

**ESTEY CENTRE FOR LAW AND ECONOMICS IN INTERNATIONAL TRADE**

**Canada-Brazil Trade Relations:  
an expedited arbitral mechanism  
may be required to resolve the  
*WTO Aircraft from Brazil/Canada dispute***

**By**

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and  
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This study is dedicated to the memory of the late Mr.  
Justice Willard Z. Estey who, in March 2001,  
recommended that it be written, due in part to the disparate  
regional impact that this dispute may have across Canada,  
should it not be settled.

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## EXECUTIVE SUMMARY

Canada and Brazil are locked in a series of almost intractable trade disputes that have bedevilled the Brazil-Canadian trade relationship and can undermine the Free Trade Agreement of the Americas initiative. This study proposes that both countries abandon the "tit-for-tat" strategy they have pursued to date, and instead adopt a strategy of "forbearance". They should arbitrate on an expedited basis any challenge that a prohibited export subsidy has been offered by the other and do so before the contract is awarded. Arbitration is suitable in part because the issue to be determined is whether the government financing assistance conforms to rules established by the OECD. If not, the issue is whether the assistance is more favourable than the terms that can be obtained on the commercial market. The large number of specific transactions reviewed in the various panel reports confirms that an adjudicatory model is appropriate.

In August 2000, the WTO ruled that Canada could impose retaliatory tariffs of \$344.2 million per year. There is little trade between the two countries in commercial aircraft. This study finds that imposing punitive tariffs of 100 percent is counterproductive. Retaliation against imports from Brazil carries the risks that exports from Canada to Brazil will be "sideswiped". For example, Canada has significant exports of potash and sulphur to Brazil. When Canada placed a temporary ban on Brazilian beef imports, there was a severe reaction against Canada in the general public and in the newspapers in Brazil. They vociferously advocated boycotts of Canadian imports and even suggested action against Canadian firms located in Brazil. Potash sales were lost. Shortly thereafter, it withdrew its restrictions on Brazilian beef.

Wisely, Canada decided not to impose retaliatory tariffs against Brazilian imports notwithstanding WTO permission to do so. Instead of retaliation, Canada has followed a "tit-for-tat" strategy of offering export-financing subsidies that it claims "match" the Brazilian PROEX financing subsidies, most recently in sales to Air Wisconsin and Northwest Airlines. In its January 28, 2002 ruling, the WTO Panel found that Canada's provision of export financing of Bombardier's sale of regional aircraft to Air Wisconsin was a prohibited export subsidy. Canada has been given 90 days to withdraw its financing support, subject to its right of appeal. Brazil has not yet challenged similar financing to Northwest Airlines and it should be successful in a new WTO complaint should a settlement not be reached.

Both countries have now been found by WTO panels to have offered prohibited export subsidies. Brazil has been directed to remove subsidies in the amount of \$2.065 billion. Canada will likely be directed to remove subsidies of up to \$1.7 billion solely in respect of the Air Wisconsin transaction, once Brazil applies to the WTO for permission to take retaliatory action against Canada. It is unlikely that either nation will comply, given the contractual obligations that they and Bombardier and Embraer have entered into with their customer airlines.

This “tit for tat” strategy does not serve Canada well. The festering trade dispute with Brazil harms Canada's international reputation as it has engaged in a “self help” remedy in a manner frowned upon by the multilateral trade community. It can cast a shadow on upcoming negotiations for a Free Trade Agreement of the Americas at a time when the crisis in Argentina may strengthen Brazil's bargaining position through an invigorated Mercosur Customs Union. It may become another factor encouraging Brazil to pursue its free trade negotiations with the European Union as a counterweight to NAFTA influence in the region. Canada and Brazil should consider that it is in their interest to settle because the regional jet aircraft market may soon no longer be a “two-party” game as a result of new entrants. An unrestricted “battle of treasuries” may be counterproductive if the European Union and/or Boeing with Ilyushin become competitors.

An agreement with Brazil to arbitrate disputes on a case-by-case basis would be superior to any other strategy the two countries can adopt. Under this mechanism, each country can challenge financing assistance offered before contract negotiations are concluded. The WTO panel reports have determined that challenges must be made on a case-by-case basis and have applied rules established by the OECD placing limits on government offers of financial assistance. Canada has stated that its objective is to ensure that Brazil adheres to these rules. Rules relating to production of documents would address Brazilian claims that Canada has not been forthright in its disclosure of details of government assistance. The adherence to the OECD rules by both nations would encourage new entrants to do likewise and avoid a debilitating subsidies war benefiting only the airlines playing one manufacturer off against the other.

If this solution is adopted, Brazil and Canada could then ignore the existing prohibited export subsidies that they have extended to date, roughly in the amount of \$2 billion each.

*“Se quiserem guerra, guerra é guerra,” Fernando Henrique Cardoso<sup>1</sup>*

## I. INTRODUCTION

Canada and Brazil are struggling with the issue of how to resolve the intractable series of *Aircraft from Brazil/Canada* disputes that have bedevilled Brazil-Canadian trade relationship and can undermine the *Free Trade Agreement of the Americas* initiative (“FTAA”) intended to be completed by 2005. Brazil, augmented by the Mercosur Customs Union,<sup>2</sup> is at best a reluctant participant in the FTAA negotiations, and one that is courting the European Union in free trade negotiations as a counterweight to the fear of North American dominance in the region.<sup>3</sup> The recent financial crisis within Argentina appears to be strengthening Mercosur, with Argentina turning to Brazil as one of its major export market.<sup>4</sup> Canada should be concerned that the continuance of the *Aircraft from Brazil/Canada* dispute will represent an important trade irritant for an invigorated Mercosur. Canada is placing its exports to the region at risk, either by institutional retaliation through the imposition of punitive tariffs or by popular revolt, as occurred in

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<sup>1</sup> “If they (Canada) want war, war is war.” *Fernando Henrique Cardoso*, President of Brazil. *Guerra é Guerra, avisa FHC*, *Economia, Comercio exterior*, O Estado de s. Paulo, February, 2001

<sup>2</sup> Founded in 1991, including Brazil, Argentina, Uruguay and Paraguay.

<sup>3</sup> *Ibid.*, at 95

<sup>4</sup> *Argentina’s Crisis, Harsh Realities*, *The Economist* Jan 26<sup>th</sup>-Feb 1<sup>st</sup>, 2002, at 34. Not all commentators agree that Mercosur will be strengthened. Inside U.S. Trade reports in an article, *Argentine Crisis Clouds Long-term FTAA Forecast, Won’t Delay Start*, (January 18<sup>th</sup>, 2002 [www.insidetrade.com](http://www.insidetrade.com)):

But one private-sector source said that the limited success of Mercosur so far cannot be blamed on asymmetrical currencies alone, and was also due to the large number of exclusions and underlying problems with that agreement itself. This source said the more important export markets for Argentina remain the U.S. and European Union and Argentina must continue to focus on agreements that will lead to increased access to those markets.

January-February 2001 during the “beef war”. This dispute is also tending to undermine an important opportunity to promote hemispheric integration.

Canada and Brazil have announced that they will meet in New York City on February 8, 2002 to attempt to settle the dispute. WTO dispute settlement panels have ordered that Canada and Brazil remove prohibited export subsidies that have been extended in various sales contracts.<sup>5</sup> This is not practicable as the contracts have been signed and any attempt to claw back the subsidies will likely place both countries in breach of contract. Not surprisingly, Canada has hinted that it might “allow” Brazil to leave the existing subsidies in place, probably in return for a similar indulgence. This will not settle the on-going dispute as both parties are reported to be more than willing to continue offering strong government support.<sup>6</sup> If history is any guide, a solution may prove elusive if the parties attempt to negotiate bright line rules that will prevent what each party considers to be “cheating” by the other. Sadly, the development of new legal rules tends to increase the number of legal proceedings and not reduce them. We believe that the creation of an expedited arbitral process that can evaluate subsidy offerings while contract competitions are still open should be considered as a term in settling this and similar disputes.

Bombardier and Embraer compete in the regional aircraft market which includes commercial aircraft of fewer than 100 seats. Both are considered key national champions in a critical high technological sector. Three-quarters of Bombardier’s profits are reported to come from the aerospace division.<sup>7</sup> The importance of Bombardier is underscored by a variety of studies that have highlighted the underdeveloped nature of Canada’s high technology sector.<sup>8</sup> Embraer was Brazil’s largest exporter in 1999 (representing 3.5% of

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<sup>5</sup> The WTO panel determination in *Canada-Export Credits and Loan Guarantees for Regional Aircraft*, WT/DS222/R, released on January 28<sup>th</sup>, 2002, that Canada must remove the subsidies extended to Air Wisconsin, is still subject to an appeal by either Canada or Brazil.

<sup>6</sup> *Ottawa puts brave face on WTO Ruling*, The Globe and Mail, Jan 29<sup>th</sup>, 2002, B6, *Brazil-Export Financing Programme for Aircraft, Recourse to Arbitration by Brazil under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement*, WT/DS46/ARB 28, August 28<sup>th</sup>, 2000, para 5.189 (“Article 22.6 Panel Report”)

<sup>7</sup> “Accentuate the positive”, The Toronto Star, February 3<sup>rd</sup>, 2002, C1 at C3

total exports),<sup>9</sup> and its importance is underscored by WTO concerns regarding Brazil's ability to finance its current account deficit.<sup>10</sup> The importance of Embraer is reflected in the difficult transition that Brazil is making from an industrial policy based on the traditional Latin American model of import-substitution, to a more open economy putting its relatively inefficient industrial structure under greater import pressure. Both Canada and Brazil view their national champions as important contributors to the development of high technology clusters and important sources of national competitive advantage.<sup>11</sup>

On August 28, 2000, *WTO Dispute Settlement Mechanism*<sup>12</sup> ("WTO DSM") panel confirmed Canada's entitlement to impose retaliation on Brazil in the amount of \$344.2 million per year. Canada refrained from doing so, in an apparent recognition that the imposition of punitive tariffs of one hundred percent on imports from Brazil would have little if any impact on Brazil's motivation to modify the PROEX program. Canada imports from Brazil goods amounting to approximately \$1.5 billion per year, the majority being primary materials or low-technology goods. The elasticity of the goods involved indicates that the imposition of retaliatory tariffs would depress, if not eliminate, bilateral trade in the goods subject to the tariffs.

Canada's decision not to retaliate may have been also based on the popular revolt that took place in January-February, 2001, when Canada imposed a ban on Brazilian beef.

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<sup>8</sup> One of the more recent is Roger L Martin and Michael E. Porter, *Canadian Competitiveness: A Decade after the Crossroads*, C.D. Howe Institute, Working Paper 2001-1

<sup>9</sup> *Trade Policy Review, Brazil 2000*, World Trade Organization, Geneva, Dec. 2000, at 93, para 67.

<sup>10</sup> *Ibid.*, at 15, para 37

<sup>11</sup> The Canadian aircraft sector is described by the Federal Government as a "vitally important incubator of advanced technologies, bringing together a critical mass of Canadian firms that are helping to build a future economy based on high-technology, valued-added products." The sector is cited as spending more than \$700 million in 1999 on research and development and investment in plants and equipment reaching \$850 million in the same year. *Canada Ready to Match Brazilian Financing Terms to Preserve Aircraft Jobs*, January 10<sup>th</sup>, 2001, Department of Industry Press Release.

<sup>12</sup> *Article 22.6 Panel Report, op cit. supra*, Note 6

Brazilian newspaper reports at the time reported that purchasing agents were cancelling orders of Canadian products and replacing them with alternative sources. For example:

“The first reaction will be in the agricultural sector because everything that Canada exports to Brazil can be substituted by other suppliers. The structure of bilateral commerce is clear: retaliation will be more negative for Canada than for us. There is no doubt that Brazilian enterprises will import from other suppliers. This Canadian action is infantile and the cost will be paid by the Canadian consumer and by Canadian enterprises that will lose business in Brazil.” *Pratini de Moraes, Agricultural Minister of Brazil.*<sup>13</sup>

The reaction to Canadian goods might have been limited solely to Canadian exports to Brazil if the dispute had continued, as Canadian investments in Brazil were also targeted:

“We will likely encourage the population not to buy lines or utilize the services of Vesper, a Canadian enterprise in the Brazilian telephone sector.” *Edwaldo Sarmento, Director and President of the Syndicate of Industries, Telecommunication Systems of the State of São Paulo*<sup>14</sup>

The intensity of the popular reaction in Brazil caught many Canadians by surprise. The result was that certain Canadian products were side-swiped by the Canadian ban on Brazilian beef, including potash exports. The boycott of Canadian potash indicates a particular vulnerability to Brazilian trade action, as the boycott was not necessarily due to government action but a rejection of Canadian product at the farm gate. This reaction suggests that aggressive trade action by Canada has the potential to result in a popular rejection of Canadian goods, should it retaliate against Brazilian imports in a manner that effectively shuts off the Canadian market. It is notable that beef products, among a number of agricultural products, are included in the target list of potential Brazilian imports that might be subjected to the punitive tariff that Canada published in the Canada Gazette in May, 2000.

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<sup>13</sup> “Brasil vai reagir a retaliações do Canadá”, *Gazeta Mercantil – Terça-Feria Jan 23<sup>rd</sup>, 2001*,

<sup>14</sup> “Comércio veta os produtos do Canadá”

Instead of imposing punitive tariffs, Canada claims to have matched what it perceived to be non-compliant subsidies under the PROEX program. It did so on two occasions: the sale of seventy-five aircraft to Air Wisconsin in January, 2001; and the sale of up to 150 aircraft to Northwest Airlines in July, 2001. Engaging in a “matching” strategy may well prove detrimental to Canada’s reputation before the multilateral trade community, as it represents the kind of self-help remedy said to threaten viability of the WTO dispute settlement mechanism. A more tangible result is that Brazil may soon be placed in a position to retaliate against Canada by imposing tariffs on Canadian imports, including potash and sulphur. In the *Canada-Export Credits and Loan Guarantees for Regional Aircraft* panel report released on January 28, 2002,<sup>15</sup> the WTO Panel determined that Canada extended prohibited export subsidies on occasion since 1996, but most notably when it offered the “matching” subsidies to Air Wisconsin.<sup>16</sup> Subject to an appeal, Canada has been given 90 days to remove the subsidies, said to constitute \$1.7 billion in financing, which will likely prove impossible due to the contractual obligations that Canada and Bombardier entered into at the time. Brazil is also in a position to commence a new WTO complaint that undoubtedly will find that prohibited export subsidies were provided to Northwest Airlines. Canada will then have “lost” two panel determinations and the score will be five to two, if keeping score serves any purpose.

