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South-South Partnership or North-South Competition?

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Abstract

To shed some light on the possibilities and limits of meaningful coalitions among emerging countries, this paper focuses on Brazil-China relations. Three main topics present a puzzle: trade relations, the political-strategic realm, and foreign direct investment. This paper develops a comparative assessment between the two countries in those areas, and identifies the extent to which the two emerging powers should be understood as partners and/or competitors. Data was collected, not only on these three aspects, but also on the governance structure and institutional safeguards in place in both China and Brazil. The analysis suggests that, even with advantageous trade relations, there is a pattern of growing imbalances and asymmetries in trade flows that are more favorable to China than Brazil. Therefore, Brazil and China are bound to be competitors, but it is not clear how bilateral imbalances may affect multilateral cooperation between the two countries.

Introduction

There are several reasons why emerging powers today are perceived to be much more than supporting actors in the international arena. First, they exert an increasing influence on global economic issues, such as trade and investments. Initially regarded as an acronym to refer to dynamic markets,[1] the BRICs (Brazil, Russia, India and China) have become integral players in the process of economic recovery after the global financial crisis in 2008 and 2009. With 40 percent of the world's population and nearly 25 percent of global GDP, these countries not only proved more resistant to the crisis, but also lead the efforts to global economic recovery when compared to the developed economies.[2] Moreover, of the top 20 companies in the 2010 Forbes Global 2,000 list, five are from the BRICs (3 Chinese, 1 Russian, and 1 Brazilian).

Second, a recurrent assumption in contemporary international relations literature is that emerging states are great powers writ small. As theories of power transition have it, these emerging countries constitute a challenge to the existing global order and, more specifically, to the world's lone superpower, the United States. After all, Brazil, Russia, India, and China share several relevant attributes. They seem to have the political, economic, and military means to influence the international order through their own regions or even globally. And they also share a mildly revisionist belief that they should play a more prominent role in global affairs. Therefore, as these countries rise, so does the notion that the tensions that come along in the process are a harbinger of a new world order yet to be unveiled.[3]

To better assess whether emerging powers pose a risk or present an alternative to the international order, one needs to move away from a perspective cantered in the United States and look closely at relations among these countries. Is it possible to infer from the interaction among emerging powers that these countries represent an alternative to the U.S.-led order? Is there such a thing as a counter-hegemonic coalition? And, if yes, how strong and coherent is this coalition? Since the findings of the literature on emerging powers and Brazilian foreign policy are inconclusive, these are all interesting questions that need to be addressed. Overall, the main international relations theoretical approaches tend to categorize emerging powers either as conflict-prone, great powers to be,[4] or as powers eager to embrace the norms of a Western-led liberal order.[5] As for recent Brazilian foreign policy scholarship, the emerging powers coalition issue is dealt mainly through the lens of South-South cooperation, or fuzzy concepts such as "autonomy through diversification" of partners.[6]

[1] Wilson, Dominic and Roopa Purushothaman, "Dreaming with BRICs: The Path to 2050," *Goldman Sachs Financial Workbench*, Global Economics Paper No. 99, 2003.
[2] "BRICs Monthly Report," Goldman Sachs, May 2009.
[3] A. Hurrell, "Hegemony, Liberalism and Global Order: What Space for Would-Be Great Powers?" *International Affairs*, 82 (1), 2006, pp. 1-19.
[4] K. Waltz, *Theory of International Politics,* McGraw-Hill, 1979.
[5] J. G. Ikenberry, *After Victory: Institutions, Strategic Restraint, and the Rebuilding of Order after Major Wars*, Princeton University Press, 2001.
[6] T. Vigevani and G. Cepaluni, "A Political Externa de Lula da Silva: A Estratégia da Autonomia pela Diversificação," *Contexto Internacional*, 29 (2), 2007, pp. 273-335.

From this paper's perspective, the truth lies somewhere in the middle of those two systemic theoretical approaches. On one hand, to affirm that emerging powers challenge U.S. hegemony is not the same as saying that these countries hold a common view on what a more representative or just global order should look like.[7] On the other hand, although these countries share some similarities as emerging powers in a predominantly liberal international order, more often than not their receptiveness to these liberal norms differs sharply. A look at recent Brazil-China relations may shed some light on this idea.[8]

Notwithstanding the emerging power label, when it comes to the design of their domestic institutions, the contrast becomes quite clear. While Brazil is a democratic market economy, China is a predominantly planned economy ruled by an authoritarian regime. How theses differences may play out in the international arena will be the general focus of this paper, which will address three main topics that present a puzzle for analysts and government officials alike: trade relations, the political-strategic realm, and foreign direct investments.

[7] Alden, Chris and M. A. Vieira, "The New Diplomacy of the South: South Africa, Brazil, India, and Trilateralism," *Third World Quarterly*, 26(7), 2005, pp. 1077-1095.
[8] B. Buzan, *The United States and the Great Powers: World Politics in the Twenty-First Century*, Cambridge University Press, 2004.

Trade Relations: Partners and Competitors

When considering challenges to the international order today, Brazil and China are often viewed as partners. Most analysts and policymakers regard these two giants as emerging powers that are increasingly coordinating their moves in the international arena, in fora such as the BRICs, the G20 (group of developing nations at the WTO Doha Round), and the BASIC (Brazil, South Africa, India, and China grouping in climate change negotiations). In 2004, an exchange of state visits between Brazilian President Lula da Silva and Chinese President Hu Jintao underlined the growing importance of this relationship. An agreement was signed to establish a bilateral mechanism of high-level strategic dialogue to address bilateral, regional, and global issues of concern—just the second strategic dialogue established by China with another developing country (the other being with India). As the Brazilian Foreign Minister stated at the time, "We are talking about a relationship between the largest developing country in the Western hemisphere and the largest developing country in the Eastern hemisphere."[9]

But, it is in the trade exchange that bilateral relations have strengthened in the past decade. Fueled by the impressive economic growth, Chinese demand for natural resources pushed the price of commodities to record-high levels, a process that greatly benefited Brazil's economy. Brazilian exports to China went from $1.1 billion in 2000, to $21 billion in 2009. Of this, approximately 78 percent accounts for basic goods (soy, iron ore, and oil). Imports from China also went up, from $1.2 billion in 2000, to $15.9 billion in 2009. In the first two quarters of 2010, China became the number one buyer of Brazilian exports, ahead of the United States, and number two source of Brazilian imports, behind the United States. Overall, in terms of total trade flows, China is Brazil's main trading partner.[10]

