



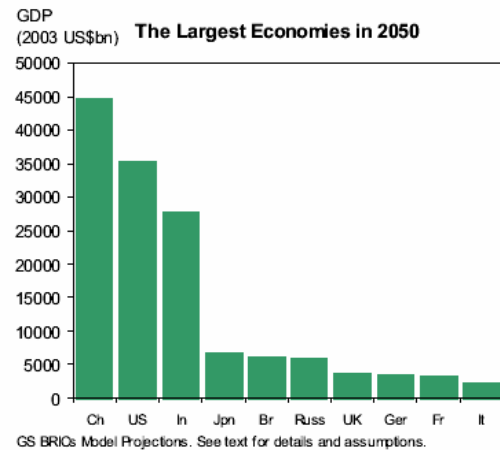
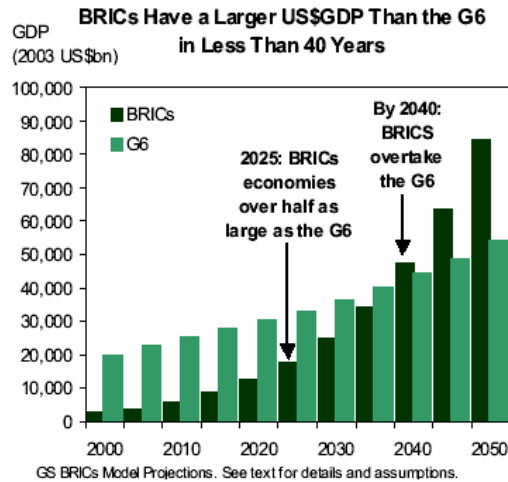
The rise of the BRICs:
Implications for transatlantic
relations.

The World Trade Organization's (WTO) suspension of the Doha Trade Round in July 2006 caused recriminations on both sides of the Atlantic. The European Trade Commissioner, Peter Mandelson, blamed the Americans for not showing "any flexibility on the issue of farm subsidies." The US Trade Representative, Susan Schwab, responded in kind, accusing EU countries of "being the ones that are reluctant to act in terms of market access." The EU and the US, however, were not divided over the usual panoply of transatlantic trade issues - aircraft subsidies, steel tariffs and bananas. Nor were they divided over what was supposed to be the key issue of the Doha round - correcting trade imbalances with least developed countries in order to aid in their development. Rather, the EU and US found themselves at loggerheads over how best to address the demands of the fastest growing developing economies - Brazil, Russia, India and China, known collectively as the BRICs. This disagreement has vast implications for the multilateral trading system, transatlantic relations and the global balance of power. This brief intends to clarify these implications in four parts. The first will consider the projected future growth rates of the BRICs; the second examines the challenges this growth poses to both sides of the Atlantic; the third explores the divergent transatlantic responses to this group; and the fourth posits some potential consequences of this divergence.

Background: The Potential Rise of the BRICs

The concept of BRICs was first developed by Jim O'Neill, chief economist at Goldman Sachs' research department. Using sophisticated econometric modeling, O'Neill and his team sought to predict the growth rates of Brazil, Russia, India and China relative to those of the current G6 - the France, Germany, Italy, Japan, the United Kingdom and the United States - over the next half century.¹ Their results are as follows:

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In 2025, the BRICs economies could account for over half the size of the current G6, and in 2040 they could be larger. By 2050, the three largest economies are projected to be China, the US and India, ranked in that order. Of the other G6 countries, only Japan may still be among the six largest economies. Crucially, the shift in GDP that would result in this outcome would be most dramatic over the next 30 years, with the annual increase in dollar expenditure by BRICs overtaking that of the G6 countries as early as 2009. In consequence, “the relative importance of the BRICs as an engine of new demand growth and spending power may shift more dramatically than expected.” This has vast implications for the strategic decisions made by multinational corporations and investment funds, who may seek to take advantage of this dramatic growth at the expense of the G6 economies.

It must be noted that these GS projections are underpinned by critical *assumptions* that may not hold. In particular, O’Neill and his team put forward the caveat that the BRICs will need “to maintain policies and develop institutions that are supportive of growth.” These entail “sound macroeconomic policies and a stable macroeconomic background, strong and stable political institutions, openness to international trade and financial markets, and high levels of education.”² A number of analysts consider the probability of these conditions being met to be remote. They point out that the political stability of China and Russia may be challenged by internal or external pressures stemming from their governments’ disregard for human rights, while the historically slow pace of economic reform in more democratic Brazil and India casts considerable doubt on both their macroeconomic stability and their openness or attractiveness to foreign direct investment.