The question arises as to what strategy Canada should adopt in trying to resolve this seemingly intractable dispute. In this study, we identify three strategies:

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<sup>15</sup> Canada –Export Credits and Loan Guarantees for Regional Aircraft, WT/DS222/R, Jan 28<sup>th</sup>, 2002, hereinafter “*Canada-Export Credits*”

<sup>16</sup> *Ibid.*, Para 8.1 “In conclusion we: ...

- (e) uphold Brazil’s claim that the EDC Canada Account financing to Air Wisconsin constitutes a prohibited export subsidy contrary to Article 3.1(a) of the *SCM Agreement*;
- (f) uphold Brazil’s claim that the EDC Canada Account financing to Air Nostrum constitutes a prohibited export subsidy contrary to Article 3.1(a) of the *SCM Agreement*;
- (g) uphold Brazil’s claim that the EDC Corporate Account financing to Comair in July 1996, August 1997 and February 1999 constitutes a prohibited export subsidy contrary to Article 3.1(a) of the *SCM Agreement*.”

- (a), a policy of forbearance by which Canada and Brazil refrain from retaliation and implement an institutional solution that adjudicates allegations of improper subsidization on an expedited basis;
- (b), Canada and Brazil enter into an unrestricted bidding war for each new contract; or
- (c), Canada and Brazil impose retaliatory, punitive tariffs on one another.

With respect to the institutional solution, the various WTO panel and appellate body determinations that have been issued in this dispute have established that the major government support programs of each country (Brazil-PROEX, Canada – the Canada Account, Export Development Corporation financing) have been modified in a way that they have been found compliant “as such” with the *World Trade Organization Agreement on Subsidies and Countervailing Measures*, (“SCM Agreement”).<sup>17</sup> Canada and Brazil must challenge each offer of support on its terms as to whether it confers a “benefit” to the customer airline contingent upon export performance. It will be difficult if not impossible to develop “bright line” rules of general application, beyond those already included in the *OECD Arrangement on Guidelines for Officially Supported Export Credits* (“OECD Arrangement”).<sup>18</sup> Both governments have demonstrated significant creativity and “flexibility of thought” in crafting new offers of support.

An arbitral mechanism should be able to determine the consistency of a specific offer of financing before the contract is awarded. The determination made in *Canada-Export Credits* suggests that Canada learned of the Brazilian offer in October, 2000, and “matched” it on May 10, 2001.<sup>19</sup> A period of seven-eight months should be sufficient to for an arbitral panel to determine whether the government offer of financial assistance

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<sup>17</sup> *World Trade Organization Agreement on Subsidies and Countervailing Measures*, (“SCM Agreement”), April 15, 1994, Marrakesh Agreement Establishing the World Trade Organization The Legal Texts – The Results of the Uruguay Round of Multilateral Trade Negotiations 264 (1994)

<sup>18</sup> *Brazil – Export Financing Programme for Aircraft, Second Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW/2, July 26<sup>th</sup>, 2001 para 5.67, at pg 23, ( “*Second Recourse by Canada Panel Report*”)

<sup>19</sup> *Canada-Export Credits*, *op cit. supra*, Note 15., at para 7.137 at 35

exceeds those available on the commercial market. Obviously, the arbitral determination should be binding on the parties either directly by enjoining the provision of non-compliant support, or enforceable in the ordinary course through the *WTO* Dispute Settlement Mechanism. This solution should also address allegations made recently by Embraer officials that Canada cannot be trusted to make full disclosure of its support programs in negotiations to resolve the dispute.<sup>20</sup> An expedited arbitration process should require disclosure of information relating to alleged subsidy programs, failing which an appropriate adverse inference might be drawn against the party failing to produce clearly relevant information.

A competition of “matching subsidies” or entering into a bidding war is a “tit for tat” strategy that takes the form of an iterative prisoner’s dilemma. Game theory provides support for such a strategy in the context of export subsidies. However, there are a number of problems with the application of game theory in this context. First, it oversimplifies the nature of the dispute, assuming the each government is a single “rational actor” that has complete knowledge of the options available and a prescient ability to forecast the utility-maximizing alternative. Graham T. Allison explains the manner in which the “rational actor” model underlies game theory and neoclassical economic theory.<sup>21</sup> He provides two alternative models based on the organizational and political aspects of governmental decision making in international conflicts or crises. These alternative models highlight the importance of institutional and business elites within Canada and Brazil in the decision process to provide on-going financial support and in fashioning a response to threats of retaliation.

The imposition of retaliatory, punitive tariffs is the least attractive solution. An analysis of the performance of the dispute settlement mechanism since the implementation of the

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<sup>20</sup> It has been alleged that Canadian government officials have not been forthcoming with information relating to various government programs that Brazil has alleged constitute WTO-illegal export subsidies. “*Ottawa can’t be trusted in jet talks: Embraer executive*”, *Financial Post*, Jan 24<sup>th</sup>, 2002, at FP5

<sup>21</sup> Graham T. Allison, *Essence of Decision, Explaining the Cuban Missile Crisis*, 1971, Little, Brown and Company, Boston

*WTO Uruguay Round Agreements* in 1995, suggest that retaliation has played little, if any, role in achieving compliance. A total of eighty-four panel reports have been adopted, along with thirty appellate reports. Only six disputes have reached the stage of an Article 22.6 panel determination authorizing a particular level of retaliation to be taken, through the imposition of punitive tariffs or the withdrawal of other obligations under the *WTO Agreements*. Three have resulted in the imposition of punitive tariffs and only in one case<sup>22</sup> has a settlement been reached, but only after the tariffs were in place for two years and it is unclear to what degree they contributed to the eventual settlement. In all three cases, the punitive tariffs appear to have been seen as a cost of doing business, justifying the continuation of the non-complying measure that gave rise to the dispute. The factor that appears to have resulted in compliance is not the threat of the imposition of tariffs, but the pressure brought by the multilateral community through the ongoing scrutiny of measures taken by the responding nation on a regular basis, pursuant to the review procedures of the WTO Dispute Settlement Mechanism.

The importance of pressure from the international community points to an important benefit of an expedited arbitral process that takes place *before* the government financing has been extended. It should help each government to answer its own constituencies in resisting pressure to take a position that is contrary to the rules of international trade. A relatively quick decision that a particular subsidy package is “offside”, presumably should allow the Canadian and Brazilian governments to withdraw, or at least modify, the financing terms. The existing provisions of the *OECD Arrangement*<sup>23</sup> will likely provide the legal rules to be applied for the expedited arbitral process, as it was reviewed extensively by the WTO panels convened in this dispute in defining the limits of the “safe haven” recognized by the *WTO SCM Agreement*.<sup>24</sup> This result should be attractive

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<sup>22</sup> *E.U. - Regime for the Importation, Sale and Distribution of Bananas* (WT/DS 27), April 9<sup>th</sup>, 1999

<sup>23</sup> *Brazil – Export Financing Programme for Aircraft, Second Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW/2, July 26<sup>th</sup>, 2001 para 5.67, at pg 23,

<sup>24</sup> The “safe haven” is found in item (k) of the Illustrative List of Export Subsidies set forth in Annex 1 of the *SCM Agreement*. *Canada – Export Credits*, *op cit supra*, note 15, paras 7.138-9 and 7.159

to Canada as the Department of Foreign Affairs and International Trade have stated that Brazilian adherence to the *OECD Arrangement* as its chosen “end game”.

In this study, it is suggested that forbearance is a superior strategy to a policy of “matching subsidies”, while the application of punitive duties is the least attractive option of the three. We start our analysis with a review of the political and economic circumstances in Brazil to place the *Aircraft from Brazil/Canada* dispute in context. The PROEX program is analyzed in the light of Brazilian economic circumstances, to demonstrate the importance of Embraer exports in helping to finance Brazil’s current account deficit through export performance. The current status of the dispute is then analyzed along with the three options outlined above. The theory underlying the concept of retaliation in trade disputes is presented, along with a discussion of the strategic factors that are important in the success of the form of retaliation under review. The case for an arbitral mechanism is discussed in the context of the “forbearance option” and its structure and design are considered.

Changes may soon take place through new entrants to the market that may highlight the need to settle this dispute. Europe-based Fairchild Dornier is reported to be “among two or three aircraft manufacturers with plans to get into the regional jet business.”<sup>25</sup> Boeing had announced a joint venture with the Ilyushin and Sukhoi aircraft manufacturers to consider building regional jet models seating up to 100 passengers, in direct competition with Embraer and Bombardier.<sup>26</sup> It is unclear the degree to which the events of September 11<sup>th</sup> will delay plans. Canadian and Brazilian officials should no longer view the regional jet aircraft market as a two-party competition, with new and deeper pockets on the horizon. They have an opportunity now to establish a new institutional mechanism that may be used to settle the multi-party contract competitions that may be on the horizon.

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<sup>25</sup> “Accentuate the positive”, The Toronto Star, February 3<sup>rd</sup>, 2002, C1 at C3

<sup>26</sup> “Boeing Wants More Russia Cooperation ,” August 18, 2001, [http://money.iwon.com/jsp/nw/nwdt\\_rt\\_top.jsp?cat=TOPBIZ&src=202 &section=news&news\\_id=reu-155964&date=&alias=/alias/money/cm/nw](http://money.iwon.com/jsp/nw/nwdt_rt_top.jsp?cat=TOPBIZ&src=202 &section=news&news_id=reu-155964&date=&alias=/alias/money/cm/nw)

## II. UNDERSTANDING BRAZIL

Brazil is a country of extremes in the midst of a political and economic experiment. Brazil ranks among the top twenty nations economically with a GDP of \$800 billion U.S. and a population of 163.9 million,<sup>27</sup> one-quarter of which live below international poverty levels, without access to adequate food, health, education and employment.<sup>28</sup> The United Nations' 1999 report on the human development index showed Brazil falling from sixty second to seventy-ninth overall.<sup>29</sup> It is a nation in a state of transition, emerging from its latest military dictatorship in 1985.<sup>30</sup>

Throughout the postwar period, Brazil followed the import substitutional strategy that was prevalent throughout Latin America. It maintained high tariffs and other non-tariff barriers to protect domestic industry from foreign competition.<sup>31</sup> The government played a leading role in organizing marketing cartels in a number of key commodities and created new state enterprises.<sup>32</sup> This resulted in the development of an inefficient manufacturing sector, with relatively poor access to technology.

After the election of Fernando Collor in March 1990, the first elected president since the fall of the military dictatorship,<sup>33</sup> Brazil began a denationalization program.<sup>34</sup> This

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<sup>27</sup> <http://www.ibge.gov.br/english/estatistica/economia/contasnacionais/vol1/tab5.shtm>, last visited August 17<sup>th</sup>, 2001

<sup>28</sup> Thomaz Guedes da Costa *Brazil in the New Decade, Searching for a Future*, The Centre for Strategic and International Studies, September 2000,

<sup>29</sup> *Ibid.*, at 1. Seventy-seven percent of Brazilian households boast running water while only 40.7 percent have sewers. *Ibid.*, at 12

<sup>30</sup> *Ibid.*, at 5

<sup>31</sup> *Ibid.*, at 10

<sup>32</sup> *Ibid.*

<sup>33</sup> *Ibid.*

<sup>34</sup> *Ibid.* at 15. In the first phase, denationalization occurred in such sectors as steel, fertilizer, and petrochemical industries through the acceptance of cash and public debt certificates as payment, for revenues of U.S. \$4 billion until 1992. The program entered a second phase in which restrictions were withdrawn that prohibited foreign investors. By December 1998, total sales

involved a move from its import substitutional model and policy of market management to “an outward-oriented, market-driven economy, supported by disciplined financial policies.”<sup>35</sup> Regional integration also became a key ingredient of the adoption of a more open trade environment with the formation of Mercosur in 1991, comprised of Brazil, Argentina, Paraguay, and Uruguay.<sup>36</sup> It has since been augmented by a free trade agreement with Chile in June 1996,<sup>37</sup> and Bolivia in December 1996.<sup>38</sup> The Mercosur nations and Chile represent more than 59 percent of Latin America and the Caribbean gross domestic product, with Brazil alone accounting for 37 percent.<sup>39</sup> A corridor runs through Mercosur plus Chile that includes twenty large cities, with seventy million urban consumers having a per capita income of approximately US \$10,000.00.<sup>40</sup>

It has been suggested that Mercosur remains the most important trade initiative on Brazil’s international affairs agenda, having a “huge impact on government ministries in mobilizing ideas and resources.”<sup>41</sup>

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revenue amounted to \$68 billion with participation of foreign investors up to \$28 billion. Canada’s participation was limited mainly to the telecommunications sector in which Canada invested \$640.7 of the total \$661.7 billion that Canada instead in the program. *Ibid.*, at 16, Table 3.4

<sup>35</sup> *Trade Policy Review, Brazil 2000, op cit., supra*, Note 9, at 1, para 1

<sup>36</sup> Sidney Weintraub, *Development and Democracy in the Southern Cone, Imperatives for U.S. Policy in South America*, the Centre for Strategic and International Studies, February 2000, at 1. It follows on two earlier failed attempts at regional integration involving *Latin American Free Trade Agreement* (“LAFTA”) reached in 1960 with the goal of reaching free trade over a twelve year period. *Ibid.*, at 8. In 1978, the Treaty of Montevideo restructured the agreement into a new organization called the *Latin American Integration Association* (“ALDI”), at 8. The agreement was flawed because it only required the parties to follow the rules to the degree possible.