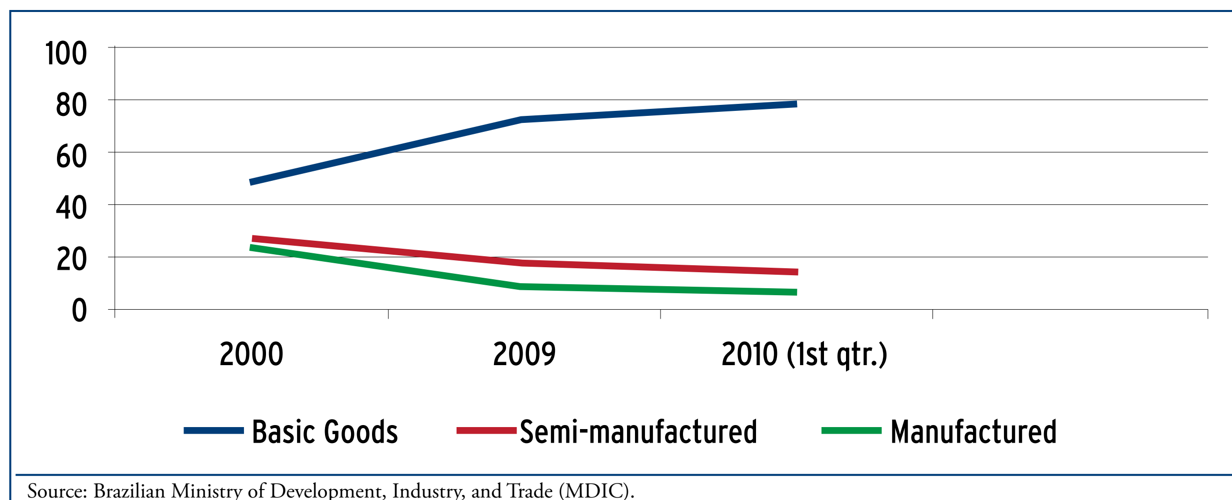
The winners of this partnership are easy to point out on Brazil's side. Agribusiness (soy and other crops) experienced a boost in productivity and record-levels of export. *Vale* became, in the past decade, one of the largest mining companies in the world. *Petrobras* benefited, not only from China's demand for oil, but also from much-needed Chinese investment in the company amidst plans to explore deep-sea oil fields off the coast of Brazil.[11] *Embraer* opened its first airplane factory overseas in China and the country became the company's second largest consumer, behind the United States. Furthermore, Brazil's infrastructure benefited from Chinese investments in the steel sector (*Companhia Siderurgica do Atlantico*), a major gas pipeline (*Gasoduto Gasene*), and a thermoelectric power plant (*Candiota*).

[9] "Parceria com chineses não é ameaça aos Estados Unidos, afirma Amorim" ("Partnership with China is Not a Threat to the United States, Says Amorim"), *Folha de Sao Paulo*, 24 May, 2004.

[10] Ministério do Desenvolvimento, Indústria e Comércio Exterior do Brasil (MDIC), <www.desenvolvimento.gov.br>.

[11] Sinopec, China's state-owned oil company, lent $10 billion to *Petrobras* in 2009. This is a good indication, not only that Brazil today constitutes one of the world's most successful oil exploitation frontiers, but also that China is hungry for oil and has the potential to become a global source of FDI. However, Philip Yang argues that in spite of the potential for a dynamic interaction between China and Latin America in the oil industry, China's presence in Latin America, especially in Brazil, is quite meager. See C. Arnson and J. Davidow, "China, Latin America, and the United States: The New Triangle," *Latin American Program*, Woodrow Wilson International Centre for Scholars, 2011.

Figure 1 – Evolution of Brazilian Exports to China (%)

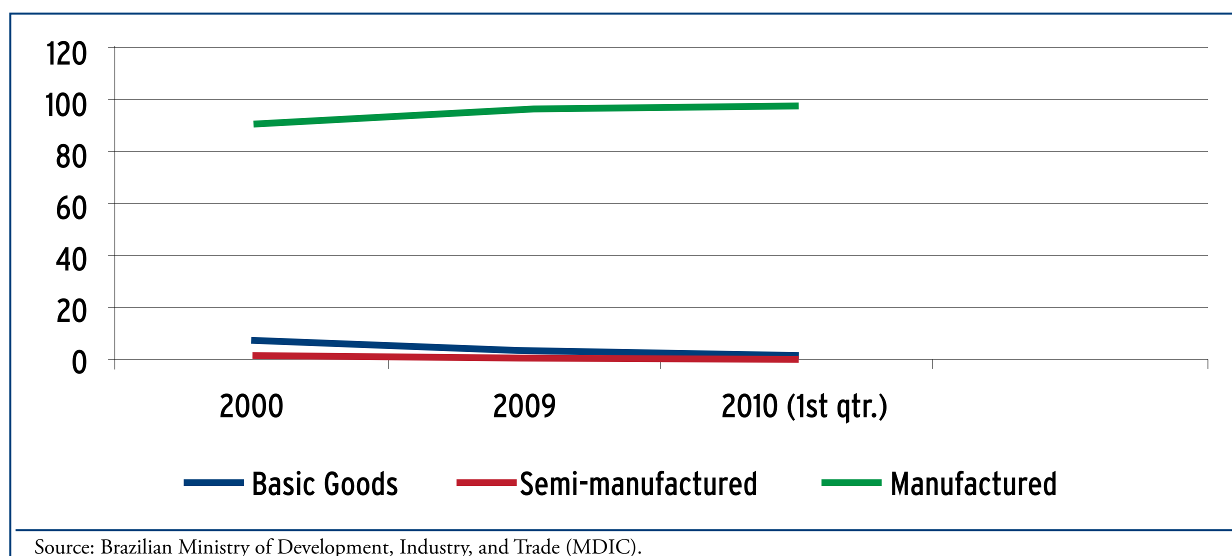


Source: Brazilian Ministry of Development, Industry, and Trade (MDIC).

However, in the past few years, the bilateral trade relationship has proved challenging, especially for Brazil. Although China became Brazil's main trading partner, Brazil does not figure among China's top ten trading partners. Moreover, relations between the two countries do notconstitute a South-South exchange (a balanced exchange between developing countries), as official Brazilian rhetoric may suggest, but an increasingly North-South relationship—with Brazil as an exporter of commodities and an importer of manufactured goods from China. Approximately 79 percent of Brazilian exports to China in the first quarter of 2010 were basic goods (soy, iron ore, and oil). And Brazil's imports from China were mostly electronic and capital goods. In 2000, 49 percent of Brazilian exports to China were basic goods (see figures 1 and 2).