Nevertheless, the transformation of these countries over the last fifteen years has been remarkable. At the end of the Cold War, predictions that the BRICs would overtake the West would have seemed absurd. Brazil, overburdened with government debt, suffered endemic high inflation and exchange rate fluctuations. Emerging from the central

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planning of the Soviet Union, Russia's inefficient, crime-fuelled economy proved to be smaller than that of Belgium. India labored under the socialist policies bequeathed by Jawaharlal Nehru and had a closed, mixed economy fabled for its inability to fulfill its growth potential. Finally, China was an autocratic pariah state under international sanctions following its brutal suppression of the student protests in Tiananmen Square. A decade and a half later, however, it is impossible to question the enormous economic potential of these states. Brazil has stabilized both the rate of inflation and the value of its currency and so is finally able to capitalize on its abundant raw materials, agricultural products and industrial manufacturing. Russia's economy, fuelled by the spike in oil prices, is restructuring itself to take advantage of its impressive human and natural resource capital stock. India capitalized upon its vast middle class to become the major destination for outsourced white collar jobs, while the owners of its vast protected industries have embarked on global expansion. As for China, the government's announcement in December 2005 that they had underestimated the size of the economy by 17% and that China's GDP was actually larger than Britain's was but one indication of its economic success. In response to this tectonic shift in the relative economic weight of the BRICs, an ever increasing share of jobs and foreign direct investment is flowing into these states. This suggests that amongst multinational firms and investors, at least, the "BRICs thesis" enjoys considerable credibility.

Projected Impacts on the EU and US

Where multinational firms and global capital see only an opportunity for profitable expansion and investment, however, *states* also see a potential threat to their relative power and the economic welfare of their citizens. This is particularly true of the US and the EU member states, which have dominated the global economy since the Industrial Revolution of the latter 18th century. While the rise of the BRICs presents enormous opportunities for mutually beneficial trade, it also poses two distinct challenges that may impact negatively on Western states.

The first challenge stems from the fact is that the participation of the BRICs in the global economy has added approximately 1.5 billion mostly unskilled workers to the global labor force. In turn, this has cut the global capital-labor ratio by close to 60%, with the result that there has been significant downward pressure on global wages, coupled with an increasing return to capital. This trend has been compounded by the ability of multinational corporations to deconstruct the production chain and outsource different segments of it to wherever it can be done most cheaply. In addition, it may not only be manufacturing wages that are being depressed. The BRICs are increasingly well endowed in human-capital stock and are consequently able to diminish the West's comparative advantage in services. This development has potentially vast implications for income distribution and popular support for economic openness on both sides of the Atlantic.

The second challenge is that the BRICs' rising share of global GDP will inevitably lead to a shift in the global balance of power. At best, the shift will be reflected in an

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increasing challenge to the West's dominance of the international monetary, financial and trading systems. At worst, it could increase the chance of an arms race fuelled by heightened competition for limited resources, such as hydrocarbons and fresh water, or by unresolved regional disputes like that over Taiwan. The former, and more likely, scenario is obviously of greater concern to the EU member states, which are already overrepresented in the institutions set up to regulate these systems in the aftermath of World War II. The latter scenario, by contrast, is most disquieting to the United States in its role as global hegemon.

There are indications that these challenges are already having an impact. In the first case, income inequality has recently increased in the majority of Western states. As a result, protectionist sentiments are on the rise on both sides of the Atlantic. This is most obviously illustrated in Europe by the French and Dutch rejections of the economically liberal European Constitutional Treaty in 2005, which survey respondents accused of being too liberal. Rising protectionism is also evident in the United States, where there is congressional nervousness over the American trade deficit and the purchase of major US companies by foreigners. In the second case, a challenge to Western economic dominance could already be discerned in the outcome of the Doha round of multilateral trade negotiations as compared to the Uruguay round which preceded it. During the Uruguay round, when the US and the EU finally reached an agreement in 1992, the rest of the participants were forced to accept the package as a *fait accompli*. In Doha, when the US and EU came to a similar agreement at Cancun in September 2003, a group of developing countries led by Brazil, China, India and South Africa were able to block the proposal.

The Cancun summit made the US and the EU acutely aware of the potential impacts the BRICs may have on their economic prosperity and institutional privileges. As a result, confronting the challenges presented by the BRICs probably dominates most other medium-term issues in transatlantic trade policy, and certainly dwarfs all bilateral disputes. In light of this, it might be expected that the two sides of the Atlantic have been attempting to converge on a common adjustment strategies and working to develop joint negotiating positions. Instead, precisely the opposite has happened.