<sup>37</sup> *Trade Policy Review, op cit., Supra*, Note 9 at 21. The *Mercosur – Chile Free Trade Agreement* will involve free trade for at least three quarters of its tariff lines by January 2006 and free trade for all tariff lines by 2014 .

<sup>38</sup> Robert Bouzas, *Mercosur’s External Trade Negotiations: Dealing with a congested Agenda*, published in Riordan Roett, *Mercosur, Regional Integration World Markets*, Lynne Rienner Publishers, Inc., 1999, 81-93, at 83

<sup>39</sup> Weintraub, *op cit., Supra*, Note 36, at 1.

<sup>40</sup> Felix Pena, *Broadening and Deepening: Striking the Right Balance*, published in Riordan Roett, *op cit., supra*, Note 38, 1999, 49-61, at 54.

<sup>41</sup> Da Costa, *op cit., Supra*, Note 28, at 22.

The Mercosur initiative is a gamble made by the Brazilian government and people, and the political consequences, both internally and externally, are significant.<sup>42</sup>

And further,

For Brazilian policymakers, the images of successful trade integration in the European Union and a history of unsuccessful schemes for commercial integration in Latin America instilled a sense of urgency to explore the possibility of a free trade zone with Argentina. Other forces pushing the Brazilian desire for Mercosur included the idea that the new trade area would function as a springboard to improve Brazilian businesses' competitiveness and production scale and that Mercosur would function as a negotiating platform to expand Brazil's political presence in global disputes on trade and investments, most notably to generate a counterweight on issues advanced by the United States.<sup>43</sup>

Mercosur is a large regional market providing a degree of insulation which Brazilian industries can use to adapt to international competition. It was established with the objective of creating a common market with the free movement of goods, services and persons by the end of 1994.<sup>44</sup> The parties later agreed to a customs union in 1995 with the introduction of a Common External Tariff ("CET"), with the full customs union being delayed until 2006.<sup>45</sup> Most tariffs between members were removed on January 1<sup>st</sup>, 1995, with 85 percent of intra-trade becoming duty free.<sup>46</sup>

While it has been suggested that market liberalization was practically the only major industrial policy initiative from 1990 through 1994,<sup>47</sup> the Mexican financial crisis of late

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<sup>42</sup> *Ibid.*

<sup>43</sup> *Ibid.*, at 8

<sup>44</sup> *Trade Policy Review, op cit., Supra*, Note 9, at 20

<sup>45</sup> Lia Valls Pereira, *Toward the Common Market of the South: Mercosur's Origins, Evolution, and Challenges*, published in Roett, *op cit., Supra*, Note 38, pp 7-23 at 11.

<sup>46</sup> *Trade Policy Review, op cit., Supra*, Note 9.

<sup>47</sup> Pedro da Motto Veiga, *Brazil in Mercosur: Reciprocal Influence*, Roett, *op cit., Supra*, Note 38, pp 25-33, at 27.

1994 marked a period of partial reversion of market liberalizing activities.<sup>48</sup> The crisis led to the implementation of the “Real Plan” fiscal measures in 1995 that stabilized the Brazilian economy, reduced inflation, but increased the Brazilian exchange rate. This had the effect of placing Brazil’s industrial sector under increasing international competition which, in turn, led to a resurgence of protectionist pressure.<sup>49</sup> The impact of the crisis on trade strategy was then exacerbated by the Russian moratorium on debt repayment and the Asian financial crisis that occurred in 1998. These crises generated a large capital flight from emerging markets requiring Brazil to further raise short-term interest rates<sup>50</sup> and undertake a tightening of the fiscal regime.<sup>51</sup> In mid-January 1999, Brazil was forced to adopt a flexible exchange rate regime which led to depreciation in its currency, the Real, by thirty percent versus the American dollar. It contributed to a substantial decrease in Brazil’s trade with its Mercosur partners in 1999.<sup>52</sup> The cost of credit remains high notwithstanding that Brazil has been able to gradually reduce interest rates since the financial shocks of 1997-8.<sup>53</sup>

The result was a worsening of the Brazilian current account and trade balance through 1999, when capital flows were negative notwithstanding a substantial increase in foreign

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<sup>48</sup> *Ibid.*, at 28-9

<sup>49</sup> *Ibid.*

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Brazilian Rates:	1995	1996	1997	1998	1999.
Savings	39.74	16.34	16.55	14.43	12.24
Deposits (90 days to 1 yr)	n.a.	26.18	23.86	26.21	24.71
Lending (90 days to 1 yr)	154.51	74.12	61.59	64.69	61.36

*Trade Policy Review, op cit., supra*, Note 9, at Table 1.1, at 3

<sup>51</sup> *Trade Policy Review, op cit., supra*, Note 9, at 5.

<sup>52</sup> *Ibid.*, para 35, at 12.

<sup>53</sup> *Trade Policy Review, op cit., supra*, Note 9, at 2.

	1995	1996	1997	1998	1999
Consumer Price Index (ICPA)	66.0	15.8	6.9	3.2	4.9

direct investment. The deterioration in the terms of trade,<sup>54</sup> led to a dampening of export activity.

**TABLE ONE**  
**BRAZILIAN BALANCE OF PAYMENTS 1995-1999** (US \$millions)<sup>55</sup>

	1995	1996	1997	1998	1999
Overall balance	13,479	9,016	- 7,846	-17,284	-10,739
Current account balance	-17,973	-23,142	-30,909	-33,615	-24,379
-Trade balance	-21,973	-26,042	-33,125	-35,394	-26,419
- Merchandise Trade bal.	- 3,352	- 5,599	- 6,846	- 6,593	- 1,207
-Exports f.o.b.	44,506	47,747	52,994	51,140	48,011
-Imports f.o.b.	49,858	53,346	59,840	57,773	49,218
- Services	-18,595	-20,443	-26,279	-28,801	-25,212
Capital account balance	29,359	33,958	25,974	20,197	13,805
Terms of Trade <sup>56</sup>	95.5	105.8	100.0	98.4	85.6

The combination of these various shocks to the economy led Brazil to begin to modify its market liberalization strategy. In 1995, Brazil began a limited process of managing imports, largely through increasing tariffs, to avoid a significant depreciation in the balance of trade, which ran a deficit for the first time that year after more than a decade of positive balances.<sup>57</sup> Brazil also introduced new government programs to provide incentives for investment and public financing (including subsidies) for export promotion.<sup>58</sup> Brazil increased the CET by three percentage points in 1997, which contributed to an increase in the average MFN tariff rate to 13.7 percent,<sup>59</sup> with an

<sup>54</sup> The decrease in the terms of trade resulted from an increase in international oil prices while the price of commodity exports remained depressed. *Ibid.*, at 7

<sup>55</sup> *Ibid.*

<sup>56</sup> 1987 = 100, US\$ based.

<sup>57</sup> Veiga, *op cit.*, *supra*, Note 47, at 28

<sup>58</sup> *Ibid.*, at 28

<sup>59</sup> *Trade Policy Review, op cit.*, *supra*, Note 9, at 26.

applied MFN tariff of 12.6 percent for agricultural goods and of 13.9 percent for manufactured goods.<sup>60</sup>

The WTO, in its Trade Policy Review of Brazil published in 2000, noted that a concern of Brazilian authorities is Brazil's ability to finance its current account deficit. FDI flows have covered the deficit but these flows may decrease as the process of privatization that has been underway is completed. As a result, the authorities perceive the need to improve export performance, to narrow the trade deficit, and perhaps even to move it into surplus.<sup>61</sup> The government had set a target of exporting \$100 billion by 2002, which is more than twice its 1999 level of \$48.1 billion.<sup>62</sup> The target becomes more significant when one considers that of the four million businesses in Brazil, less than one half of one percent export and 90 percent of exporting income is concentrated in eight hundred businesses.

The balance of payments will be the factor to monitor for signs of a policy shift. As payments for the denationalization program approach deadline (as there are fewer enterprises to privatize) and the balance of trade continues to be negative the balance of payments will be a key indicator of Brazil's ability to sustain a favourable environment for foreign direct investment and open trade policies. As long as Brazil is able to sustain a positive perspective in attracting capital investment and income, internal popular demands of consumers and producers regarding the pace of opening Brazil's economy can be satisfied by the Central Bank's instruments to manage a favourable cash flow and its ability to meet foreign payment commitments. If the trends increasing the stock of external public and private debt and diminishing liquid foreign reserves (in the end of the period), pressure will increase to shift the picture of the balance of payments with protectionist measures.<sup>63</sup>

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<sup>60</sup> *Ibid.* at 31 The tariff shows a clear escalation, with a higher tariff average on processed items than on semi-processed goods and raw materials. This pattern holds for all industries with an average tariff rate of 15.8 percent on finished goods, 11.9 percent on semi-processed goods and 8.9 percent on raw materials.

<sup>61</sup> *Trade Policy Review, op cit., Supra*, Note 9, at 15, para 37

<sup>62</sup> da Costa, *op cit., Supra*, Note 28, at 21.

<sup>63</sup> *Ibid.*, at 31.

Now the importance of Embraer and the aircraft industry becomes evident. In the context of Brazil's economic and political environment, Embraer is a powerful national symbol, becoming Brazil's largest exporter in 1999, representing 3.5% of total Brazilian exports.<sup>64</sup> It is Brazil's largest aircraft manufacturer having been founded as a government company in 1969.<sup>65</sup> It helps support a cluster of 500 companies employing 50,000 people. It holds a 45% market share in the regional jet market and 24% of the 20-40 seat market segment.<sup>66</sup> By June 2000, the company held an order book of US\$21 billion of which US\$8.6 billion were firm orders.<sup>67</sup> Its exports in 1999 amounted to US\$1.7 billion, representing 95% of the company's revenue (up from 63.1% in 1994). It provided a net foreign exchange contribution (after deducting imports and PROEX payments) of U.S.\$647 million. The aircraft industry in Brazil is considered to be its most dynamic export sector with its 1995 to 1999 performance as follows:

**TABLE TWO,  
BRAZILIAN AIRCRAFT SECTOR EXPORTS (U.S. million)**

<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>
283.8	681.0	1,159.0	1,771.8 <sup>68</sup>

The political and economic importance of EMBRAER to Brazil is reflected in the allocation of financial support through PROEX. The program was established in 1991, with the objective of increasing Brazilian exports by facilitating access to export financing especially in respect of goods that require medium- to long-range financing.<sup>69</sup> The importance of the program is reflected in its timing early in the adoption of a more

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<sup>64</sup> *Trade Policy Review, Brazil 2000, op cit., Supra, Note 9, at 93, para 67.*

<sup>65</sup> *Ibid.*, at 92, para 64-6. The company is now controlled by a Brazilian investment conglomerate, Bozano, Simosen Group and its two largest pension funds, Sistel and Previ. In 1999, it formed strategic alliances with the main French Aerospace companies (Aerospatiale-Matra, Dassault Aviation, Snecma, and Thomson-CSF).

<sup>66</sup> *Ibid.*, at 92, para 66

<sup>67</sup> *Ibid.*, at 93, para 67

<sup>68</sup> *Ibid.*, at 88, Table IV.4

<sup>69</sup> *Ibid.*, at 60, para 150

open market strategy, both internationally and through the formation of Mercosur. Its orientation is reflected in the requirement that Brazilian goods are eligible for the maximum financing under the program if they contain 60% domestic content.<sup>70</sup> The program is widely available to Brazilian exporters, with an expansion in its coverage at the end of 1998 to include 94% of all lines in Brazil's tariff schedule and more than 80% of exports. Brazilian authorities indicate that 15% of all exports benefit from PROEX support.<sup>71</sup> While this may be true, EMBRAER absorbed 39-45% of total PROEX resources in 1998.<sup>72</sup>

Brazil's political and economic stability appear to depend on its ability to re-orient its industrial structure from its traditional import substitutional model to a more open one that includes international competition. The opening of the economy is occurring slowly in key sectors, but with processed and technological goods enjoying higher rates of protection. Brazil must increase its exports substantially, to stabilize its current account deficit to avoid the economic instability that occurred in 1994 in Mexico and most developing nations in 1997-8 in the midst of the Asian financial crisis. It must attract the capital investment needed to increase internal development and international competitiveness. This is a significant challenge in circumstances where "Brazilian industrial development has [traditionally] displayed a chronic incapacity to control or reduce public deficits used to invest in infrastructure industries and social goods and to increase personal savings."<sup>73</sup>

In these circumstances, EMBRAER must be seen as a national champion and a powerful symbol of Brazilian potential in world trade.<sup>74</sup> Brazil can be expected to resist a

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<sup>70</sup> *Ibid.*, at 60, para 151. Goods with a 60% domestic content are eligible for interest rate equalization payments on 85% of their value. Goods that have a domestic content less than 60% are eligible for an interest rate equalization reduced according to the percentage of domestic content.