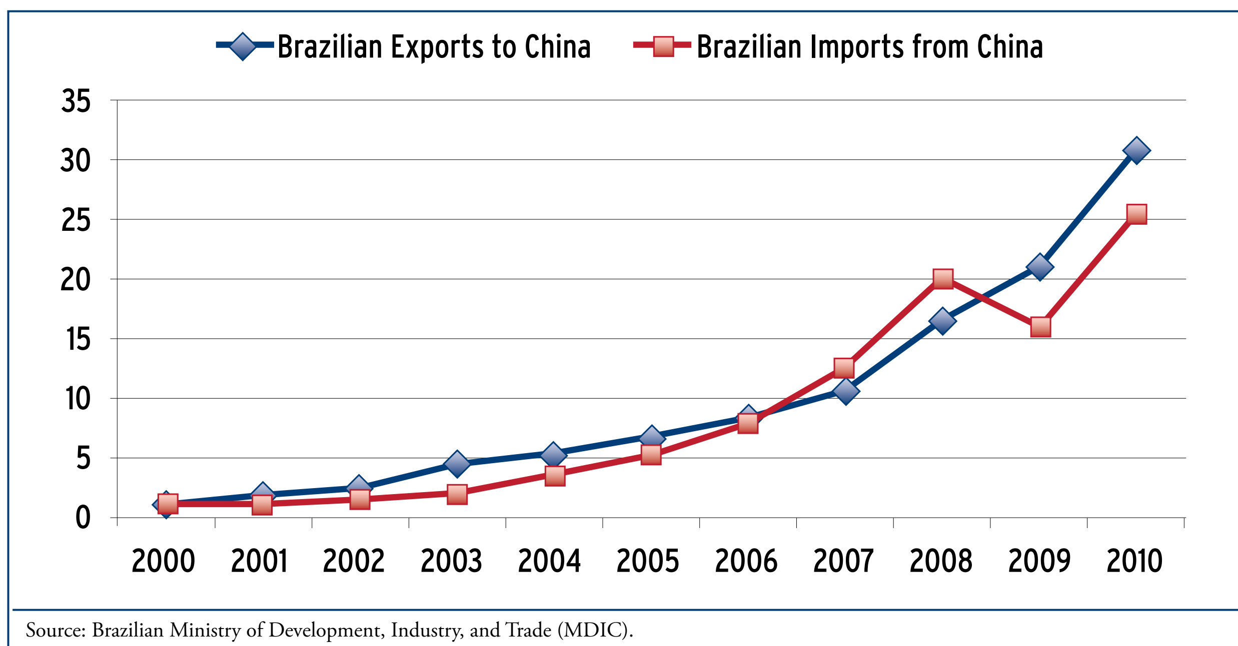
Furthermore, a recent study by the Brazilian National Development Bank (BNDES) shows a significant increase in imports from China. This strongly suggests two unfavorable trends for Brazil. First, it confirms the changing nature of the bilateral exchange—a shift from labor-intensive imports to knowledge- and technology-intensive imports from China. Second, the study points to the correlation between the import coefficient from China and the competitiveness of Brazilian products abroad. The Brazilian sectors (knowledge- and technology-intensive) that have shown a significant increase in Chinese imports have

Figure 2 – Evolution of Brazilian Exports from China (%)



Source: Brazilian Ministry of Development, Industry, and Trade (MDIC).

Figure 3 – Brazil-China Trade (US$ billions)



Source: Brazilian Ministry of Development, Industry, and Trade (MDIC).

also shown a lack of competitiveness in global markets. One may draw two different readings from this. First, Brazil's growing comparative advantage to produce and export basic goods may be seen as a result of China's growing economy. In a less favorable light, however, this specialization of the Brazilian economy is due to increased difficulties to compete with Chinese products elsewhere.[12]

Add to this situation each country's currency. China's credentials as a market economy are unconvincing, with its currency pegged to the dollar and undervalued. Brazil's currency has been floating its way to become one of the most overvalued in the past year. According to Brazilian Finance Minister Guido Mantega, the result is a potential "international currency war," with negative effects on trade. In fact, before the global financial crisis, Brazil faced two consecutive years of trade deficits in 2007 and 2008. Although Brazil sustained a considerable surplus with China in the last two years ($5.1 billion in 2009 and $5.2 billion in 2010), imports from China (up 61 percent from 2009 to 2010) have been increasing at a faster pace than Brazilian exports to China (up 47 percent in the same period) (see figure 3).

The concerns of top Brazilian economic officials regarding the negative effects of a currency war with China, reflect concerns in Brazil's non-commodity sectors. Brazilian industries and pressure groups, such as *Federacao da Industria do Estado de Sao Paulo* (FIESP) not only opposed the government's intention to grant China market status in 2004, but also pleaded for protectionist measures against Chinese products.[13] While this problem does not pertain only to Brazil's relations with China, it does highlight the potential for economic instability derived from China's authoritarian control over economic policies. In this sense, China is seen both as a clear competitor, and as a competitor who is difficult to neutralize with policy interventions, because the fear of retaliation on the commodity trade is too high. Argentina's recent struggles with China can attest to this.[14] Furthermore, the prospect of a Chinese

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[12] Puga, Fernando and Marcelo Nascimento, "*Visão do Desenvolvimento: o efeito China sobre as importações brasileiras*" ("The China Effect on Brazilian Imports"), BNDES, 2010.

[13] According to CNI (Brazilian National Confederation of Industries), of 134 protectionist measures Brazil undertook until March 2010, more than 30 percent had China as a target.

[14] In 2010, China suspended soybean oil imports from Argentina in retaliation to Argentina's restrictions on Chinese manufactured imports. After approximately six months, Argentinean officials put an end to the dispute.

slowdown in the near future may increase uncertainty in the Brazilian commodity sector, and its economy in general. In fact, the long-term challenge for Brazil, among other Latin American countries, is to effectively manage the commodity bonanza fueled by Chinese demand.

Despite efforts by the Brazilian Foreign Ministry to curb criticisms and sustain the idea of China as an important strategic partner, the country has shown increasing signs of divisiveness toward China in the past several months. In government circles, top economic officials (in the Finance Ministry, National Development Bank, Central Bank, etc.) have shown increased concern. Other ministries are moving to implement restrictive measures as well, mainly related to Chinese investments in land purchases. The Ministries of Defense and Agricultural Development, and the Federal Prosecutors Office (AGU) have recently pushed for new legislation to restrict land purchases by foreigners. There have been reports that these acquisitions, mainly by China's state-owned enterprises, are getting out of control and could have a negative impact on security issues, and land and commodity prices. Another issue causing dissatisfaction is the recently announced closure of *Embraer's* plant in China, due to China's plan to build aircrafts in competition with the Brazilian firm. Some, in fact, argue that the Chinese copied Brazilian technology to do this.

China also poses a threat to Brazil in third markets, namely in the United States and Latin America, where Brazil's exports are mostly manufactured goods. A look at 31 main Brazilian exports to the United States between 2003 and 2010 shows that Brazil decreased its total share on the U.S. market by 0.15 points (from 1.42 to 1.27), while China gained 6.54 in the same period (from 12.10 to 18.64). The correlation between Brazilian losses and Chinese gains becomes clear when taking into account the export of manufactured goods in traditionally important markets for Brazil. In Latin America, Brazil faces a similar problem. From 2002 to 2010, China's share of Argentina's total import market grew at a faster pace than Brazil's, rising from 5.6 percent to 12.5 percent. Brazil's share went from 25.6 percent to 31.4 percent in the same period. In the home appliances sector, for example, China surpassed Brazil as Argentina's main supplier. In Mexico, the evidence is even starker. Brazil's share of the Mexican market went from 1.3 percent in 2002, to 1.4 percent in 2010. China's soared from 2.6 percent to 13.9 percent in the same period. Although Brazil still benefits from an automotive deal with Mexico, it is losing market share. Despite the rewards in bilateral trade relations for both China and Brazil, there has been a growing perception, among Brazilian authorities and the private sector, that China is increasingly becoming a direct competitor of Brazilian manufactured goods abroad.