Divergent Policy Responses

After the 2003 Cancun summit, the EU and the US realized that they would have to offer a greater incentive for the developing countries to sign on to a new deal. The most obvious was access to their highly protected and subsidized agricultural sectors. In return, however, they demanded greater market access for high-skill goods and services in the BRICs. Despite this common objective, however, the EU and the US were unable to agree on the exact formula for the *quid pro quo*. This resulted from the fact that, while the EU and the US are equally exposed to international trade (18.2% insertion into the global economy), they have quite different trade profiles.

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The EU

Accounting for 17.1% of global exports in goods and services and 17.8% of imports, the EU is the largest trader in the world and in 2004 was running a small trade surplus of \$80 billion. It is also the single largest trade partner of each of the BRICs – a fact that could grant a significant degree of leverage in trade negotiations. The EU, however, is constrained from using this leverage both domestically and internationally by its Common Agricultural Policy. On the one hand, there is a powerful agricultural lobby in Europe centered in France and Italy that opposes any major reductions in the high tariffs currently protecting domestically produced agriculture. On the other hand, the European Commission has sought to use the artificially high prices which result from these tariffs as a tool of development policy.³ In particular, the EU has long standing agreements with the African Caribbean and Pacific (ACP) country grouping that ensures their agricultural products have tariff free access to the EU market. Should the EU reduce its agricultural tariff to a country like Brazil – which has the third largest agro-industry sector in the world – the ACP producers market share would be wiped out by competition. In consequence, the EU is willing to make significant concessions to the BRICs on restricted market access for manufactures goods, if it can maintain an agricultural policy that meets its commitments both to the domestic farming lobby and to the ACP countries.

The US

While the US is responsible for 20.8% of global imports, it only accounts for 11.3% of global exports, which in 2004 translated into a trade deficit of \$ 597.5 billion. An increasing amount of this deficit is held by the BRICs, and, unlike the EU, the US has few preferential trade agreements with developing countries. The key priority for the US is to increase its exports in high-skill goods and services in order to reduce this vast deficit. For each dollar of agricultural subsidy it removes, it expects an equal reduction in the subsidies and/or tariffs protecting manufacturing and service markets in the BRICs. The US, therefore, had less incentive than the EU to compromise with the BRICs. They found the *quid pro quo* suggested by the EU unacceptable, and so negotiations ground to a standstill with little chance of recommencing in the near future.

The collapse of the Doha round has raised the possibility of an increasing proliferation of bilateral and regional agreements.⁴ In economic terms, this augurs fierce competition between the US and EU for preferential market access to swiftly developing economies. It will also, therefore, have political ramifications. One of the myriad benefits of multilateral tariff reductions is that they reduce the incentive for countries to use trade as a tool of foreign policy. The reverse is true of bilateral and inter-regional trade agreements. Consequently, the collapse of Doha also threatens to exacerbate transatlantic *strategic* differences on how best to accommodate the rising power of the BRICs. These differences can be characterized as follows:

1. **Brazil** is the country about which the US and EU have the least disagreement. With the third largest agro-business sector in the world, Brazil has an obvious