<sup>71</sup> *Ibid.*, at 60, para 153

<sup>72</sup> *Ibid.*, at 93 para 68

<sup>73</sup> *Brazil in the New Decade, op cit., supra*, note 27,

<sup>74</sup> "Since its privatisation, Embraer has become a source of pride in Brazil. It is a high-tech export success – foreign sales rose 60% last year to \$2.7 billion – capable of fighting rich countries'

meaningful reduction in PROEX support, especially when Brazilian officials do not appear to clearly accept the findings of the WTO panel, especially when exonerating Canadian programs while continuing to find its programs noncompliant. Embraer officials “often say WTO rules are designed by rich countries to benefit their economies, so Brazil couldn’t possibly get a favourable decision.”<sup>75</sup>

The recent financial crisis within Argentina appears to be improving the prospects of Mercosur and further regional integration.<sup>76</sup> Argentina had actively courted the United States throughout the 1990s, by pegging its currency to the United States dollar and by attempting to engage the United States in free trade negotiations.<sup>77</sup> Mercosur had struggled since 1999 when Brazil devalued its currency in a manner that exacerbated the recession in Argentina that did not have similar flexibility in its monetary policy.<sup>78</sup> Argentina is now turning to Brazil as one of its major export markets, especially at a time when the IMF and the United States may be tightening access to the capital markets. In June 2001, Henry Kissinger stated that “Argentina is, in a sense, a proxy for the rest of the region.”<sup>79</sup> If true, Canada should be concerned that the continuance of this dispute will represent a trade irritant for an invigorated Mercosur that may look increasingly to

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aerospace giants on equal terms. More than equal: whereas it is selling regional airlines a full model range from 47 to 108 seats, Bombardier has no model at the bottom end and Fairchild Dormier has nothing in the most popular 50-seat range.” *Regional Jets, Small is Beautiful*, The Economist, March 17<sup>th</sup>, 2001, at 65.

<sup>75</sup> InfoBrazil, “From Embraer-Bombardier Dispute to Brazil-Canada Showdown, InfoBrazil interviews Ambassador Jean Pierre Juneau, January, 2001.” [http://www.infobrazil.com/Conteudo/Front\\_Page/Twenty\\_Questions/Conteudo.asp?ID\\_Noticias=439&ID\\_Area=2&ID\\_Grupo=10](http://www.infobrazil.com/Conteudo/Front_Page/Twenty_Questions/Conteudo.asp?ID_Noticias=439&ID_Area=2&ID_Grupo=10), last visited, August 19, 2001

<sup>76</sup> *Argentina’s Crisis, Harsh Realities*, The Economist Jan 26<sup>th</sup>-Feb 1<sup>st</sup>, 2002, at 34. Not all commentators agree that Mercosur will be strengthened. Inside U.S. Trade reports in an article, *Argentine Crisis Clouds Long-term FTAA Forecast, Won’t Delay Start*, (January 18<sup>th</sup>, 2002 [www.insidetrade.com](http://www.insidetrade.com)). See footnote 4, *infra*.

<sup>77</sup> Kissinger, *Does America Need a Foreign Policy? Toward a Diplomacy for the 21<sup>st</sup> Century*, June 2002, Simon & Schuster, at 95

<sup>78</sup> *Mercosur Averts Trade Collision*, August 2<sup>nd</sup>, 1999, WTOWATCH.ORG

<sup>79</sup> Kissinger, *op cit.*, *supra*, note 77, at 108

the E.U. as a counterweight to negotiation of a FTAA. The negotiation of an *E.U. – Mercosur* association agreement appears to be an important trade initiative for the E.U..<sup>80</sup>

### **III. THE HISTORY OF THE AIRCRAFT FROM CANADA/BRAZIL DISPUTE**

Canada and Brazil have been embroiled in this dispute since 1996. A significant number of panel reports have been issued, with no end yet in sight if the dispute is not settled. Canada is defending an important industry within a sensitive geographic region. Brazil is defending a crucially important industry, but also perceives this dispute as one between a developed and developing nation on the basis of rules that favour the former.

#### *(a). Canadian Challenge of Brazil's PROEX Program*

In 1996,<sup>81</sup> Canada requested the establishment of a WTO Panel to rule on the legality of PROEX a program established by the Government of Brazil to provide export credit to Brazilian exporters.<sup>82</sup> With direct financing Brazil lends a portion of the funds required for the transaction. When extending interest rate equalization, Brazil provides to the financial institution extending the credit (domestic or foreign) an equalization payment to cover, at most, the difference between the interest charges contracted with the buyer and

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<sup>80</sup> An E.U. Council Meeting report released on January 28<sup>th</sup>, 2002, (<http://ue.eu.int/Newsroom>) stated:

In the context of the current crisis in Argentina, the Council welcomes the will expressed by the Mercosur Foreign Affairs Ministers in their Joint Declaration, made in Buenos Aires on 11 January, 2002, to strengthen the integration process amongst their countries.

The Council believes that a strengthened Mercosur will be the key to the development of the region.

Finally, the Council reiterates the importance it attaches to the establishment of an Association Agreement between the E.U. and Mercosur. It welcomes the progress achieved so far in these negotiations and reiterates the EU commitment to continue to make further progress.

<sup>81</sup> *Brazil – Export Financing Programme for Aircraft*, WT/DS46/R, 1999, para 1.1, at 1 (“Initial Panel Report”)

<sup>82</sup> *Brazil-Export Financing Programme for Aircraft – Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW, May 9<sup>th</sup>, 2000, at para 2.1, at 2 (“First Article 21.5 Panel”)

the borrowing costs to the financier.<sup>83</sup> The term for equalization payments for aircraft is often extended to fifteen years, by waiver of PROEX's guidelines of ten years. The interest rate spread to be equalized ranges up to 2.5 percentage points for a term of nine years or more.<sup>84</sup>

On August 20, 1999, the Dispute Settlement Body ("DSB") adopted the Appellate Body Report recommending that Brazil bring the PROEX program into compliance with the *WTO SCM Agreement*.<sup>85</sup> It was found that the PROEX program provided export subsidies prohibited by SCM Article 3.2.<sup>86</sup> The Dispute Settlement Body recommended that Brazil withdraw export subsidies for regional aircraft within 90 days.<sup>87</sup> On May 9, 2000, the WTO panel determined that Brazil's changes to the PROEX program did not bring the program into compliance.<sup>88</sup> Canada provided notification to Brazil that it

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<sup>83</sup> *Ibid.*, at para 2.2

<sup>84</sup> *Ibid.*, at para 2.3 PROEX interest rate equalisation payments are established at the time the manufacturer requests a letter of commitment on behalf of the Government of Brazil, if the contract is entered into within ninety days. *Ibid.*, at para 2.5. PROEX payments begin after the aircraft is exported and paid for by the purchaser, with the payments resembling a series of zero-coupon bonds which mature at six-month intervals over the course of the financing period. *Ibid.*, at para 2.6

<sup>85</sup> *World Trade Organization Agreement on Subsidies and Countervailing Measures*, ("SCM Agreement"), April 15, 1994, Marrakesh Agreement Establishing the World Trade Organization The Legal Texts – The Results of the Uruguay Round of Multilateral Trade Negotiations 264 (1994)

<sup>86</sup> *First Article 21.5 Panel Report, op cit Supra*, Note 81, para 6.9 at 7. Article 3.2 provides: "A Member shall neither grant nor maintain subsidies [contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex 1]."

<sup>87</sup> *Ibid.*, at para 1.2.

<sup>88</sup> On November 19, 1999, Brazil submitted a status report indicating certain changes to the PROEX program which, in Brazil's view, brought the program into compliance. *Ibid.*, at para 1.3. Canada requested a panel pursuant to WTO DSM Article 21.5 to determine whether the measures taken by Brazil did indeed achieve this result. On May 9<sup>th</sup>, 2000, the original panel that heard the dispute determined that the PROEX program was not brought into compliance. On July 21<sup>st</sup>, 2000, the Appellate Panel confirmed the Article 21.5 panel determination. *Brazil – Export Financing Programme for Aircraft, Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/AB/RW, July 21<sup>st</sup>, 2000 ("First Article 21.5 Appellate Report")

proposed to undertake retaliation in the amount of \$700 million (Cdn)<sup>89</sup> through one or more of the following measures:<sup>90</sup>

- (a) Application of a 100 percent surtax on selected imports from Brazil;
- (b) Suspension of Brazil from the list of countries eligible for the General Preferential Tariff;
- (c) Suspension of injury inquiries under the *Special Import Measures Act*, in countervailing duty investigations in respect of goods from Brazil that benefit from PROEX subsidies;
- (d) Suspension of Canada's obligations to Brazil under the *WTO Agreement on Textiles and Clothing* (the *Multifibre Agreement*); and
- (e) Suspension of Canada's obligations to Brazil under the *WTO Agreement on Import Licensing*, permitting Canada to impose special licensing requirements on imports from Brazil.

The list of goods referred to in the first measure above, is set forth in Appendix I, which also indicates the import volume in these goods from Brazil from 1996 to 2000, as well as those products excluded from the target list. To give a clear picture of the pattern of bilateral trade, Appendix II provides an analysis of the exports to Brazil from Canada based on the target list.

On May 22, 2000, Brazil requested the Dispute Settlement Body to re-convene the panel for the limited purpose of determining whether the "countermeasures" requested by Canada were appropriate.<sup>91</sup> The panel report was released on August 28, 2000 and issued the following award:

[T]he Arbitrators decide that, in the matter *Brazil – Export Financing Programme for Aircraft*, the suspension by Canada of the application to Brazil of tariff concessions of other obligations under GATT 1994, the

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<sup>89</sup> *Brazil – Export Financing Programme for Aircraft, Recourse to Arbitration by Brazil Under Article 22.6 of the DSU*, WT/DS46/ARB, August 28<sup>th</sup>, 2000, ("Brazil Article 22.6 Panel Report"), para 1.1

<sup>90</sup> *Notice of Intention to Retaliate in Response to the Government of Brazil's Refusal to Eliminate Illegal Subsidies on Exports of Regional Aircraft*, *Canada Gazette*, Part I, May 13, 2000, at 1454-64

<sup>91</sup> *Panel Report*, op cit. Supra, Note 6, para 1.2

*Agreement on Textiles and Clothing* and the *Agreement on Import Licensing Procedures* covering trade in a maximum amount of C\$344.2 million per year would constitute appropriate countermeasures within the meaning of Article 4.10 of the Agreement.

In this respect, the Arbitrators urge Canada to make sure that, if it decides to proceed with the suspension of certain of its obligations vis-à-vis Brazil referred to in document WT/DS46/16 other than the 100 per cent surtax, this will be done in such a way that the maximum amount of countermeasures referred to in the preceding paragraph will be respected.<sup>92</sup>

Canada was granted authority to impose “economic countermeasures” against Brazil, but has declined to do so. Instead, on January 10, 2001, Canada “matched” Brazilian financing terms on a sale to Air Wisconsin to secure a contract for seventy-five jets. On March 12, 2001, this financing was challenged by Brazil through the commencement of a panel review of the Canadian financing on the basis that it was a form of retaliation that had not been either notified or sanctioned by the WTO Dispute Settlement Body. On July 9, 2001, Canada claimed that it had matched Brazilian financing terms to Northwest Airlines to secure a contract for up to 150 jets.

At the time when Brazil commenced the complaint in respect of the Air Wisconsin contract, Canada brought a further proceeding challenging the manner in which Brazil changed its PROEX program to bring it into compliance with the *WTO SCM Agreement*.<sup>93</sup> It was found that the revised program was compliant with Section 3.1(a) of the *SCM Agreement*, “as such”.<sup>94</sup> This section prohibits subsidies that constitute a

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<sup>92</sup> *Article 22.6 Panel Report, op cit., Supra*, Note 6 para 4.1-4.2, at 27

<sup>93</sup> The dispute was commenced on January 22<sup>nd</sup>, 2001. *Brazil- Export Financing Programme for Aircraft, Second Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW2, July 26<sup>th</sup>, 2001,

<sup>94</sup> *Ibid.* at para 5.206-8, pg 51. Paragraph 3.1(a) of the *SCM Agreement* provides:

Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:

- (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance including those illustrated in *Annex I*.

financial contribution by a government which confers a benefit and which is contingent upon export performance.<sup>95</sup> The panel reviewed the structure of the PROEX program in a “*per se*” manner that does not involve consideration of specific instances in which PROEX support is provided.

Under this approach, panels have not found legislation as such to be inconsistent with GATT/WTO obligations, unless that legislation mandated, or required, the executive branch to take action which was not in conformity with a Contracting Party’s/Member’s obligations under the GATT 1994/WTO Agreement.<sup>96</sup>

The panel in *PROEX III* concentrated on two substantive provisions within the revised program, the first requiring that interest rate equalization be established on a case-by-case basis at levels that may be below the Commercial Interest Reference Rates (“CIRR”) published monthly according to the OECD. The CIRR is established by the *OECD Arrangement* as the “acceptable” interest rate that members may offer without risk of retaliation or criticism. The second provision is that the eligibility request be analyzed with reference to “the financing terms practised in the international market.”<sup>97</sup> The panel found that these provisions are in compliance with Article 3.1(a) because “Brazil maintains the discretion to limit the provision of PROEX III interest rate equalization payments to circumstances where a benefit is not conferred in respect of regional aircraft.”<sup>98</sup>

The panel also found that the PROEX III program complied with the “safe harbour” exception to Article 3.1(a), in circumstances where Brazil complied with the *OECD Arrangement*.<sup>99</sup> It provides rules for the calculation of country-specific interest rates as well as the design of other terms and conditions of sale and establishes the most generous

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<sup>95</sup> *Ibid.*, para 5.19, at 13

<sup>96</sup> *Ibid.*, para 5.09, at pg 11

<sup>97</sup> *Ibid.*, paras 2.4-5, at pg 2-3

<sup>98</sup> *Ibid.*, para 5.55-6, at pg 21

<sup>99</sup> *Ibid.*, para 5.67, at pg 23, (“*OECD Arrangement*”)

terms that can be offered. The *WTO SCM Agreement* accepts the *OECD Arrangement* as a “safe harbour” and that compliance with its terms by either members such as Canada or non-members such as Brazil will be deemed compliant with the *WTO SCM Agreement*, notwithstanding the fact that the subsidies in question would otherwise be considered WTO-illegal export subsidies. Brazil was found in compliance with the *OECD Arrangement* because *PROEX III* provided the measure of discretion necessary to allow Brazil to select interest rates and terms and conditions of sale that are consistent with it.<sup>100</sup>

Throughout the decision, the panel stresses that its decision is limited to a “*per se*” analysis as to whether the structure of the program mandated non-compliance with Article 3.1(a) or the *OECD Arrangement*. The finding of compliance was made notwithstanding the anecdotal evidence that Canada submitted indicating that Brazilian officials intended to operate the program in a way such that it would not be compliant.<sup>101</sup> Canada also alleged that in two recent cases, Brazil had offered interest rate support, through Embraer, on terms that did not satisfy the provisions of the *OECD Arrangement*. The panel accepted Brazil’s statement that it had not issued any letters of commitment concerning regional aircraft under the PROEX program and Canada failed to provide any evidence to the contrary.<sup>102</sup> At the end of its decision, the panel once again returned to the limitation placed on its decision that PROEX III was compliant with Article 3.1(a) and the *OECD Arrangement*:

Our conclusion that the PROEX III program, as such, is not inconsistent with the *SCM Agreement* is based on the view that it is legally possible for Brazil to operate the PROEX III program in such a way that it will:

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<sup>100</sup> *Ibid.*, paras 5.206-8.