The fact of the matter is that a diverse coalition of stakeholders is becoming more vocal toward China. As they observe China's actions in other regions, like Africa and other Latin American countries, it becomes clearer that China regards Brazil as a source of natural resources rather than a partner in the political and strategic sense. Although both countries have benefited from trade exchanges in the past year, some Brazilian authorities are realizing that there are serious risks in the relationship with China that must be addressed. These include currency wars, trade deficits, competition in third markets, and investments.

Information that was recently disclosed by *WikiLeaks* furthers the argument. According to U.S. government reports on the perception of Chinese scholars and Latin American diplomats posted in China, the economic crisis of 2008 and 2009, and the changing global economic balance for power, forced China to diversify its export market and target more developing countries. The document, however, stresses two caveats to this strategy. First, the increasing perception by Chinese scholars and Brazilian diplomats that China's interests in Latin America remain primarily economic, with the main goal of securing natural resources. As the Council General of the Brazilian Consulate in Shanghai Marcos Caramuru de Paiva stated, "China's strategy is very clear: it is doing everything possible to control the supply of commodities." Consequently, China faces an image problem in the region, which it must address by taking Latin

American interests into account. Second, according to the report, many interests between China and Latin America's most developed economies do not overlap, "because many Chinese exports compete directly with exports from Latin America."[15]

Although China and Brazil have shown considerable degrees of coordination on multilateral negotiations such as the Doha Round of the WTO, trade relations between the two countries point to a more multifaceted arrangement. Clearly, there are those who underscore the win-win situation of the bilateral exchange, with both countries capitalizing on their areas of comparative advantage. But, as the exchange becomes more asymmetrical (in China's favor), it is reasonable to consider whether Brazilian officials will alter their stance toward China, in order to attend to rising domestic distributive conflicts between winners and losers in that relationship. Furthermore, another reasonable line of questioning is whether the bilateral imbalance, if it persists, will affect Brazil and China's multilateral trade coordination at the WTO. As long as Brazil mistakenly treats China as a full-fledged market economy (by WTO's rules), these risks will likely persist.

Despite the Memorandum of Understanding signed between the two countries in November 2004, in which Brazil recognized China's market economy status, the Brazilian government has not yet fully implemented this measure. According to recent press reports,[16] while the Foreign Ministry (MRE) still pushes for the implementation of the decree, the Ministry of Development, Industry, and Trade (MDIC), along with the inter-ministerial trade agency (CAMEX), seem more receptive to the concerns of domestic industrial groups. Nevertheless, Brazil has refrained from using unilateral safeguards against China that would be incompatible with WTO procedures, in order to avoid a potential "trade war" that may also taint the political agenda.

[15] See cable 09SHANGHAI170, China's Growing Trade and Investment ties with Latin America, 04/15/2009 <http://wikileaks.ch/cable/2009/04/09SHANGHAI170.html>.

[16] "Velha Nova Polêmica" ("Old New Controversy"), *Revista Veja online*, January 27, 2011 <http://veja.abril.com.br/blog/radar-on-line/governo/velha-nova-polemica/>.

The Political-Strategic Realm: Emerging Powers with Different Interests

China's overall positive effect on Brazilian exports and economy generated high political expectations, primarily from Brazilian officials. A special partnership with China—in the economic and political sense—seemed like a perfect match for Brazilian foreign policy under President Lula. Concepts such as autonomy, pragmatism, assertiveness, and South-South cooperation became dogmas of President Lula's diplomacy. In order to increase Brazil's leverage in international multilateral arenas, such as the United Nations, IMF, World Bank, and WTO, considerable attention was given to a strategy that became known as South-South diplomacy, or emerging powers coalition. The main goal of Brazilian diplomacy was to strengthen economic and political ties with other developing nations and regional powers, in groupings like the BRICs or IBSA (India, Brazil, and South Africa). China's presence in the Doha Round's Brazil-led G20 coalition, among other groupings, seemed to confirm the effectiveness of Brazil's course of action toward the Asian country.[17]

From a Brazilian perspective, the recent history of the bilateral relation also sheds light on the rationale behind Brazil's strategy to engage with China on equal terms. After the reestablishment of diplomatic relations in the 1970s, there was a push toward bilateral technological cooperation in the space satellite industry in the 1980s. At that time, Brazil and China had similar GDPs and Brazil had the upper hand in terms of satellite technology. This fueled the mindset of many Brazilian officials, that there was increasingly symmetrical interaction between the two countries. The fact that economic agents labelled Brazil and China as emerging economies in the early 2000s also contributed to the misperception that both countries share common interests in the economic arena and beyond. There are several examples of this miscalculation by Brazil, such as its unsuccessful effort to broaden the agenda of its Doha Round developing countries coalition (the trade G20) to include industrial issues. China, among other countries, refused. The politicization of the BRICs forum, regardless of a common political agenda, may also reveal limitations to the emerging powers coalition in the near future.

Although some political coordination between Brazil and China was deemed successful, such as the increase of voting shares both countries hold in the IMF, the caveats to this strategic partnership are visible. In the political and strategic realms, China's main interests differ from Brazil's. While Brazil has been considered a regional power with global ambitions, China already is a global power with nuclear weapons (Buzan 2004). Moreover, the two countries face very different regional contexts. In contrast with the rapprochement seen between South America's two largest powers, Brazil and Argentina, in the last three decades, rivalry among Asian countries still sets the tone for security concerns. To illustrate this point, Brazil's bid for a permanent seat on the UN Security Council was initially thought to be accepted by China, which is already a permanent member. But when Brazil launched a collective bid with India, Germany,

[17] For a panoramic view of President Lula's overtures towards China and the scope of bilateral cooperation, see Brazilian Ministry of Foreign Relations press releases n. 213, 526, and 527, <www.itamaraty.gov.br>.

and Japan in 2005, China immediately opposed any Security Council reform. This took Brazilian officials aback, since they had made an effort, despite strong domestic opposition, to start the process to recognize China's market economy status the year before (a prerequisite for China's full admission to the WTO). Although there was no explicit bargain on both issues, recognition of China's status was the highest political card Brazil had to offer.[18]

When it comes to issues such as human rights, climate change, and nuclear proliferation, coordination between Brazil and China is also difficult. Brazil's recent voting record at the United Nations Human Rights Council and General Assembly reflects a traditional concern for non-intervention and support for authoritarian regimes. However, in actuality, Brazil is a vibrant democracy with increasingly open debate about its foreign policy on human rights. Official rhetoric aside, in the long-term, Brazil is likely to stand on different ground when it comes to human rights. As for the climate change negotiations, both countries support the principle of shared, yet differentiated, responsibilities between developed and developing nations. However, as their economies expand, significant differences in terms of environmental policies are likely to become more visible. While China's greenhouse gas emission is the result of more industrial output, Brazil's is primarily the result of deforestation. In terms of electricity output, for example, Brazil's credentials as a green economy are more impressive. Brazil operates at at least 80% of its hydroelectric capacity, and is a major biofuels market. Finally, Brazil and China show a limited capability of cooperation on nuclear proliferation. When Brazil and Turkey tried to broker a deal between the UN Security Council and Iran last year, China voted for the U.S.-backed resolution to sanction Iran.

