CACM, CARICOM, NAFTA, ALBA, UNASUR, SACN, ACS MERCOSUR-Chile; MERCOSUR-Bolivia MERCOSUR-Peru; MERCOSUR-Colombia, Ecuador, Venezuela Venezuela-CARICOM; Chile-Bolivia; Colombia-CARICOM; Chile-Colombia; Bolivia-Mexico; Chile-Ecuador; Colombia-Venezuela; Chile-Peru; Costa Rica-Mexico; CACM-Dom.Rep.; CACM-Chile; Costa Rica-Trinidad&Tobago; Costa Rica-CARICOM; Nicaragua-Mexico; Mexico-Guatemala, El Salvador, Honduras CARICOM-Dom.Rep. Chile-Bolivia; Chile-Venezuela; Chile-Colombia; Chile-Mexico; Chile-C.America; Chile-Cuba Mexico-Venezuela, Colombia; Mexico-Costa Rica; Mexico-Uruguay; Mexico-Panama | CARICOM – MERCOSUR CAN – Guatemala, El Salvador, Honduras Mexico - MERCOSUR |
| Extra-Regional | Chile – Canada, USA, EU, EFTA Mexico – USA, Canada, EFTA, UE, Japan CAFTA-Dom.Rep-CACM Dom.Rep.-USA; Ecuador - USA Costa Rica – Canada Chile-S.Korea; Chile-New Zealand, Singapore, Brunei MERCOSUR – India; MERCOSUR-Israel; MERCOSUR-SACU Peru – Canada; Peru – USA; Colombia - USA | Ecuador – USA MERCOSUR– European Union CACM – European Union CARICOM – European Union CARICOM – Canada Chile-China; Peru – Thailand MERCOSUR–Persian Gulf Countries Brazil-Morocco; Brazil - Egypt |

Source: adapted from ECLAC (2006), p. 84.

Apart from the potential risks in terms of trade diversion implicit in this web of agreements, this increasing simultaneity of agreements brings about costs of several kinds. They imply higher administrative costs, as custom officials have to deal with different tariff rates for any given product, according to their geographic origin. Simultaneous agreements raise the risk of having to adopt more ambitious norms than those already agreed at the WTO level, and even more so if negotiations take place between countries of markedly different economic sizes: developing countries are more vulnerable to interest groups in industrialised countries. The mushrooming of preferential agreements might also negatively affect the very existence and operational capacity of the WTO, by weakening its role as a ruler of international trade.

Even if the different agreements were conceived as ‘building blocks’, it is by now conceded that one major problem is the relatively slow pace comprised in the chronograms of tariff reduction in the various agreements. A good deal of barriers remains and are likely to be in operation even within several years from now.

There are (at least) two other reasons that support the argument for promoting faster convergence of these schemes: i) tariff preferences correspond to an increasing share of trade in Latin American and Caribbean countries (over two-thirds of total trade by Latin American and Caribbean countries are done on the basis of some type of intra- or extra-regional preferential market access); ii) regional integration schemes favour the exports of products with higher value-added.

In summary, the option for more intense regional ties might be seen as inevitable. Nevertheless, lack of clarity with regard to what can be expected from Latin American regional trade often leads to the perception that this is a goal too difficult to be reached, even though the goal itself is not clearly specified. As a consequence, the negotiation processes to drop remaining barriers becomes increasingly complex.

Furthermore, if some decades ago this option was rather undisputed as a tool to promote industrialization, today what can be expected from a more intense integration process is less defined, from the perspective of an economy with the characteristics of the Brazilian economy. Given the differences in size and productive potential among Latin American countries this makes the objectives for regional integration less clear and as a consequence affects the whole negotiating process.

V.3. Challenge # 3: Where exactly are we going?

The idea of creating a common market to facilitate industrialisation in the region – by means of enlarging the domestic markets and therefore allowing for gains from productive plants of larger scale – has been present in the reasoning about regional integration by some think tanks such as ECLAC since the late 1940s.

In the 1950s and 1960s the perspective of recurrent balance of payments disequilibria, reducing the access to imported capital goods, required for making viable the priority given to industrialisation, reinforced the demand for regional integration. Trade preferences should be granted gradually, so as not to disturb the (limited) access to capital goods. Moreover, those preferences should be granted to the highest possible number of countries in the region, with differential treatment given to smaller economies.

The 1970s were a period of very low interest in regional integration in Latin America. Difficulties comprised the payment constraints following the first oil shock, limitations imposed by the decision process in LAFTA²³ and – not less important – the fact that several

²³ Latin American Free Trade Area

countries in the region had military governments, not prone to make concessions that affect national sovereignty.