<sup>101</sup> *Ibid.*, para 5.189, at 48. “Canada refers to a number of press reports and reported statements by Brazilian officials. According to one such statement, attributed to the then-Foreign Minister of Brazil, Brazil will not respect the 10-year maximum term for interest rate equalisation.”

<sup>102</sup> *Ibid.*, para 5.190, at 49. Canada had provided the panel with sworn declarations of people who claimed to know the terms offered by Embraer in the relevant sales campaigns involving regional aircraft.

- (a) not result in a benefit being conferred on producers of regional aircraft and, hence, not constitute a subsidy within the meaning of Article 1.1 of the *SCM Agreement*; or
- (b) result in a benefit being conferred on producers of regional aircraft, but conform to the requirements of the safe haven of the second paragraph of item (k) in which case it would not constitute a prohibited export subsidy within the meaning of Article 3.1 of the *SCM Agreement*.

We wish to be clear, however that it does not necessarily follow from our conclusion that future application of the PROEX III program will, likewise be consistent with the *SCM Agreement*. It should be mentioned in this regard that Canada is free to challenge such future application in accordance with the provisions of the DSU if it considers it not to be in conformity with the *SCM Agreement*.<sup>103</sup>

If the PROEX program is compliant *per se*, each offer of government financing support must be reviewed on a case by case basis. Pursuant to the WTO Dispute Settlement Mechanism, the illegality of a specific application of the program will not be determined until well after the subsidy has been bestowed.

Notwithstanding that the PROEX programme is now compliant *per se*, Brazil has not fully complied with the directions of the WTO panel. Brazil has yet to withdraw the PROEX subsidies that had been extended in contracts executed prior to November 18<sup>th</sup>, 1999, in respect of aircraft not yet delivered.<sup>104</sup> The fact that the withdrawal of these subsidies may place Brazil in breach of contract is considered irrelevant by the WTO panel:

Nor are we convinced that a different interpretation is required because Brazil asserts that it has a contractual obligation to issue PROEX bonds pursuant to commitments already entered into, and that it would be liable to damages for breach of contract if it failed to do so. Assuming that Brazil is correct in this regard, the implication of this view would be that Members could contract to grant prohibited subsidies for years into the

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<sup>103</sup> *Ibid.*, para 6.2-3, at 63-4

<sup>104</sup> *Brazil-Export Financing Programme for Aircraft-Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW, May 9<sup>th</sup>, 2000, (“*Brazil Export Financing, First Recourse*”)

future and be insulated from any meaningful remedy under the WTO dispute settlement system. Nor is this a purely hypothetical situation. If Canada's figures are correct – and Brazil has not disputed their overall accuracy – Brazil has outstanding commitments to issue NTN-1 bonds pursuant to PROEX as it existed before modification in respect of nearly 900 regional aircraft that have yet to be exported. Letters of commitment in respect of some 300 regional aircraft were issued after the Panel Report in the original dispute was circulated to Members on 14 April 1999. By Brazil's reasoning it should be allowed to continue issuing bonds upon the exportation of these aircraft for years to come.<sup>105</sup>

These outstanding commitments provided the basis for the calculation giving rise to the authorization of countermeasures in the amount of \$2.065 billion that was then allocated over a five year period at a level of \$344.2 million per year.<sup>106</sup>

(b) *Brazil's Challenge of Canadian Support Programs*

After Canada commenced the initial complaint, Brazil responded with its own challenge of Canadian government programs, commencing its complaint on March 10th, 1997.<sup>107</sup> The WTO panel found that Federal "Canada Account" financing<sup>108</sup> and the Technology Partnerships Program<sup>109</sup> to be prohibited export subsidies and the finding was affirmed on appeal and adopted by the Dispute Settlement Body on August 20<sup>th</sup>, 1999.<sup>110</sup> The 1996/7

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<sup>105</sup> *Ibid.*, at para 6.16, at 9

<sup>106</sup> *Brazil Article 22.6 Panel Report*, op cit. supra, note 88, at para 3.19, 3.66, 4.10

<sup>107</sup> *Canada-Measures Affecting the Export of Civilian Aircraft*, WT/DS70/R, 1999, at 1

<sup>108</sup> "The Canada Account operates under the mandate of the EDC, and, per EDC's 1995 annual report, is used to "support export transactions which the federal government deems to be in the national interest but which, for reasons of size or risk, [the EDC] cannot support through regular export credits." *Canada-Measures Affecting the Export of Civilian Aircraft, Recourse by Brazil to Article 21.5 of the DSU*, WT/DS70/RW, May 9<sup>th</sup>, 2000, para 5.53, at 17

<sup>109</sup> The Technology Partnerships program was introduced in 1996 as "an effective, market-driven tool to stimulate the development and commercialization of technologies ...[that] share[s] risk with private sector, participants, gain royalties from successful projects and reinvest these repayments to help support new initiatives." *Science and Technology for the New Century A Federal Strategy* Canadian Ministry of Supply and Services, March 11, 1996, at 13

<sup>110</sup> *Ibid.*, at para 1.1, at 1 ("Brazil Recourse to Article 21.5"), affirmed on appeal, WT/DS70/AB/RW, AB-2000-4, July 21<sup>st</sup>, 2000

Business plan for the Technology Partnership program stated that in the aerospace sector, it will “directly support the near market R&D projects with high export potential.”<sup>111</sup> After the panel report was affirmed, the Minister for International Trade developed a policy guideline and undertook “not to authorize any transaction under the Canada Account unless it complied with the OECD Arrangement.”<sup>112</sup> Canada also undertook to change the Technology Partnerships Program to ensure it complied.<sup>113</sup> On subsequent review, the WTO panel determined that Canada had brought the Technology Partnerships into compliance but that the Canada Account was still not compliant, as the new policy guideline was not sufficiently restrictive.<sup>114</sup> The restrictions the panel required to be implemented included that the net interest rates be at or above the relevant CIRR, and that “no derogations would be made, either at Canada’s initiative or via matching.”<sup>115</sup>

The *Canada-Export Credits* panel report released on January 28, 2002,<sup>116</sup> found that the “Canada account” financing provided to Air Wisconsin by the Export Development Corporation, was a prohibited export subsidy.<sup>117</sup> It was determined that the support constituted a “financial contribution” that conferred a “benefit”,<sup>118</sup> that was “contingent upon export performance.”<sup>119</sup> Canada defended the financial support on the basis that it

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<sup>111</sup> *Brazil Recourse to Article 21.5, Ibid.*, at para 5.20, at 10

<sup>112</sup> *Ibid.*, para 1.4, at 1

<sup>113</sup> *Ibid.*, para 1.6, at 2

<sup>114</sup> *Ibid.*, para 5.147, at 40

<sup>115</sup> *Ibid.*

<sup>116</sup> *Canada-Export Credits*, WTO Panel Report, *op cit.*, *supra*, note 15

<sup>117</sup> *Ibid.*, at para 7.182, at 46. The panel found that the support constitute a “financial contribution” (para 7.141),

<sup>118</sup> The finding of benefit was made in part because “Minister Tobin stated that Canada is providing Air Wisconsin with ‘a better rate than on would normally get on a commercial lending basis.’”, *Ibid.*, at para 7.143

<sup>119</sup> *Ibid.*, at para 7.182, at 38 due in part to the Canada Account’s mandate which is “to support and develop Canada’s export trade and Canadian capacity to engage in that trade ..”

was protected by the “safe haven” provided by the *OECD Arrangement*<sup>120</sup> which allows the “matching” of an offer of financial support. This “arrangement” is a gentlemen’s agreement that has no enforcement provision other than allowing parties, on notice to the other members, to match the interest rate terms and conditions offered either by members or non-members.<sup>121</sup> The panel rejected Canada’s “safe haven” argument in a manner consistent with earlier panel reports.<sup>122</sup> The Panel noted that the determination depended on what was being matched, with certain “permitted exceptions” from the *OECD Arrangement* being eligible for matching while “derogations” could not be matched.<sup>123</sup> The Panel noted that non-members to the *Arrangement* – such as Brazil – would not have access to information regarding the terms and conditions offered or matched by members and so the non-members would be placed at a systematic disadvantage.<sup>124</sup> The *PROEX III* panel had indicated that the rationale for the disciplining aspect of the matching provision within the *Arrangement*, is not applicable to the *WTO SCM Agreement*. “The *SCM Agreement*, is a binding instrument, and it is enforceable through the WTO dispute settlement mechanism.”<sup>125</sup> The *Canada-Export Credits* panel report that was just released also commented on the nature of the WTO dispute settlement process:

Canada also submits that although the SCM Agreement disciplines trade distorting subsidies, the prospective nature of the dispute settlement remedies means that – in the absence of matching – illegal subsidies will

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<sup>120</sup> *Brazil – Export Financing Programme for Aircraft, Second Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW/2, July 26<sup>th</sup>, 2001, para 5.94, at 28 (“PROEX III”)

<sup>121</sup> *Canada-Measures Affecting the Export of Civilian Aircraft, Recourse by Brazil to Article 21.5 of the DSU*, WT/DS70/RW, May 9<sup>th</sup>, 2000, at para 5.82, at 24

<sup>122</sup> In *PROEX III*, Canada, the United States and the European Union argued that utilization of the matching provisions should be accorded “safe haven” status under the *WTO SCM Agreement*. *PROEX III, op cit. supra*, note 119, para 5.110 at 32-3

<sup>123</sup> A “permitted exception” is “an action itself foreseen and permitted within limits by the *Arrangement*, while a derogation is “an action itself not permitted under any circumstances by the *Arrangement*.” *Canada-Export Credits, op cit, supra*, Note 15, at 7.164. *PROEX III, op cit. supra*, note 119, para 5.109, at 32

<sup>124</sup> Members of the *OECD Arrangement* are required to disclose the terms of the financing that they are offering to the other members. *Canada-Export Credits, op cit., supra*, Note 15 at 7.164; *PROEX III, op cit., supra*, Note 119, at 5.109 at 32.

<sup>125</sup> *Ibid.*, para 5.115 at 34

have a perpetual advantage....In any event, even if the WTO dispute settlement mechanisms does only provide for prospective remedies, we note that it does so in respect of all cases, and not only those involving prohibited export subsidies. Article 23.1 of the DSU provides that Members shall resolve all disputes through the multilateral dispute system to the exclusion of unilateral self-help. Thus, to the extent that the WTO dispute settlement system only provides for prospective remedies, that is clearly the result of a policy choice by the WTO Membership. Given this policy choice, and given the fact that Article 23.1 of the DSU applies to all disputes including those involving (alleged) prohibited export subsidies, we see no reason why the (allegedly) prospective nature of WTO dispute settlement remedies should impact upon our interpretation of the second paragraph of item (k).

Canada has resorted to a self-help remedy by unilaterally matching what it considered to be a Brazilian offer of prohibited export subsidies. By doing so, Canada no longer enjoys a moral high ground before the WTO in this dispute and the resort to a self-help remedy may well be seen as a more egregious breach of its international obligations than the continuance of the PROEX program by Brazil. The WTO Dispute Settlement mechanism is designed to prevent such unilateral action, requiring parties to resort to the WTO to determine the level of retaliation to be imposed or to seek approval of the measures to be suspended.<sup>126</sup> This provision was established specifically to prevent the United States from unilateral trade action through its Section 301 trade remedy.

While the Air Wisconsin subsidies were the main issue in the *Canada-Export Credits* panel report, a number of other claims were made by Brazil. These claims included the allegation that the EDC Corporate Account and Investissement Québec constituted prohibited export subsidies “as such”.<sup>127</sup> The panel rejected the allegation that these

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<sup>126</sup> *WTO DSM Agreement*, Article 23.2 of the said agreement provides that:

In such cases, Members shall: ...

(c) follow the procedures set forth in Section 22 of the Understanding to determine the level of suspension of concessions or other obligations and obtain DS authorization in accordance with those procedures before suspending concessions or other obligations under the covered agreements in response to the failure of the Member concerned to implement the recommendations and rulings within that reasonable period of time.

<sup>127</sup> *Canada-Export Credits*, *op. cit.*, *supra*, note 15, para 8.1 at 92.

programs were prohibited “as such,” on the basis that Brazil had failed to identify any provision demonstrating that the programmes mandate the extension of prohibited subsidies.<sup>128</sup> Brazil also challenged twelve specific transactions in which EDC financing was provided. In each case, the panel compared the financial terms offered to the evidence of commercial terms otherwise available. The panel upheld Brazil’s claims that four transactions involved prohibited export subsidies,<sup>129</sup> rejecting the balance of the allegations.<sup>130</sup> The *Canada –Export Credits* panel determined that Canada is required to withdraw the subsidies within 90 days,<sup>131</sup> subject to Canada’s right of appeal.

(c) *Observations that should be made by the participants on February 8th*

It is clear from the history of the dispute that both Canada and Brazil intend to continue offering financial support to their respective national champions. Politically, they have little alternative given the symbolic importance of Bombardier and Embraer and their

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<sup>128</sup> *Ibid.*, *Canada Account*, at 7.77; *EDC Services*, 7.110; *Investissement Québec* at 7.126.