In this light, do Brazil and China share common views regarding the main aspects of post-Cold War world order? China and Brazil (along with the other two BRIC countries) seem to have the political, economic, and military means to influence the international order throughout their own regions, or globally. Moreover, they also share a mildly revisionist belief that they should play a more prominent role in global affairs. What this role should encompass, however, is open to different interpretations. China's nuclear status places it in a different arena when it comes to international security regimes and great power coordination (in the Security Council, for example). As for other relevant transnational regimes (human rights, climate change, etc.), domestic variables, such as political regime (democracy-autocracy) and energy production (more or less carbon-intensive), seem to restrain any deepening of coordination between Brazil and China in the international arena. Moreover, with regards to regional rivalries, Brazil's relatively comfortable position in South America poses a different type of constraint than the one China faces. This, in turn, may alter how each country operates, both within its region and in how it deals with U.S. presence in those regions.

In sum, despite the sometimes overly ambitious official rhetoric from both governments (although this paper focuses mainly on the Brazilian side), preliminary evidence suggests that the possibilities for long-term coordination in multilateral forums are limited by domestic (institutional) and regional variables.

[18] This frustration, from Brazil's perspective, may also help explain why Brazil seems to be dragging its feet regarding full implementation of the decree that grants China market economy status.

Foreign Direct Investment (FDI) and Quality of Governance

It is now a common assumption among institutional economics and politics that the quality of the institutional environment of a country is essential to long-term economic performance.[19] Countries with better institutions, capable of protecting property rights, checking politicians' discretion, and applying less distortionary policies, will invest more in physical and human capital, and will use these factors more efficiently to achieve better long-term economic performance.

It is also assumed that good institutions and quality of governance are crucial aspects in helping developing countries attract foreign direct investment (FDI) conducive to growth. Although literature has suggested that it is difficult to establish a robust causal relationship between the degree of FDI and output growth performance, several developing countries with greater financial integration have also experienced higher rates of economic growth. In the particular case of China, foreign-invested firms have contributed significantly to China's impressive export expansion and to China's overall economic growth.[20] FDI has also been a major contributor to Brazil's impressive post-war industrial growth. Brazilian economic history shows two distinct periods: the inward, Import Substitution Industrialization (ISI) period, and the outward export period. In both periods, FDI had a decisive influence.[21]

Institutional quality is an important determinant of capital inflows.[22] In addition, the legal origin of a country had a direct impact on capital inflows from 1970 to 2000. Strong empirical evidence supports the view that countries are considerably more likely to benefit from financial globalization when they take simultaneous steps—sometimes even modest ones—to improve governance, transparency, and financial sector regulation.[23] In other words, as a country makes progress on transparency, control of corruption, rule of law, and financial supervision capacity it will be in an increasingly better position to benefit from financial globalization.

Corruption has a strongly negative effect on FDI inflows. A high degree of corruption may affect the composition of a country's capital inflows in a manner that makes it more vulnerable to the risks of speculative attacks and contagious effects. In addition, countries with weaker governance, as reflected by a higher perceived level of corruption, are more likely to have a structure of capital inflows that is relatively light in FDI and relatively heavy in foreign bank credits. On the other hand, transparency of government operations, which might be interpreted as another indicator of good governance, has a strong positive effect on investment inflows from international mutual funds.

[19] D. North, Douglas, *Structure and Change in Economic History*, W. W. Norton, 1981 and D. Acemoglu, S. Johnson and J. A. Robinson, "The Colonial Origins of Comparative Development: An Empirical Investigation," *The American Economic Review*, 91(5), 2001, pp. 1369-1401.

[20] N. Lardy, Nicholas, *China in the World Economy,* Institute for International Economics, 1994.

[21] W. Fritsch and G. Franco, "Foreign Direct Investment in Brazil: It's Impact on Industrial Restructuring," OECD, 1991.

[22] L. Alfaro, S. Kalemli-Ozcan, and V. Volosovych, "Capital Flows in a Globalized World: The Role of Policies and Institutions," NBER Working Paper, 2005.

[23] Prasad, Rogoff, Wei, and Kose, "The Effect of Financial Globalization on Developing Countries: Some Empirical Evidence," International Monetary Fund Occasional Paper 220, 2003.

In 2002, M. Habib and L. Zurawicki corroborated a similar position by empirically demonstrating that foreign investors avoid corruption, both because they believe it is morally wrong, and because it can be risky, costly, and difficult to manage.[24] Their study also found "a negative effect due to the difference in corruption levels between the home and host countries." This further suggests that foreign firms are unwilling to deal with the planning and operational pitfalls related to an environment with a different corruption level. Studies by S. Wei also found clear evidence that corruption in host countries discourages foreign investment.[25] J. Hines found that American firms tend to invest less in corrupt countries, as a consequence of the U.S. Foreign Corrupt Practices Act, which, until 1999, had made the United States the only source country in the world that penalizes U.S. firms for bribing foreign government officials.[26] Like many developing countries, Brazil and China have made huge improvements in order to attract foreign direct investment in the last twenty years. From being incapable of, and sometimes hostile to attracting large amount of FDI until the early 1990s, China has become a true money magnet. In the last few years, it has become the largest developing country attracting FDI, and the second largest in the world (only after the United States). According to Acemoglu, "China would never be able to achieve the current economic miracle with a closed economy, relying mostly on its own domestic market."[27]

Brazil, on the other hand, was the single largest host country to FDI among developing countries until the late 1970s, but began losing its appeal to investors in the early 1990s due to successive economic crises, macroeconomic instability, indebtedness, slow growth, etc. Only after its macroeconomic stabilization, beginning with the "Real Plan" in 1994, has Brazil regained importance to foreign investors. However, it was still ranked fourth among developing countries in 2009, below China, Russia, and India respectively. Both China and Brazil suffered considerably during the recent international financial crisis; but they have already bounced back and are expected to return to the pre-crisis rates of FDI in 2010 (see Figure 4).

The distribution of foreign direct investment between China and Brazil, however, presents a puzzling picture to institutional economics and politics scholarship. As previously discussed, this literature predicts a positive correlation between the quality of institutional safeguards and FDI. In other words, foreign investors would prefer to allocate their money in countries with higher governance quality. Despite Brazil's higher scores on institutional quality, China has attracted more FDI in gross terms than Brazil.

As we can see in the Table 1, Brazil scores better than China in nearly all governance indicators, except "governance effectiveness," in which China did slightly better than Brazil in 2009. Nevertheless, Brazil improved its rank in this particular sub-index from 54.4 to 57.6, in 1998 and 2009 respectively. In fact, Brazil has improved on all governance indicators with the exception of "Regulatory Quality," which declined from +0.30 to +0.18.[28] Even on this particular matter, Brazil does comparatively better than China, which scores a negative -0.20. China worsened its rank position in three important governance indicators during this same period: "voice and accountability" (from 9.6 to 5.2), "political stability" (from 38.5 to 29.7), and "control of corruption" (from 47.1 to 36.2). It is important to bear in mind that these three indicators are the most important aspects in assuring a safer environment for investors. In other words, since China has not provided enough

[24] Habib, M. and L. Zurawicki, "Corruption and Foreign Direct Investment," *Journal of International Business Studies* 33 (2), 2002, pp. 291-307.