The second oil crisis plus the debt crisis imposed a shortage of foreign currencies to most Latin American countries. Reduced trade performance, coupled to idle capacity in some countries and excess demand in others led to regional integration gaining momentum in the political agenda of the region since the mid-1980s.

In this new era regional integration was seen as not only a means to widen domestic markets and allowing for scale gains, but it also proved a way out of crises: regional trade makes it possible in the short run to use installed capacity, and clearing schedules adopted by central banks in the region allowed for regional trade with less need of scarce foreign currencies. Furthermore, in the long run what makes integration sustainable is not the unlimited elimination of trade barriers, but rather the efforts to complement productive structures, so integration exercises should be seen as also a tool for the creation of common economic spaces. Lastly, because the renewed interest in regional integration took place at the same time that most economies adopted more liberal trade policies as a means to fight inflation, not only the integration processes should be designed in such a way to be compatible with multilateral opening, but exports to neighbouring countries should be seen as a 'learning process', by which producers could gain experience that would later make them able to try and explore more sophisticated markets (ECLAC 1984; CEPAL 1985).

The 1990s – the 'decade of reforms' in Latin America – added new arguments. The economic reasoning in the 90s stressed competitiveness, in the same way as it emphasized multilateral opening. There are benefits stemming from regional integration in that it allows for the reduction of unproductive rents related to lack of competitiveness, affects expectations of domestic and foreign investors, reduces transaction costs, increases productive efficiency, therefore contributing to price stability and facilitating the absorption of technical progress by stimulating less vertical productive processes, sub-contracting of smaller firms and the employment of qualified workers. The liberalisation of regional trade should also provide support to intra-industry specialisation, given that the products traded within the region tend to be more technology-intensive than the exports to the rest of the world. According to the new thinking, the benefits of integration go even further, by affecting positively the economic and institutional environment: joint infrastructure projects, as well as joint initiatives in areas such as education and development of capital markets have widespread effects (ECLAC 1994).

There were, hence, in the 1950s, 1960s, 1980s and 1990s clearly identifiable arguments in favour of policies stimulating regional integration. In the years 2000s, however, new overall conditions impose a challenge in trying to identify clear arguments for integration.

The outcome of trade concessions is affected by the international movement of capital; hence trade liberalisation can not be thought of independently of the policies towards the capital account. This is particularly relevant in a context such as the Latin American, where there has been little if any macroeconomic coordination.

Regional negotiations (the regional agenda) should go beyond the trade dimension: there is an increasing need to deal, for instance, with financing infrastructure items, such as energy, environmental policies and water supply, not to speak of measures to improve financial cooperation. This can be a major constraint when a given regional agreement is formed by countries with very different economic conditions.

The record of regional integration in Latin America in the years 2000s show relatively slow progress, when compared to other regions. This is due in part to the fact that regional integration takes place in parallel to an increasing number of extra-regional preferential agreements. It is also due to the fact that the domestic political environment in several countries is not compatible with the concessions required to foster integration processes.

High mobility of international capital, in a context where most countries have opened both their trade and capital accounts, is a major element affecting bilateral exchange rates, therefore determining trade flows and output growth, and hence also the expectations of potential investors.

The weakening of the WTO, in parallel to the mushrooming of bilateral and plurilateral agreements, imposes a challenge to regional preferences in that they increase the probability of trade diversion, negatively affecting regional trade. As a consequence, it reduces the margin for exploiting the potential these regional agreements might provide as a tool to foster economic development via changes in the productive structure.

Furthermore, the emergence of new actors in the international scenario (such as some Asian countries), in parallel to the weakening of some industrialized economies, raises the perspective of a new 'policentrism' in international economic and political relations. This increases the list of 'natural candidates' that Latin American countries should look for in their selection of potential partners for bilateral agreements. To the extent that recent agreements involve themes that go beyond purely trade subjects, the approximation with different partners at the same time might have damaging effects on a given group of countries participating in the same regional initiative.

Lastly, agreements negotiated by each country individually with third parties might deal with one same subject in different ways, leading to different rules than those prevailing within the regional agreements.

It is, therefore, less clear in the present decade, as compared to previous periods, what each country or group of countries can expect from regional preferential agreements.

Volatility of capital flows is indeed a matter for concern. In a situation where it has become clear that supervision at the financial centres are not as efficient as one would have thought and expected it to be, and even more, in a context where new players (such as sovereign funds) are having an increasingly important role, this poses a challenge to macroeconomic policies in developing economies and seems to be an argument for monetary coordination, eventually with the formation of common funds to provide liquidity in emergency situations.