<sup>129</sup> *Ibid.*, at 8.1:

“(f) uphold Brazil’s claim that the EDC Canada Account financing to Air Nostrum constitutes a prohibited export subsidy contrary to Article 3.1(a) of the *SCM Agreement*;

(g) uphold Brazil’s claim that the EDC Corporate Account financing to Comair in July 1996, August 1997 and February 1999 constitutes a prohibited export subsidy contrary to Article 3.1(a) of the *SCM Agreement*”.

<sup>130</sup> *Ibid.*, at 8.1:

“(h) reject Brazil’s claim that the EDC Corporate Account financing to ASA, ACA, Kendell Air Nostrum and Comair in December 1996, March 1997 and March 1998 constitutes a prohibited export subsidy contrary to Article 3.1(a) of the *SCM Agreement*;

(h) reject Brazil’s claim that IQ equity guarantees to ACA, Air Littoral, Midway, Mesa Air group, Air Nostrum and Air Wisconsin constitute prohibited export subsidies contrary to Article 3.1(a) of the *SCM Agreement*; and

(i) reject Brazil’s claim that IQ loan guarantees to Mesa Air Group and Air Wisconsin constitute prohibited export subsidies contrary to Article 3.1(a) of the *SCM Agreement*.

<sup>131</sup> *Ibid.*, at para 8.4

importance in supporting clusters of high technology industries. Both nations are required to withdraw prohibited export subsidies and this appears to require the withdrawal of financial assistance required to be provided pursuant to contracts that have already been signed. The amounts involved are equally balanced, with Brazil required to withdraw \$2.065 billion in subsidies and Canada required to withdraw as much as \$1.7 billion.<sup>132</sup> It is also apparent that any complaint will have to be made against specific transactions and not the programs *per se*. The outcome will depend on whether the particular support is compliant with the *OECD Arrangement*, which establishes specific rules<sup>133</sup> intended to place “limitations on the terms and conditions of export credits that benefit from official support.”<sup>134</sup> It should be in the interest of both nations to limit a debilitating competition of national treasuries that can only benefit the customer airlines.

The history of this dispute and the number of specific transactions reviewed indicates that it is appropriate to consider an adjudicatory model to determine compliance with the *OECD Arrangement*. Canada has already suggested in both disputes that the WTO panels establish verification procedures in respect of future arrangements to bring any subsidies into compliance with the *WTO SCM Agreement*. The suggestion was rejected by the panel.

Canada asks only that the Panel endorse the establishment of such verification procedures, and is not proposing an ongoing role for the Panel should a verification process be established. Brazil does not, in principle,

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<sup>132</sup> *Pettigrew may allow Brazil's Plane Subsidies*, Financial Post, January 29<sup>th</sup>, 2002, FP4. This figure does not include any calculation of subsidies that were extended to Northwest Airlines in July 2001.

<sup>133</sup> Some of these rules include: Art 15 – Minimum Interest Rates; Art 16 – Construction of CIRRs; Art. 17 – Application of CIRRs; Art 18 – Cosmetic Interest Rates; and Article 19 – Official Support for Cosmetic Interest Rates; Art 22: minimum interest rates with respect to all new aircraft except large aircraft, along with spare engines spare parts, maintenance and service contracts with respect to those aircraft, and Art 28(b) covers minimum interest rates with respect to used aircraft. *Canada – Measures Affecting the Export of Civilian Aircraft, Recourse by Brazil to Article 21.5 of the DSU*, WT/DS70/RW, May 9<sup>th</sup>, 2000, at 5.83, at 24.

<sup>134</sup> *Canada – Measures Affecting the Export of Civilian Aircraft, Recourse by Brazil to Article 21.5 of the DSU*, WT/DS70/RW, May 9<sup>th</sup>, 2000, at 5.82, at 24. In short, it is to set a limit on the “most generous repayment terms and conditions that may be supported,” and thus to restrict debilitating subsidy competitions.

oppose the establishment of such verification procedures, but considers that they are not compatible with the spirit, if not the letter, of Article 19 of the DSU. Brazil believes that such procedures are better agreed to by the parties in the course of bilateral consultations.

We note that by virtue of Article 19.1 of the DSU, the Panel “may suggest ways in which the Member concerned could implement the recommendations.” In our view, Article 19.1 envisions suggestions regarding what could be done to a measure to bring it into conformity ... It does not address the issue of surveillance of those steps. For that reason, we decline to make the suggestion requested by Canada.<sup>135</sup>

The Panel hastened to add that “this does not mean that the Panel in any way discourages agreements between WTO Members that may facilitate transparency with regard to the implementation of WTO obligations.”<sup>136</sup> Any mechanism to establish verification procedures or to implement them on an on-going basis through an adjudicatory process must be established by the parties through negotiation.

#### **IV. THE ALTERNATIVES TO SETTLE OR CONTINUE THE DISPUTE**

It is unclear the degree to which both parties have the political will to resolve its disputes particularly if it requires the negotiation and adherence to new rules in addition to those included in the *OECD Arrangement*. Canada claims that it simply wants Brazil to adhere to the *OECD Arrangement*.<sup>137</sup> Brazil has taken the position before the WTO panel that verification procedures should be negotiated by the parties and Embraer officials have recently complained about a lack of disclosure by Canada of the details of its support

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<sup>135</sup> *Ibid.*, at para 6.1, at 43

<sup>136</sup> *Ibid.*, Footnote 135 at 43

<sup>137</sup> The Minister for International Trade identified these terms as the basis for a resolution of the case in a press release issued at the time the PROEX III decision was released including: limitations on the rate of interest, such that it is no lower than the Commercial Interest Reference Rate (CIRR); restrictions on the duration such that any financing does not exceed 10 years or 85 percent of the value of the transaction; and that the interest rate should include a risk premium commensurate with the credit worthiness of a particular airline. *Canada Wins Fifth WTO Ruling In Aircraft Dispute*, [bulletins@dfait-maeci.gc.ca](mailto:bulletins@dfait-maeci.gc.ca), "Trade News Release" [itnews@listserv.dfait-maeci.gc.ca](mailto:itnews@listserv.dfait-maeci.gc.ca)

programs.<sup>138</sup> These positions would appear to provide an agenda for resolution, and there appears to be at least three possible outcomes that could result from the negotiations that will begin on February 8, in New York:

- (i), a policy of forbearance by which Canada and Brazil refrain from retaliation and implement an institutional solution that adjudicates allegations of improper subsidization on an expedited basis;
- (ii), Canada and Brazil enter into an unrestricted bidding war for each new contract; or
- (iii), Canada and Brazil impose retaliatory, punitive tariffs on one another.

(a) *FORBEARANCE & AN EXPDITED ARBITRAL MECHANISM*

Generally, retaliation has been ineffective in achieving compliance with WTO panel reports requiring the withdrawal of the impugned measure, particularly in circumstances where entrenched political interests support non-compliance. Retaliation is even less effective when the two protagonists involved have a limited amount of bilateral trade. It is one thing for the United States to engage in threats of retaliation; it is quite another when Canada is issuing threats in the context of a relatively modest level of bilateral trade. Retaliation can be more symbolic in nature than a serious penalty intended to cause the respondent to modify its behaviour. The application of punitive tariffs might satisfy domestic trade interests calling for some form of retaliation, even though they will have little impact in terms of forcing a change to the respondent's trade policy.

An effective resolution of the dispute would be to forbear from retaliating in favour of the introduction of an arbitral mechanism that could determine the consistency of the financing terms being offered with the provisions of the *OECD Arrangement*, before the end of the contract competition. The question arises whether there would be sufficient time to choose an arbitral tribunal and for it to issue a determination before the contract was awarded. Canada claims that it learned of the terms being offered by Brazil to Air

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<sup>138</sup> "Ottawa can't be trusted in jet talks: Embraer executive", Financial Post, Jan 24 2002, at FP5

Wisconsin in October, 2000,<sup>139</sup> decided to “match” the offer in January, 2001, and the panel report states that the support was “offered” on May 10, 2001.<sup>140</sup> This provides a period of eight months in which an arbitration could be completed. An expedited procedure will have to be developed including: the selection of arbitrators from a standing list; production of documents and interrogatories (probably written); and a limited oral hearing.

Care will have to be taken in the rules regarding production of documents, due to the time available and the complaints that Embraer officials have made with respect to disclosure regarding Canadian programs. It is unlikely that either nation will allow the arbitral panel to order production of documents that might be subject to cabinet or other government privilege. The failure to produce documents – whether subject to a claimed privilege or otherwise – may be dealt with by allowing the panel the discretion to draw an adverse inference in appropriate circumstances. It will also be important to establish protective orders for confidential and commercially-sensitive business information. There is substantial experience dealing with these issues in the form of the Administrative Protective Orders that can be obtained in trade cases, such as in the Softwood Lumber IV case now before the United States’ Department of Commerce and International Trade Commission.

With respect to substantive issues, the evidence required for the determination of whether the specific financing terms constitute a prohibited export subsidy, should be available. The WTO places the burden of proof initially on the complainant which must establish a prima facie case of inconsistency.<sup>141</sup> The complainant, therefore, should be required to establish that a financial contribution has been offered that is contingent upon export performance and contravenes the *OECD Arrangement*. The onus of proof might then shift to the respondent to demonstrate that the offer of financial terms is no more favourable than those that are commercially available. This should impose no hardship on

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<sup>139</sup> *Canada-Export Credits, op cit., supra*, note 15, at para 7.155, at 38

<sup>140</sup> *Ibid.*, at para 7.137 at 35

<sup>141</sup> *Canada-Measures Affecting the Export of Civilian Aircraft, Recourse by Brazil to Article 21.5 of the DSU*, WT/DS70RW, May 9<sup>th</sup>, 2000, at para 5.13-14, at 7

the respondent, who will be encouraged to carefully analyze what terms are commercially available at the time the offer is prepared, and to have that information readily available should a challenge be made.

The parties will likely have to develop this arbitration mechanism independent of the World Trade Organization, as the WTO panels declined Canada's invitation to establish verification procedures, let alone to play an ongoing supervisory role. The question arises whether the parties should utilize one of the existing arbitral conventions and the procedural rules established thereunder or to develop a completely unique and separate mechanism crafted specifically for this dispute. Canada has agreed in NAFTA and other trade agreements<sup>142</sup> that the each party should promote private commercial arbitration through the adoption of "the 1958 *United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards* ("New York Convention") or the 1975 *Inter-American Convention on International Commercial Arbitration*" ("Inter-American Convention"). Canada has signed the New York Convention while Brazil has signed the Inter-American Convention.

While the parties should agree that the decision is binding upon them, the need to adopt an existing Convention will depend in large part on the method of enforcement. If the arbitral panel will have the power to issue an injunction preventing the offering of the financial terms in question, the adoption of an existing convention will be helpful due to the rules included therein regarding the adoption and enforcement of arbitral decisions.<sup>143</sup> It is unlikely that the parties will agree to enforcement through the domestic courts and so

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<sup>142</sup> NAFTA (Article 2022), the *Canada-Chile FTA* (Article N-21), and the *Canada-Costa Rica FTA* (Article XIII.21) provide that each Party should "encourage and facilitate the use of arbitration and other means of alternative dispute resolution for the settlement of international commercial disputes between private parties in the free trade area." Each Party can do so if it is a member of "the 1958 *United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards* or the 1975 *Inter-American Convention on International Commercial Arbitration*."

<sup>143</sup> The *Inter-American Convention* O.A.T.S. No. 42, 14 I.L.M. 336 (1975). Article 4 provides that an arbitral decision may be ordered in the same manner as that of decisions handed down by national or foreign ordinary courts. Article 5(1) and 5(2) provide that enforcement may be refused only if: (a) parties were subject to some incapacity; (b), responding party had no notice of the arbitration procedure or the appointment of the arbitrator; (c), decision concerns a dispute not envisaged in the agreement; (d) the correct procedure wasn't followed.

there is no reason why an independent procedure cannot be crafted, based on the existing conventions as procedural models.<sup>144</sup>

It is possible that the parties will agree only that the result would be enforceable through the WTO Dispute Settlement mechanism relying on moral suasion. While this would be disappointing, it would still represent an improvement, as the decision may well help Brazil and Canada answer the domestic constituencies supporting the extension of prohibited export subsidies. Although clearly imperfect, the advantage of a policy of forbearance and, if necessary, reliance on moral suasion, is that it capitalizes on what appears to be the effective element that has resulted in compliance – the pressure applied by the *WTO Dispute Settlement Body* itself.

The *WTO DSM Agreement* represents a substantial improvement over the GATT 1947, with the introduction of the appellate body as well as automatic adoption of panel reports. An attempt has also been made to make enforcement more automatic.<sup>145</sup> With respect to remedies, the WTO Dispute Settlement Mechanism states that its first objective is to “secure the withdrawal of the measures concerned if these are found to be inconsistent with the provisions of any covered agreement.”<sup>146</sup> The “last resort” in terms of remedies “is the possibility of suspending the application of concessions or other obligations under the covered agreements on a discriminatory basis vis-à-vis the other Member, subject to

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<sup>144</sup> Article 5(2) provides that enforcement may be denied by a domestic court if (a), the subject of the arbitration cannot be settled by arbitration under the law of that State; or, (b), recognition or enforcement would be contrary to public policy. It is possible that limits may exist on the degree to which Brazilian courts can limit Brazilian government action in terms of issuing support for its industries. As a result, the adoption of the Inter-American Convention in the circumstances of this dispute would be pointless.