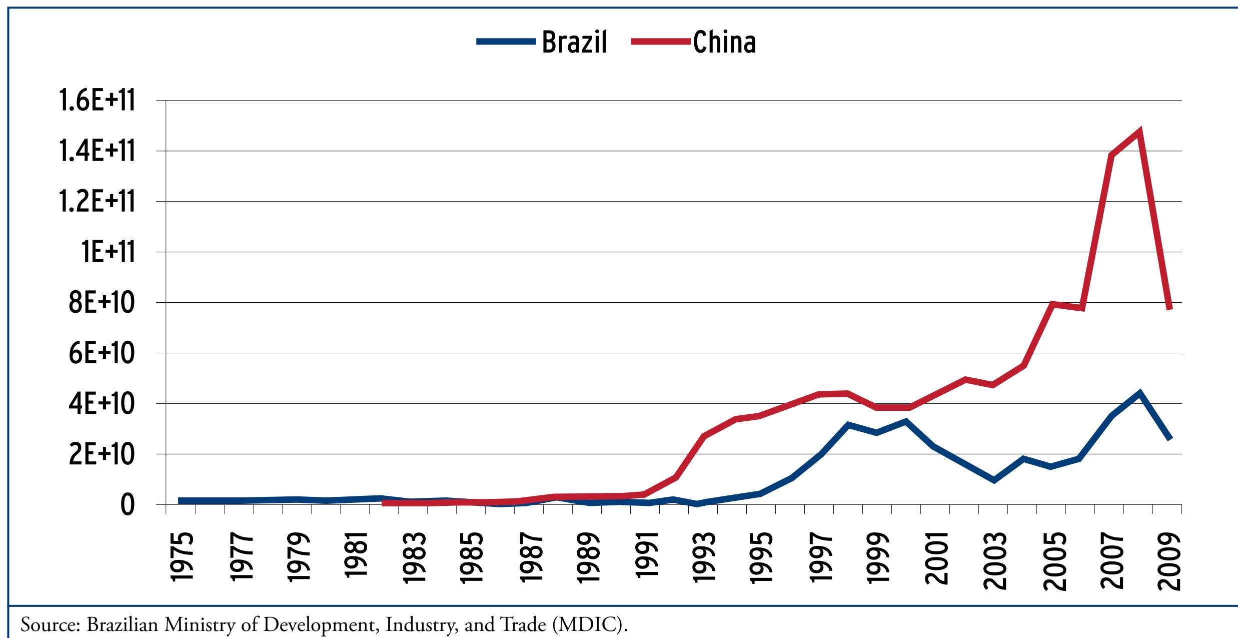
[25] Wei, Shang-Jin, "Corruption in Economic Development: Beneficial Grease, Minor Annoyance, or Major Obstacle?" Paper presented at the Workshop on Integrity in Governance in Asia, UNDP, 1998.

[26] Hines, J., "Forbidden Payments: Foreign Bribery and American Business after 1977," NBER Working Paper 5266, 1995.

[27] Acemoglu, D., Interview in *VEJA Magazine*, 2010.

[28] It took awhile for the current administration in Brazil to understand the importance of the regulatory system as a decisive institutional safeguard for investors. Even today, there are concerns about the governance conditions of the regulatory environment in Brazil. There is evidence, for instance, that the government has systematically impounded agencies' budgets, which has tremendously threatened their autonomy and capacity to operate. Correa, P, C. Pereira, B. Mueller, and M. Melo, "Regulatory Governance in Infrastructure Governance," The World Bank Press, 2006.

Figure 4 – Foreign Direct Investment, net inflows (BoP current US$): Brazil and China



Source: Brazilian Ministry of Development, Industry, and Trade (MDIC).

institutional safeguards for foreign investors, Brazil's higher quality of governance should make it a better candidate for FDI than China. However, evidence shows that China has done better in attracting FDI as measured in gross terms.

Therefore, China has contradicted the literature's expectation that "as a country makes progress on transparency, control of corruption, rule of law, and financial supervisory capacity, it will be in an increasingly better position from financial globalization."[29] However, China has not definitively increased accountability in regards to political stability and corruption. Although China has indeed improved its regulatory quality and rule of law, these governance indicators still present negative scores.

Table 1 – Ranking Governance Indicators in Brazil and China (Percentile Rank, 0-100)

Governance Indicator	Brazil		China	
	1998	2009	1998	2009
Voice and Accountability	55.3 (+0.19)	62.1 (+0.51)	9.6 (-1.38)	5.2 (-1.65)
Political Stability	29.8 (-0.38)	54.2 (+0.29)	38.5 (-0.16)	29.7 (-0.44)
Government Effectiveness	54.4 (-0.10)	57.6 (+0.08)	44.7 (-0.33)	58.1 (+0.12)
Regulatory Quality	59.5 (+0.30)	55.2 (+0.18)	39.0 (-0.26)	46.2 (-0.20)
Rule of Law	43.8 (-0.30)	49.5 (-0.18)	40.0 (-0.37)	45.3 (-0.35)
Control of Corruption	58.7 (+0.05)	56.2 (+0.07)	47.1 (-0.26)	36.2 (-0.53)

Note: In parenthesis the Governance Score, which ranges from -2.5 to +2.5.
Source: D. Kaufman, A. Kraay, and M. Mastruzzi, "The Worldwide Governance Indicators: Methodology and Analytical Issues," World Bank Policy Research Working Paper 5430, 2010.

[29] Prasad, Rogoff, Wei, and Kose, "The Effect of Financial Globalization on Developing Countries: Some Empirical Evidence," International Monetary Fund Occasional Paper 220, 2003.

To further underscore the point, Transparency International recently released its annual CPI (Corruption Perception Index) report for 2010. This composite index uses several international evaluations of corruption around the world to rank countries on a scale from zero (total corruption) to ten (zero corruption). In 2009, Brazil was ranked 75th and China ranked 79th among 180 nations. In 2010, Brazil was ranked 69th and China improved one position, ranking now 79th among 178 countries—with the same scores (3.6 and 3.7 respectively). The 69th rank is "shared" by Cuba, Brazil, Montenegro, and Romania. The first rank is shared by Denmark, New Zealand, and Singapore. In Latin America, Chile ranked 21st—above the United States, Uraguay, and Venezuela at 22nd, 24th, and 164th respectively. Among Asian countries, China ranked 14th behind Japan, Taiwan, South Korea, and Malaysia (5th, 6th, 9th, and 11th respectively). Somalia was "last," in 178th rank.

How can this puzzle be solved? In other words, with worse governance indicators, why and how has China been able to attract greater foreign direct investment than a higher quality ranked country like Brazil, where personal and property rights are better secured?