V.4 – Challenge # 4: The much needed monetary cooperation

Monetary and financial cooperation in the region has two basic characteristics. It is quite limited, in view of what is needed and in comparison to the experience in other regions. It is also strongly influenced by the concerns with fostering regional integration, that is, the various initiatives aim at improving the financing of large and much needed infrastructure projects, or at building a mechanism to deal with foreign exchange shortages, or even to build a regional capital market.

These are all noble objectives in themselves. When taken jointly, however, they make the actual direction to follow less clear, both with regard to the instruments as well as in relation to the priorities.

In the last 25 years Latin American countries have looked for the support by the IMF in situations of liquidity crises, with a much higher intensity than, say, Asian developing economies. This obtained both in terms of number of operations (84 operations by Latin America countries between 1984 and 2007, more than twice the 35 operations by Asian countries) and in terms of their total value (DES 26 billion in Asia in 1984-2007, as compared to DES 66 billion in Latin America). As it turned out, Asian countries have focused and acted more on the basis of building up regional mechanisms to deal with external shocks (pool of reserves, regional bond markets, joint surveillance mechanisms and other initiatives), whereas in Latin America one might identify some type of ‘moral hazard’ that has postponed more decisive action towards regional solutions for the crises²⁴.

This is not to say that in Latin America there has been a total accommodation. As a matter of fact, there are at least two remarkably positive experiences, in providing a mechanism to foster regional trade and in dealing with the provision of liquidity.

The Agreement on Payment and Reciprocal Credit was signed by the Central Banks of LAIA member countries in 1965. By 1989 this mechanism was used to facilitate not less than 90% of total regional trade. Between 1966 and 2004 (when its conditions changed and the mechanism became virtually non-existent) this instrument made possible that almost ¼ of total regional trade took place without foreign currency transfers among Central Banks. This is one type of ‘swap’ of foreign currencies that took place well before the Asian so-called Chiang Mai Initiative (put in place in 2000).

In 1978 the Latin American Reserve Fund was created among Andean countries. This fund played an important role in providing foreign exchange to member countries during the external debt crisis. Again, this anticipated by 22 years the Chiang Mai Initiative.

Be that as it may, the perception in Latin America of the importance of some kind of monetary and financial coordination in order to foster regional integration is still conditioned by the traditional approach to monetary cooperation as a last stage of regional integration.

²⁴ Baumann/Mussi (2008)

This understanding has been increasingly questioned by facts, as coordination can be an important tool to promote the very process of integration in its different stages. And lack of coordination might impair integration processes, whenever external shocks are dealt with by uncoordinated devaluation by individual countries.

Recently Brazil and Argentina have adopted an alternative mechanism, by allowing bilateral trade to be financed in local currencies. It is still too early to know the actual outcome of this facility, but it seems reasonable to expect that the implicit reduction of transaction costs will stimulate bilateral trade, especially by small and medium firms.

Theory would suggest that the higher the weight of trade with neighbouring countries the higher the interest in promoting macroeconomic convergence, because the impact of bilateral disequilibria would be more intense. Latin American regional trade still accounts for a limited share of total external trade. One of the reasons for that is the difference in productive potential, as already mentioned.

In order to deal with these differences Brazil and other South American countries have tried to foster complementary productive projects, for this would help improve supply conditions in smaller economies and allow for the absorption of gains from larger productive scale, which, on its turn, helps improve competitiveness. This calls for the need of creating some mechanism – such as a regional capital market, and/or improved access to external financing sources - to provide low cost long-term capital to finance investment projects.

At the same time, turbulence caused by external shocks can be damaging if there is a regional contagion. It is, therefore, to the interest of all countries in the region to count with some mechanism for the provision of foreign currencies to deal with unpredicted shocks. Latin American countries (and, for that matter, most developing economies) have built relatively large reserves of foreign exchange in recent years, profiting from the favourable external conditions and based on the lessons from the mid-1990s crises. Provided that there is no efficient universal mechanism most countries have looked for some type of 'self-insurance'.

The problem is that high level of reserves means high fiscal costs. The Asian and the Andean experiences are, in this sense, rather suggestive that an adequate level of reserves can be obtained at lower costs if there are mechanisms for the pooling of reserves.

The regional agenda should therefore comprise the resumption of demand-inducing mechanisms to foster regional trade, such as the Reciprocal Credit Agreement, as well as the increase of the existing preferences for trade among LA countries, at the same time that it should provide instruments to deal with external shocks, such as joint liquidity provisions (swap mechanisms and pooling of reserves).

V.5 – Challenge # 5: What about the effects of the crisis?

The present situation of low economic activity and restrained liquidity imposes new challenges for regional trade. Previous sections have shown the increasing risks of trade diversion stemming from the various preferential trade agreements and parallel weakening of the WTO. Low economic activity is likely to reduce the stimulus to negotiate new preferential agreements. If anything, it is more likely that political pressure will go on the opposite direction, with increasing resistance to grant any concession, so as to preserve domestic jobs.