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- stake in accessing both American and European agricultural markets. However, as the least well-performing of the BRICs in terms of growth, Brazil offers only limited opportunities as an export market. What Brazil does have to offer is its influence as the largest member of MERCOSUR, the South American trade grouping.⁵ The US and EU have long competed for preferential access to this grouping – the US through the Free Trade Area of the Americas (FTAA) and the EU through an interregional free trade agreement. Neither attempts have been successful to date, but competition is likely to remain fierce.
2. **Russia:** For the EU, Russia is not only a vast, nuclear-armed neighbor, but also a critical supplier of energy, accounting for 40% of natural gas imports. Unsurprisingly, therefore, the EU has long sought to cement a solid economic partnership embodied in the Partnership and Cooperation Agreement (PCA) signed in 1994, which granted Russia “Most Favored Nation” status. The EU’s ability to negotiate a comprehensive agreement on trade and investment, however, has been recently hampered by the entrance of former Warsaw Pact states like Poland. In contrast, the US has traditionally sought to use the prospect of better economic relations and its veto over Russian entry into the WTO as tools to promote democratic and economic reforms. In an effort to dilute its energy dependence on the Middle East, however, the Bush Administration agreed in November 2006 to admit the Russia to the WTO. While this has realigned US economic strategy with that of the EU, the US in general has a more aggressive stance in regard to Russia, as demonstrated by Russian-US competition for basing rights and pipe line ownership in Central Asia.
 3. **India:** In the aftermath of Doha, the Indian trade minister Kamal Nath declared, “The US brought nothing to the table. They stuck to their old position. We will pursue our bilateral trade agreements. We are looking at, we are examining, economic co-operation agreements with the European Union.” Negotiations for the free trade agreement are due to commence in March. This, however, paints an over simplistic picture of transatlantic positions over India. While the EU has moved swiftly to cement the good economic relations in the aftermath of Cancun, the US sees India as a crucial strategic ally in its bid to contain the rising power of China. In March 2006, for example, the Bush administration agreed a controversial deal to provide India with nuclear technology in exchange for India opening its current nuclear facilities to inspection. Consequently, it is likely that the US will seek to bolster this strategic cooperation with bilateral trade agreements.
 4. **China** is probably the country about which the EU and the US have the largest number of disagreements. The US sees China as a major strategic competitor and the two states are involved in a military escalation over the issue of Taiwan. Increasingly, the US also views China as a damaging economic competitor, and the Bush administration has repeatedly criticized China’s trade policy as unfair. With the recent victory of the increasingly protectionist Democratic party in the

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US mid-term elections, the criticisms will only increase. The US is hampered in its ability to affect Chinese trade policy, however, by the fact that Chinese central bank holds \$600 billion in its foreign currency reserves. For the EU, in contrast, China represents an enormous opportunity. As the swiftest developing country, the Chinese market has a massive demand for machine making tools and transport infrastructure in which the EU has comparative advantage. Equally, China represents an enormous potential market for struggling European armaments companies. Indeed, in 2004 the French and German governments tried to lift the current EU arms embargo on China, but were met with stiff US resistance backed by the UK. This incident reflected the somewhat schizophrenic nature of the EU's attitude towards China. On the one hand, states like France and Germany see China as an inevitable emerging power in a multipolar world which should be accommodated as soon as possible. On the other, China's exports are imposing devastating competition on European manufacturing – particularly in countries like Italy.

What is clear from this overview is that the US and EU are allowing strategic considerations to determine their trade policies. The result is an increasingly fierce competitive pursuit of privileged market access. This not only distorts global patterns of trade, but also aggravates transatlantic policy divergences in other areas. Though the likelihood of a world divided into economic blocks is still slim, the lack of a common strategy for how best to respond to the economic and geopolitical challenges implicit in the rise of the BRICs may increase it. In other words, by pursuing divergent policies, the US and the EU risk unraveling the international economic order they have so painstakingly built since the end of World War II.

Conclusion

The big issue in transatlantic trade is no longer how Europe and America deal with one another, but rather how they respond jointly to the rise of BRICs. While there are good reasons to question the Goldman Sachs predictions on the future of the BRICs, their economic growth over the past 15 years has already had an impact on income distribution in Western states and the global balance of power – both economic and political. Faced with the challenge of absorbing these dynamic new economies into the global economy, the US and the EU have a vested interest in formulating joint strategies to mitigate the impact on their own citizens, as well as to capitalize on opportunities for mutually beneficial trade. Instead, the two sides of the Atlantic have allowed this issue to divide them and are now pursuing independent policies. The result has been that the BRICs economies themselves have a diminishing stake in abiding by the rules of the multilateral system. In response, they are deepening cooperation between themselves, and so strengthening their ability to challenge this system by playing the US and EU against each other. If the US and the EU do not reconcile their differences and confront these trends, they will only aggravate the already steep challenges these dynamic new economies pose.

¹ See Dominic Wilson and Roopa Purushothaman, *Dreaming with BRICs: the Path to 2050*. Goldman Sachs Financial Workbench, Global Economics Paper No: 99.

<http://www2.goldmansachs.com/insight/research/reports/99.pdf>

² *ibid.* pp. 2 & 14.

³ See brief in series “Transatlantic perspectives on trade and development”:

http://www.unc.edu/depts/europe/business_media/busbrief0705-development.htm

⁴ For more details, see brief in series “The Demise of Doha: the end of the multilateral trading system?”:

http://www.unc.edu/depts/europe/business_media/busbrief0705-doha.htm

⁵ MERCOSUR stands for Mercado Commun del Sur. Its members are Argentina, Brazil, Paraguay, Uruguay and Venezuela. Associate members are Bolivia, Chile, Colombia, Ecuador and Peru.