China and Brazil both have a very strong bias favoring the executive branch. However, in Brazil, this does not mean a blank check for the president. In other words, Brazil is a consolidated democracy with several power alternations since its re-democratization in 1985. Additionally, several institutions, such as an independent judiciary, independent public prosecutors, *de facto* independent Central Bank, audit courts, and a free and competitive media check the executive's dominance.[30] The same, however, cannot be said about China, where there are very few, if any, independent accountable institutions capable of constraining the Communist Party's control of government.

This is even more puzzling when governance indicators among emerging economies are compared, particularly among the BRICs. Figure 5 shows the governance composite index (an average of the six indicators) among these countries, demonstrating that Brazil is better positioned than China, India, and Russia, as well as among other emerging economies. Why then does Brazil's better quality of governance not translate into higher FDI, especially in comparison with China?

A number of factors could explain this puzzle, favoring China in comparison with Brazil. In 1979, the "Law on Chinese-Foreign Equity Joint Ventures," together with the establishment of four special economic zones, China opened the door for foreign direct investment. In the following years, the Chinese government promulgated laws and regulations specifically to attract investments from overseas.

China's remarkable economic success rests on a foundation of political reform providing a considerable degree of credible commitment to markets. This reform reflects a special type of institutionalized decentralization called "federalism, Chinese style."[31] This form of decentralization has three consequences. First, it fosters competition, both in product markets and among local governments, for labor and foreign capital. This competition, in turn, encourages local government experimentation and learning, with new forms of enterprises, regulation, and economic relationships. Second, it provides incentives for local governments to promote local economic prosperity. Finally, it provides a significant amount of protection to local governments and their enterprises from political intrusion by the central government.

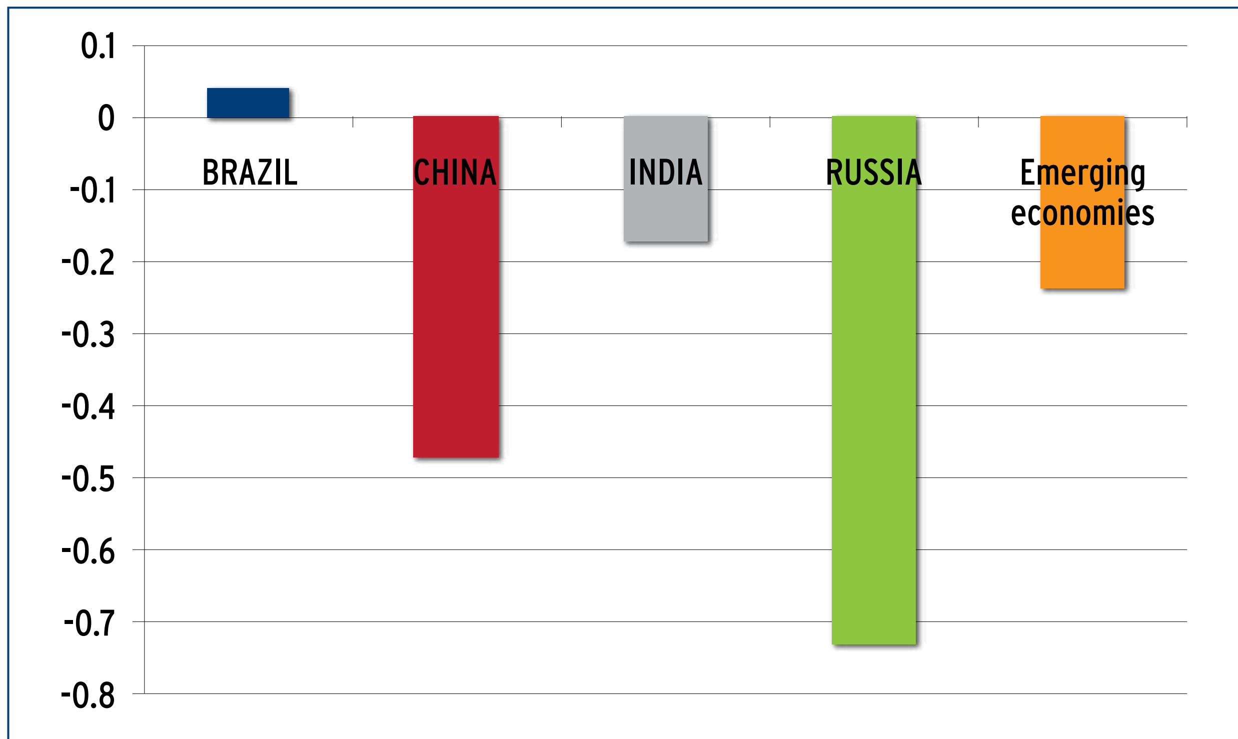
In addition, China has offered "super treatment" to all foreign invested firms in a variety of ways: an initial two years of tax holiday, plus three subsequent years of half of the normal tax rate. Such benefits, however, are not extended to domestic Chinese firms.

Contrary to general expectation, however, China is an underachiever as a host of direct investment,

[30] Brazil is currently 58th in the Freedom of Press Index, while India is 122nd, Russia is 140th,and China is 171st. In fact, Brazil was the only country that improved in this rank among BRIC countries.

[31] Weingast, B., Q. Yingyi, and G. Montinola, "Federalism, Chinese Style: The Political Basis for Economic Success in China," *World Politics* 48 (1), 1995, pp. 50-81.

Figure 5 – How Do BRICs Measure Up on Governance?



Source: D. Kaufman, A. Kraay, and M. Mastruzzi, "The Worldwide Governance Indicators: Methodology and Analytical Issues," World Bank Policy Research Working Paper 5430, 2010.
Note: Made by the authors based on an average of the six governance indicators.

considering its size, proximity to major source countries, and other factors.[32] Hong Kong is the dominant direct investor in China, with nearly a 60 percent share of FDI. Japan and the United States are the second and third largest investors in China. In, "Sizing up Foreign Investment in China and India," author Shang-Jin Wei questions if Hong Kong's investment in Mainland China should be counted as FDI, particularly after July 1, 1997, when Britain finally turned over the territory to China. Wei argues that this "round-tripping" capital, in fact, has originated in the mainland disguised as Hong Kong investment to take advantage of tax, tariffs, and other benefits accorded to foreign-invested firms. Wei also provides evidence that corruption is very high in China, which further discourages foreign investors.

Thus, while the absolute value of foreign direct investment in China looks very impressive in recent years (see Table 2), when variables such as population size are controlled, China is found to be a significant underachiever as a host of FDI. In other words, China could have done far better attracting FDI if it had improved its governance quality. The last column of Table 2 clearly illustrates that Brazil and Russia perform better than China in terms of FDI per capita.[33]

Table 2 – BRICs Basic Statistics

Country	Pop. (mn)	GDP (bn)	GDP per cap. ('000s)	Annual FDI (bn)	FDI per capita
Brazil	192	1,575	8.2	319	1,659
Russia	142	1,679	11.8	256	1,800
India	1,140	1,159	1.0	161	141
China	1,325	4,327	3.3	576	435

[32] Wei, Shang, Jin, "Sizing up Foreign Investment in China and India," Stanford University Working Paper 85, 2000.
[33] Kaufman, D., A. Kraay, and M. Mastruzzi, "The Worldwide Governance Indicators: Methodology and Analytical Issues," World Bank Policy Research Working Paper 5430, 2010.