As far as the effects on multilateral negotiations are concerned the trend is less predictable. There can be pressures to foster negotiations as a means to open additional markets for exports. But there might be instead – at least for some time – a movement towards the reduction of preferences, if domestic producers are allowed an active lobbying capacity, with the consequent resistance to resume the Doha Round.

In any case, it is not realistic to expect that - in a context of reduced production and increasing unemployment, with a difficult dialogue to resume multilateral negotiations at the WTO - we are not going to see some trade distortions, be it in terms of new open or disguised barriers or subsidies to specific sectors.

Such circumstances might provide additional arguments in favour of intensifying economic relations on a regional basis. The experience of the early 1980s is suggestive in that sense: when Latin American countries lacked hard currencies they have been able to sustain the rhythm of activity and trade flows by intensifying regional trade. It should be no surprise if Latin American governments would signal in favour of the regional market as a mechanism to compensate for the less dynamic external demand.

Recent example of Asia is also remarkable: the relatively high share of regional on total exports reflects complementarities of productive structures for goods aimed mostly at the US and European markets. Recession in these markets led to impressive reduction of activity in Asia. This is a very different situation from Latin America, where regional trade has a good deal of final goods for domestic consumption. Productive complementarities to jointly explore third markets seems to be a necessary condition to overcome disparities among countries and hence allow for deepening integration. But it should not replace the need for reducing trade barriers, so as to improve the conditions for exploring the peculiarities of the regional market.

In summary, the regional option is not a sufficient condition. It should be seen as a complementary measure to a 'global trader' perspective. Yet it goes in the right direction, and not only for political or diplomatic reasons. From the strict economic viewpoint there are important dynamic gains that can accrue from closer trade relations with neighbouring countries, even with the discrepancies among the economies of these countries. The necessary condition for that is to overcome such discrepancies and turn the whole process into a positive sum game.

VI – Final Remarks

Policy-makers in economies with large potential domestic markets face a natural difficulty in dealing with the stimuli to domestic economic development and at the same time providing the conditions for an efficient relation with the rest of the world. It is comparatively 'easier' for small countries to opt for a full adherence to international markets.

Brazil has gradually increased its degree of exposure to international flows of goods, services and capital. Notwithstanding considerations about the depth, pace and sequencing of this opening, this article has discussed some of the basic characteristics of this process.

Emphasis in closer regional links is likely to remain an important issue in the Brazilian international agenda. Be it for the specificities of the recent conjuncture or for the structural trend to look for deeper and more substantive productive relations with neighbouring countries, it is very unlikely to see this issue as downgraded as it was back in the 1970s.

Such a process depends on joint action by the government and private actors. The involvement of these agents requires positive expectations with regard to what can be achieved.

These expectations are, nevertheless, not as clear today as one would have expected. What level of relative importance can or should regional trade achieve, in relation to total exports? How efficient is regional trade in stimulating medium/high technology products in comparison to trade with other regions? How sensitive to the business cycle is regional trade as compared to other markets? To what extent is regional trade dependent on terms of trade gains by neighbouring countries? Will the recent pace hold in the present scenario of lower commodity prices? What institutional arrangements are required to help deepen regional trade? To what extent has regional trade led to convergent interests, so as to provide positive outcomes in international negotiations? To what extent the emphasis in regional markets affects potential gains stemming from closer relations with other, wealthier partners?

The option for intensifying regional trade links is a reasonable one and perhaps even inevitable, taking into account the experience elsewhere, but the actual regional conditions raise a number of questions that have to do both with further empirical assessment and to more specific identification of expectations with regard to probable achievements. This article has shown that the road to reach significant progress in this direction is not flat and requires more clear signalling to economic agents, strong political will and a good deal of specific measures. But it has also suggested that it might provide positive results.

The policy suggestions that the analysis presented leads to are, first and foremost, to broaden regional trade preferences. Secondly, to adopt measures that might allow for joint exploration of third markets, such as complementary investment programs. Both measures should contribute to improve the positive perception from the agents in neighbouring countries, with regard to the benefits of regional integration, a pre-condition for its

sustainability. Third, to create mechanisms that stimulate transnational subsidiaries operating in Brazil to speed up the technological content of the export bill; overcoming infrastructure limitations and fostering human qualification are necessary conditions for that. Fourth, in times of reduced availability of foreign currencies, past experience has proved the importance of mechanisms to allow for the financing of regional trade; it is in moments when resources are scarce that the good will to create such mechanisms favours initiatives in that direction.

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