<sup>145</sup> Following a panel determination that a measure is inconsistent with obligations under a WTO-covered agreement, the respondent is required to report to a Dispute Settlement Body meeting held within 30 days after the adoption of the panel or appellate report as to its intentions with respect to the implementation of the panel recommendations and rulings. *WTO Understanding on Dispute Settlement*, Article 21.3. The respondent will be given a “reasonable time” to implement changes the duration of which will be determined through binding arbitration within 90 days if the parties cannot otherwise agree. Arbitration is also available under Article 21.5 should the parties disagree “as to the existence or consistency with a covered agreement of measures taken to comply.”

<sup>146</sup> *WTO Understanding on Dispute Settlement*, Article 3.7.

authorization by the [Panel] of such measures.”<sup>147</sup> As a result, approval is required and it must be consistent with the WTO-covered agreements, and this requirement is imposed even if the parties negotiate a mutually acceptable settlement of the dispute.

The question arises as to the effectiveness of these provisions in achieving compliance in circumstances where a WTO Panel or Appellate Body report has been adopted confirming a violation. Appendix III<sup>148</sup> provides a summary of the panel proceedings that have been commenced since the inception of the WTO in 1995, as reported in the dispute settlement section of its annual reports. It indicates the following results:

**TABLE THREE**  
**APPENDIX III: WTO DISPUTE SETTLEMENT SUMMARY**

NUMBER OF PROCEEDINGS	PANEL REPORTS	APPELLATE REPORTS	ARTICLE 21.5 ARBITRATION	ARTICLE 22.6 ARBITRATION
84	47	30	10	6

As indicated above, an Article 21.5 arbitration involves a determination whether the proposed measures are consistent with a covered agreement, while an Article 22.6 arbitration involves a determination as to the level of suspension proposed. With fifty panel reports and thirty appellate body reports issued, only ten have reached the first stage of the arbitral process established for the imposition of retaliation.<sup>149</sup> Only six cases

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<sup>147</sup> *Ibid.* Article 22.6 provides that the WTO Dispute Settlement Body shall authorize the requested suspension within thirty days of the expiry of the “reasonable period of time unless the DSB decides by consensus to reject the request.” Arbitration is available if the respondent objects to the level of suspension proposed and it will be completed by the original panel within sixty days. The arbitrator’s authority is limited to the question whether the level of such suspension is equivalent to the level of nullification or impairment or whether the principles and procedures have been applied. The arbitrator “shall not examine the nature of the concessions or other obligations to be suspended.” No right of appeal is allowed. Article 21.6.

<sup>148</sup> This analysis is current to September 1, 2002. It is currently being updated and will be available shortly.

<sup>149</sup> Some of these panel reports may be subject to appellate review and have simply not reached the point where an Article 21.5 arbitration can be commenced.

have reached the stage of an Article 22.6 arbitration and the status of these cases is summarized in the following table:

**TABLE FOUR ARTICLE 22.6 PANEL ANALYSIS**

<i>Case</i>	<i>Complainant</i>	<i>Date of 22.6 Report</i>	<i>Amount Authorized</i>	<i>Current Status</i>
<i>E.U Bananas</i> <sup>150</sup>	United States	April 9/99	\$191.4 Mill U.S.	100% tariffs since 1999 on \$190 mill U.S. Trade dispute resolved by Agreement dated April 13 <sup>th</sup> , 2001. <sup>151</sup> Retaliation to be suspended if a licensing system was introduced by July 1 <sup>st</sup> , 2001. 100,000 additional tons of “C” quota transferred to Caribbean nations effectively to the benefit of U.S. banana producers.
<i>E.U. Meat</i> <sup>152</sup>	United States	July 1999	\$116.8 Mill U.S.	100% tariffs since 1999 on \$117 Mill E.U. So far not effective in forcing compliance to date. Negotiations continue with U.S. meat producers asking for expanded access to the EU beef market for 12 years for hormone-free beef, while EU offering a four to five year period. <sup>153</sup>
<i>E.U. Meat</i> <sup>154</sup>	Canada	July 12/99	\$11.3 Mill Cdn	100% tariffs since August 1 <sup>st</sup> , 1999. <sup>155</sup> The products affected are all in the meat sector (beef and pork), except for cucumbers and gherkins. So far not effective in forcing compliance.
<i>Australia – Salmon</i>	Canada			July 1999, Commenced retaliation proceedings but it was suspended pending a compliance review. <sup>156</sup>
<i>Brazil/Aircraft</i> <sup>157</sup>	Canada	Aug 28/00	\$344.2 Mill Cdn	No implementation. De facto retaliation of matching PROEX

<sup>150</sup> E.U. - Regime for the Importation, Sale and Distribution of Bananas (WT/DS 27), April 9<sup>th</sup>, 1999

<sup>151</sup> *Text: U.S.-EU Banana Agreement* April 13, 2001 Inside US Trade, <http://www.insidetrade.com>. Agreement that by Jan 1, 2006, a “tariff only” regime will be introduced.

<sup>152</sup> *EU- Measures Concerning Meat and Meat Products*, (WT/DS26/ARB 12, July 1999

<sup>153</sup> *EU REJECTS US BEEF INDUSTRY CALL FOR 12-YEAR EXPANDED QUOTA*, June 22, 2001, Inside US Trade, [www.insidetrade.com](http://www.insidetrade.com)

<sup>154</sup> EU - Measures concerning Meat and Meat Products (WT/DS 48 ) 12 July 1999

<sup>155</sup> *Canada Retaliates Against the EU*, DFAIT News Release, July 29, 1999, No 174 [http://198.103.104.118/minpub/publication.asp?FileSpec=/Min\\_Pub\\_Docs/102518.htm](http://198.103.104.118/minpub/publication.asp?FileSpec=/Min_Pub_Docs/102518.htm)

<sup>156</sup> *EU Approaches U.S. About Low-Key Handling Of FSC Dispute*, Inside U.S. Trade, September 15, 2000

				export subsidies.
<i>Canada-Milk</i> <sup>158</sup>	New Zealand, U.S.			A 22.6 panel appointed March 1 <sup>st</sup> , 2001, pending a compliance review. Retaliation suspended during interim period. The earliest that retaliation could be commenced is early 2002. <sup>159</sup>

Retaliation has been imposed in three cases (*EU-Bananas*, *EU/US-Meat*, *EU/Can-Meat*), quantified in *Brazil-Aircraft* and is a serious possibility in the *Canada-Milk* case. The *Australia-Salmon* case has been included but its current status is uncertain and appears to be held in abeyance. It is unclear what role retaliation played in the resolution of the *E.U.-Bananas* dispute. Punitive tariffs were imposed for a period of two years before a settlement agreement was negotiated. It is difficult to determine whether the tariffs applied significant pressure that helped result in the settlement agreement. However, it is notable that the duration of the tariffs was quite lengthy, suggesting that the tariffs were not the most important factor.<sup>160</sup>

The measure of retaliation taken by the United States in the *E.U-Meat* dispute and retaliation has proved ineffective in achieving compliance. This appears to be a more intractable dispute, due to the collision of a WTO determination with European agricultural interests. It suggests that a political decision has been made within the European Community that the cost of retaliation is more palatable than effecting immediate and unacceptable changes to its agricultural program. The cost of retaliation provides the time necessary to work out an acceptable compromise.

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<sup>157</sup> Brazil - Export Financing Programme for Aircraft (WT/DS 46)

<sup>158</sup> *Canada - Measures Affecting the Importation of Milk and the Exportation of Dairy Products*

<sup>159</sup> *DFAIT Summary of WTO Cases to which Canada is a Party*, [http://www.dfait-maeci.gc.ca/tna-nac/dairy\\_update-may01-e.asp](http://www.dfait-maeci.gc.ca/tna-nac/dairy_update-may01-e.asp)

<sup>160</sup> A recent joint declaration of the E.U. and the U.S. suggests that retaliation may not have been as important as the pressure applied by the on-going surveillance of the WTO DSU mechanism. Text Excerpt from the Declaration of the U.S.-E.U. Summit I Goteborg, Sweden, June 15, 2001, Inside U.S. Trade, [www.insidetrade.com](http://www.insidetrade.com)

The effectiveness of retaliation, however, may well prove itself in a separate case, *United States – Tax Treatment for “Foreign Sales Corporations”*.<sup>161</sup> The dispute involves tax advantages given to American corporations under the Internal Revenue Code relating to extraterritorial income through special purpose corporations. Such treatment was earlier ruled to contravene the *WTO SCM Agreement* as a prohibited export subsidy and that changes to the program did not bring it into compliance.<sup>162</sup> The appeal of the continuing non-compliance decision was released on January 14, 2002, upholding the panel determination. The European Union is seeking authorization to impose retaliatory tariffs of \$4 billion U.S.. The United States will challenge the level of retaliation and the panel should be appointed by March 28. As a result, the European Union may be in a position to impose retaliation by late summer.<sup>163</sup> It has been reported earlier that the United States Congress is reluctant to make substantive changes to the program notwithstanding the threat of retaliation.<sup>164</sup> This dispute may well become a litmus test of the effectiveness of the remedy of retaliation, simply due to the amounts at issue when balanced against a Congressional reluctance to effect changes. Of course, if the prospect of retaliation does provide an incentive leading the United States’ Congress to make the required changes, it may say more about the effectiveness of retaliation in the context of an immense bilateral trade relationship, than it does in circumstances where the amount of bilateral trade is extremely limited.

The result confirms that arbitration has been used relatively rarely to achieve compliance. The major factor is more likely related to the international opprobrium associated with continued non-compliance with a WTO panel/appellate report determination that the respondent is in breach of its obligations. Where retaliation has been imposed, the result has been ambivalent in achieving the result desired, with the elapse of time in the *E.U.*-

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<sup>161</sup> *United States – Tax Treatment for “Foreign Sales Corporations”*, WT/DS108/RW 20, August 2001, Recourse to Article 21.5 of the DSU by the European Communities.  
<http://www.wto.org/disputes>.

<sup>162</sup> *Ibid.*, at para 1.1

<sup>163</sup> *U.S. Lawyers Praise Reasoning of WTO Tax Ruling But Impact Unclear*, Inside U.S. Trade, January 18, 2002

<sup>164</sup> *Zoellick signals FSC Solution may be Tied to WTO Round Launch*, Inside U.S. Trade, July 27, 2001, 1-2

*Bananas* case suggesting that retaliation during the course of negotiations may have been seen simply as the cost of doing business. Any continuing pressure on the respondent to comply would appear to arise from the periodic review by the WTO Dispute Settlement Body.

In the circumstances of the *Aircraft from Brazil/Canada* dispute, we suggest that the parties should agree to forbear from retaliation. The parties should agree to ignore the prohibited export subsidies that both nations have been directed to remove. The introduction of a binding and enforceable expedited arbitral mechanism, could determine whether a particular offer of government financing is consistent with the *WTO SCM Agreement* and the *OECD Arrangement*. The result should be binding upon the parties and enforceable. The adoption of an arbitral procedure would still be an improvement even if the determination resulting therefrom can only be enforced by agreement that the determination will be adopted by the WTO Dispute Settlement Body in the ordinary course and subject to WTO surveillance.

(b) *AN UNRESTRICTED SUBSIDIES COMPETITION*

The second possible outcome after negotiations break down, is that both parties engage in an unrestricted subsidies with scant regard for the *OECD Arrangement*. The parties in effect engage in a “war of the treasuries” with little intention to comply with the outstanding panel directions to remove existing/future subsidies. A “subsidies war” represents a transfer of wealth from the “winner” of the contract to the airline customer.

Support for the adoption of this strategy may be found in “game theory”. A strategy of matching subsidies is an iterative prisoner’s dilemma, which provides an opportunity to condition the other party to enter into cooperative strategies. Each new contract competition is an iteration of this “two-party” game. It has the potential to place the greatest degree of pressure on Brazil/Canada, because it places Embraer/Bombardier exports at risk, and thus challenges the key constituency within Brazil/Canada supporting non-compliance.

The structure of an export subsidy competition requires the development of a payoff matrix such that two nations have various rewards depending on whether they cooperate or defect in an attempt to achieve a superior payoff. “Each country has access to an interventionist policy that is in its national interests but reduces the welfare of the other country. Cooperating means refraining from using the policy; defecting means adopting the policy.”<sup>165</sup> This structure is the classic “prisoner’s dilemma”, in which cooperation is the best mutual outcome but non-communication or suspicion leads both nations to engage in non-cooperative strategies to avoid the worst-case scenario. The *WTO SCM Agreement* and the *OECD Arrangement* can be seen as attempts to limit such competitions and to achieve the superior outcome by prohibiting export subsidies except in limited circumstances.<sup>166</sup> However, this competition is not a true prisoner’s dilemma:

A major problem with the theory of the prisoner’s dilemma ... is that it’s restricted to the case of once and for all strategy choices. In reality, a decision to use subsidies ... is not irrevocable and will usually be reviewed at regular intervals. In effect, the prisoner’s dilemma game is repeated indefinitely. Repetitions of the decisions make the game much more complicated in that relatively complex strategies become possible.<sup>167</sup>

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<sup>165</sup> An example of a payoff matrix is as follows:

		<i>Country B</i>	
		<i>Cooperate</i>	<i>Defect</i>
<i>Country A</i>	<i>Cooperate</i>	400, 400	50, 500
	<i>Defect</i>	500, 50	100, 100

If both nations cooperate, they each obtain a payoff of 400 units. If one defects while the other cooperates, the former increases its reward to 500 if the other nation continues to cooperate and reduces its payoff by 350 to 50 units. If both defect, each reduces its payoff by 300 to 100 units. James A. Brander, *Rationales for Strategic Trade and Industrial Policy*, published in Paul R. Krugman, *Strategic Trade Policy and the New International Economics*, Massachusetts Institute of Technology, 1995, 23 at 37. Alan O. Sykes, *Constructive Unilateral Threats in International Commercial Relations: The Limited Case for Section 301*, 23 *Law & Policy in International Business*, 263, 272-5 (1991-2)

<sup>166</sup> *Canada-Measures Affecting the Export of Civilian Aircraft, Recourse by Brazil to Article 21.5 of the DSU*, WT/DS70/RW, May 9<sup>th</sup>, 2000, at para 5.82, at 24

<sup>167</sup> *Ibid.*, at 39 The competition between Embraer and Bombardier may have an additional degree of complication. The competition described above appears to involve each competitor having one chance to select its strategy without an opportunity to change its selection before the outcome is determined. It is quite possible that market “intelligence” might allow one party to learn what subsidy package the other party has chosen and to adjust its strategy before the outcome is determined. The question then arises whether the other party has a similar opportunity to respond or the inclination to do so.