Therefore, the institutional economics literature may be correct. Quality of governance matters, especially for sustained long-term socioeconomic growth, as it provides institutional safeguards to foreign investors. As conventional economic fundamentals fall in place, governance indicators become increasingly binding.

Brazil and China are strong competitors for foreign investment, but their competition is complex. If quality of governance played a negligible role, there would be no clear alternative in terms of policies or institutional reforms for Brazil to increase the flow of FDI vis-à-vis China. Because of its population size, and lack of institutions to provide checks and balances, China would naturally be a preferred target for investments. But if governance does matter in the long run, the correlation between positive indicators and growing investment flows is likely to become more evident sooner or later. Thus, if institutional reform yields good results, each country is capable of fostering a favorable environment for more investments, regardless of how other countries behave on this matter.

Conclusion and Recommendations

The future of Brazil-China relations will pose a constant challenge to policymakers and analysts alike. Although the two countries may be defined generally as emerging, regional powers with global ambitions, this definition does not provide a framework capable of capturing all the nuances of the relationship. A closer look at regional context provides insight into the countries' different approaches to international security. While strategic rivalry has been an outdated concept in South America since the Brazilian-Argentinean nuclear rapprochement of the 1980s, China still faces a classic security dilemma in its own region, with potential rivalries emerging from Japan, India, and Russia, and the constant military presence of the United States.

How China and Brazil have been affected by and reacted to the globalization process also poses a puzzle. On trade, despite a very lucrative period for both countries in the past decade, the relationship is becoming increasingly asymmetrical. Some even argue that the "North-South" aspect of the China-Brazil trade relationship is a harbinger of profound and dramatic changes in Brazil's economy, such as deindustrialization.[34] As for investments, the disparity between the two countries in terms of governance indicators and capital inflow indicates an intricate parallel. While the initial argument suggests China has the advantage, a closer look reveals the correlation between good governance and investments is real in the long run. This is more favorable to democratic Brazil. Moreover, this disparity may suggest a different approach in terms of foreign economic policy. Both China and Brazil have increased foreign direct investments abroad, primarily in Latin America, Africa, and Asia.[35] It has yet to be examined if Brazil and China use different approaches in dealing with governance indicators in host countries, and if that may lead to more competition between the two countries in the emerging world.

This paper assessed the extent in which Brazil and China can be interpreted as partners or competitors. Apart from trade, where both traits are present, China and Brazil tend to have a more competitive relationship in the long-term, which may become more intense as both countries increase their presence in other regions. Even in trade relations, Brazil and China have today an imbalanced relationship (in China's favor). Their products compete for access to other markets; and they strongly compete to attract foreign investments. These growing disparities stem mainly from different domestic institutional structures in each country, a market-friendly and democratic Brazil, and an authoritarian and economically manipulative China. How these trends will evolve will be crucial, not only to the economic dimension of the relationship, but also to the political-strategic aspect as well. Surely areas of cooperation between the two countries exist, but the idea of a strategic

[34] According to the Brazilian Institute of Geography and Statistics (IBGE), the industrial sector share of Brazil's GDP fell to 15.5 percent in 2009, the lowest figure since 1947.

[35] Chinese investment in Latin America between 2008 and 2009 (from $3.7 billion in 2008, to $7.3 billion in 2009) suggests that China's role in the region is continuing to accelerate at a rapid pace. Statistics from China's Ministry of Trade indicate that, after Asia, Latin America is the second largest destination for Chinese investments.

partnership should be put into a more realistic perspective. There is a strong likelihood that persistent bilateral differences (trade imbalances, political disagreements, competition for FDI, etc.) may have a spill-over effect on multilateral cooperation between China and Brazil, particularly on issues where core economic interests are at stake.

Concerning trade, Brazil may address the asymmetries of the bilateral exchange with China through industrial and innovation policies, new legislation (tax reform, for example) and development agencies, to increase the competitiveness of Brazilian firms and add value to exports. Although domestic political skirmishes and institutional imperfections are a major source of Brazil's lack of competitiveness, China looms as an increasing source of imbalance to important sectors of the Brazilian economy.

Another way in which Brazil can address the asymmetries is by diversifying its trade partners, seeking more trade agreements in the region and with other major economies. In the past decade, Brazil's trade policy has been hampered by watered down agreements and the lack of a more liberalizing agenda. Furthermore, Brazilian officials should hold China accountable for the imbalances that stem from market-unfriendly economic policies, such as currency manipulation, dumping, and protectionism. Brazil should also review its promise to grant China market economy status and work alongside the United States and the European Union (neither of which has granted China market economy status) to press the Chinese government to implement economic reform as prescribed by the World Trade Organization.[36]

To increase the capacity for foreign direct investments, both China and Brazil would benefit enormously from strengthening institutions capable of curbing corruption through checks and balances. Brazil has made huge efforts in that direction by strengthening the institutional capacity and political autonomy of public prosecutors and audit institutions, creating independent regulatory agencies at the national and sub-national levels, delegating powers to the Office of the Comptroller General (CGU) to oversee mayors at the local level, and increasing the technical and intelligence capacity of the Federal Police. The Federal Police have become an increasingly active and potent force in investigating and rooting out corruption in the public arena, both at the federal and state level.

There are other initiatives in the political realm as well. The recent approval of the Clean Slate Law (*Ficha Limpa*) in June 2010 has actually stopped notoriously corrupt politicians from running for elected positions. This is a major change from past practice where populists, demagogues, and thieves routinely managed to wipe their criminal records clean by popular votes. In the public sector, nepotism and clientilism are now rare; Competitive and fair public exams allocate public sector positions.

Despite these pro-accountability initiatives, there have been many attempts, especially during the Lula administration, to decrease the autonomy of regulatory agencies. According to the government, the actions and decisions of anti-corruption agencies reduce the pace of appropriations and delay the execution of important infrastructure projects that cannot be postponed. President Lula himself made several public statements constraining the actions of the National Audit Institution (*Tribunal de Contas da Uniao-TCU*) and the Electoral Supreme Court (TSE), which had decided to go against the executive's interests, despite the power and public support of the president. The TCU's board, for instance, has decided to suspend or veto several projects under suspicions of corruption.

Therefore, it is important to make the distinction between past and present-day Brazil when comparing it to its peers. Although Brazil has made tremendous improvements, it has a long way to go in the direction of good governance in order to become a global player capable of attracting foreign direct

[36] "Brazil and China: A Young Marriage on the Rocks," *Reuters*, February 3, 2011.

investment sustainably. China, on its own terms, should not be deceived by its current economic performance. It should seek to enhance governance, especially with regard to "voice and accountability" and "control and corruption," indicators which China increasingly struggles. Sooner or later, China must improve its institutional safeguards to increase its capacity to attract foreign investors.

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