Experiments have suggested that one should cooperate if the rival cooperates and quickly punish non-cooperative behaviour, in order to condition the rival to cooperate.<sup>168</sup>

The challenge in justifying the export subsidy competition in practice as a prisoner's dilemma, is the need to develop a meaningful payoff matrix. This involves a complex evaluation of the expected political and economic impact of sanctions in both countries.<sup>169</sup> The analysis in these circumstances becomes highly case-specific and involves a broad range of questions relating to the relative economic and political costs imposed by sender (Canada/Brazil) and receiver (Brazil/Canada). The political costs are the most difficult to model because of the degree of subjectivity and dynamism involved. How robust is support for matching subsidies if the underlying theory upon which it relies is relatively fragile?

Game theory is too simplistic for modeling the impact that retaliation may have in this dispute due in part to its adoption of various simplifying assumptions. Graham T. Allison<sup>170</sup> highlights these assumptions in developing the "rational actor" model that is

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<sup>168</sup> *Ibid.*, at 41. One well-known experiment was conducted by Robert Axelrod of the University of Michigan. He invited game theorists from several countries to submit strategies for an iterative prisoner's dilemma. The winning strategy was submitted by U of T's Anatol Rapoport that was a "tit for tat" strategy and was the simplest solution that had been submitted. *Ibid.*, at 40

<sup>169</sup> The economic impact of the retaliation will depend on the size of the economies involved, the degree of bilateral trade between the two nations and the composition of this trade and its relative importance. The higher the ratio of the share of the complainant's GNP that is accounted for by the respondent's exports, the higher the odds of a successful outcome. The balance of trade is also important as the greater the trade surplus enjoyed by the respondent nation in bilateral trade with the complainant nation, the greater the influence that the complainant should have. The impact will depend on the ability of the industries targeted to adjust to the punitive tariffs, or to find alternative markets for those goods should a denial of access to the complainant's market occur. *Ibid.*, 270-1. This is illustrated in part by the "gravity model" of trade that predicts that the amount of trade between two countries will be positively related to the product of their outputs (a measure of size or mass), and negatively related to the distance between them. This model has been utilized to explain trade patterns since the 1960s, as well as to evaluate the effectiveness of sanctions. Gary Clyde Hufbauer, Kimberly Ann Elliott, Tess Cyrus, Elizabeth Winston, *U.S. Economic Impact on Trade, Jobs and Wages*, Institute for International Economics, 1997, <http://w.iece.com/CATALOG/WP/1997/SANCTION/SANCTNWP.HTM>

<sup>170</sup> Graham T. Allison, *Essence of Decision, Explaining the Cuban Missile Crisis*, 1971, Little, Brown and Company, Boston

often used as a paradigm to explain government strategy in international disputes. Allison indicates that this model underlies both game theory and neoclassical economics.

Classical ‘economic man’ and the rational man of modern statistical decision theory and game theory make optimal choices in narrowly constrained, neatly defined situations. In these situations rationality refers to an essentially Hobbesian notion of consistent value-maximizing reckoning or adaptation within specified constraints. In economics, to choose rationally is to elect the most efficient alternative, that is, the alternative that maximizes output for a given input or minimizes input for a given output.<sup>171</sup>

In this model, government decision-making takes place in a “black box” that hides any internal organizational or political processes that are involved. Government action is viewed as the choice of an action with full knowledge of the options available, made on the basis of the alternative that maximizes the nation’s strategic goals. The model assumes “comprehensive rationality” involving “powers of prescience and capacities for computation resembling those we usually attribute to God.”<sup>172</sup> Influencing government action is simply a question of manipulating the costs or benefits of a particular alternative to make it the rational choice.

A more complex “organizational process” model postulates that there are numerous actors within government such that “its acts are not those of a unitary, rational, perfectly informed entrepreneur but of an organization.”<sup>173</sup> Each decision is contributed to by several organizations in a manner that fractionalizes and distributes power. Government leaders coordinate the exercise of this power and can substantially disturb, but not control, the outcome.<sup>174</sup> Each organization has its own fixed set of standard operating procedures that take over when the organization is engaged.<sup>175</sup> These procedures limit the

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<sup>171</sup> *Ibid.*, at 29

<sup>172</sup> *Ibid.*, at 71

<sup>173</sup> *Ibid.*, at 37, 74

<sup>174</sup> *Ibid.*, at 67

<sup>175</sup> *Ibid.*, at 68

range of effective choice open to government leaders when confronted with a problem, thus representing constraints on government action.<sup>176</sup> Instead of “comprehensive rationality”, the model assumes “bounded rationality” that recognizes the physical and psychological limits of a government’s ability to understand its alternatives and to make the optimal decision.<sup>177</sup>

Allison presents a third model that recognizes the political processes included in government decision-making instead of its organizational aspects. Each central player is involved in a bargaining process that defines the constraints with which the decision must be made.

In this [political] process, sometimes one group committed to a course of action triumphs over other groups fighting for other alternatives. Equally often, however, different groups pulling in different directions produce a result, or better a resultant – a mixture of conflicting preferences and unequal power of various individuals – distinct from what any person or group intended.<sup>178</sup>

Decision-making power is shared because participants have independent power bases, with different political actors in the ascendancy at different points in time, dependent on a host of opaque factors. Regular channels – both formal and informal – structure the bargaining process. Government action is seen as an agglomeration or collage of relatively independent decisions and actions in a variety of bargaining processes, with the outcome representing a combination of the preferences and relative influence of central players or subsets of players.<sup>179</sup>

Allison does not select among these three models, but indicates that each represents a paradigm that illustrates various factors that must be understood to explain government actors in a particular international dispute. What may appear at first to be an illogical

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<sup>176</sup> *Ibid.*, at 79

<sup>177</sup> *Ibid.*, at 71

<sup>178</sup> *Ibid.*, at 145

<sup>179</sup> *Ibid.*, at 164

response based on a stark evaluation of the implications of the alternatives, may be quite rational given the organization and political aspects of the decision in question. A combination of the three models provides an insight that suggests that the adoption of game theory alone to determine whether Canada/Brazil should retaliate, oversimplifies the analysis that is necessary, given the complex organizational issues and political processes within Brazil/Canada. It is a mistake to assume that either government is a single rational actor that is strictly motivated by economic incentives. Predicting the effect that retaliation will have must take into account the multi-faceted nature of government decision-making practices that inject a significant measure of uncertainty into the response.

A brief review of the nature of Brazilian democratic institutions give an inkling of the complexities of the political actors, groups and processes that will determine the response should Canada decide to retaliate. Brazil has relatively little experience with democracy, with less than 25 years of democratic rule since its independence in 1822. By the end of military rule in 1985, it was described as a divided Leviathan, with the executive playing the major role in the state, but its effect weakened by competition between powerful state agencies with overlapping authority. The state agencies often established “innumerable links to business groups, both through associational and personalistic channels, or ‘bureaucratic rings.’”<sup>180</sup> Clientelistic politicians were reported to have penetrated the public agencies, having cronies appointed to important administrative positions through patronage. “This clientelistic interference made the politically appointed public officials indebted to and dependent upon non-state actors and thus weakened the bureaucratic hierarchy and undermined the internal cohesion of the state apparatus.”<sup>181</sup>

In the post-1985 period, Brazil’s incipient democracy was under significant pressure from this entrenched system of patronage. Brazil’s new constitution completed in 1988, settled on a presidential system, in which decision-making power was concentrated in the hands

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<sup>180</sup> Kurt Weyland, *The Brazilian State in the New Democracy*, published in *Democratic Brazil, Actors, Institutions and Processes*, Peter R. Kingstone and Timothy J. Power, eds., 2000, at 38

<sup>181</sup> *Ibid.*

of the president. Executive power was augmented by a relatively weak Congress that was hamstrung by factionalism.<sup>182</sup> Clientelistic conflicts came to pervade the entire state apparatus, such that politicians negotiated the division of the “spoils”, to ameliorate the buildup in tensions between rival groups.<sup>183</sup> This formative period of Brazilian democracy was marked by a “considerable waste of resources”, causing a dramatic increase in expenditures. It contributed in no small way to Brazil’s slide into a deep fiscal crisis in the late 1980s “marked especially by skyrocketing inflation rates of 981 percent in 1988 and 1,973 percent in 1989.”<sup>184</sup>

The election of President Collor in late 1989, marked a new point of departure in an attempt to limit clientelism but perversely, increased presidential corruption to unprecedented levels. The Collor Administration did not consult after the election with the most powerful business associations when instituting a stabilization plan in March 1990.<sup>185</sup> The Administration cut many bureaucratic rings and ignored existing interest groups. This caused rent-seekers within the business community to establish influence with the Administration in other ways, allowing Collor’s former campaign manager to allegedly increase “the going rate of bribes to 40-50 percent of the value of public works contracts.”<sup>186</sup> This led to Collor’s impeachment in 1992, when the failure of his stabilization plan weakened his position and permitted clientelistic politicians and interest groups to appropriate public funding to quell their growing opposition to Administration policies.

The interim Franco Administration from 1992-4, lasting the balance of Collor’s presidency, was hamstrung by the lack of a political mandate. His attempts to strengthen

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<sup>182</sup> *Ibid.* at 39 . Congressional weakness was such that seventy-five percent of the legislative agenda emanated from the executive branch.

<sup>183</sup> *Ibid.*, at 40

<sup>184</sup> *Ibid.*, at 40-2

<sup>185</sup> *Ibid.*, at 45

<sup>186</sup> *Ibid.*, at 45

the state were frustrated by powerful political interests even though the Brazilian Constitution automatically came up for review due to a sunset review provision.<sup>187</sup> His Administration is remarkable largely for the appointment of Fernando Henrique Cardoso as the Finance Minister who implemented the Plano Real (Real Program) that drastically reduced inflation without the attendant constriction in GDP that occurred during the early 1990s.<sup>188</sup> Cardoso was elected President on the strength of the success of the Plano Real, and took office in January 1995. A new era was ushered in, seeking reform by negotiation with interest groups, instead of attempting to bypass them:

Whereas Collor confronted – and antagonized – clientelistic politicians, rent-seeking interest groups, and powerful state governors, Cardoso has sought to bargain with them. Given the interest of these “veto players” in maintaining many aspects of the status quo, the progress of Cardoso’s reform initiatives, especially in the area of state building, has been very slow and uneven. Although the Brazilian state is gradually regaining strength, for instance, through an increase in tax revenues, it is unlikely to achieve a high degree of autonomy from clientelistic politicians and business groups, who continue to have a strong influence on substantial parts of the public bureaucracy.<sup>189</sup>

Not surprisingly, business groups continue to have a significant influence on government policy. Their support for the stabilization programs is essential and has been achieved by providing payoffs, such as selective protection from foreign competition or the bailout of bankrupt firms, particularly in the banking sector. The Cardoso Administration is reported to have doled out considerable patronage to achieve support. These payoffs are reported to have accelerated with Cardoso’s successful campaign to obtain a constitutional amendment permitting him to achieve re-election to a second term.<sup>190</sup>

In addition to tarnishing the “modern,” clean image of the Cardoso government, all those favours have also created heavy pressure on the

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<sup>187</sup> *Ibid.*, at 46-7

<sup>188</sup> *Ibid.*, at 49

<sup>189</sup> *Ibid.*, at 49

<sup>190</sup> *Ibid.*, at 53

public budget. For instance, federal personnel expenditures rose by a whopping 22 percent in 1995, and total spending increases have exceeded the substantial rise in revenues produced by the temporary tax reform and the economic recovery beginning in 1991. The fiscal crisis has therefore not eased much.<sup>191</sup>

Cardoso's presidency must be understood in terms of his relationship with key business elites within Brazil, whose support for continued stabilization programs is essential. It should not be seen as a coincidence that, the PROEX program was introduced in 1991, and financial contributions increased through the late 1990s with Embraer's share increasing to 39-45% of total PROEX expenditures during 1998.<sup>192</sup> This occurred at a time when Collor, Franco and Cardoso were courting support from the business elites. The support of these elites is courted by Cardoso, due to the nature of Brazilian democracy but also the continuation of the stabilization programs that have been buffeted by such economic shocks as the Asian Crisis in 1997 and the Russian suspension of payments in 1998. Embraer support is also drawn from its importance as a symbol to the success of the Administration's neo-liberal trade agenda involving the opening of Brazilian borders to trade.

From the standpoint of the organizational and political models, it is significant that the PROEX program, and the bias evident in the program supporting Embraer, occur at the time that Collor and Cardoso are "buying" support for Administration stabilization programs. It suggests that the Bozano, Simosen Group, and Brazil's two largest pension funds, Sistel and Previ,<sup>193</sup> that own a majority interest in Embraer, wield significant influence within the Cardoso Administration.

An important question arises as to the implications of Allison's framework for Canada's strategy of "matching" PROEX subsidies as a form of "tit for tat" retaliation. Allison's bureaucratic and political models suggest that governmental processes involve complex and highly individualistic bargaining games that are opaque in nature to outside observers

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<sup>191</sup> *Ibid.* at 53-4

<sup>192</sup> *Trade Policy Review, Brazil 2000, op cit., Supra*, Note 9 at 93, para 68

<sup>193</sup> *Ibid.*, at 92, para 64-6

that may produce outcomes that are difficult to predict even by the participants themselves. The loss of Brazilian sales may be expected to impact on the political constituency within Brazil that supports Embraer. However, “tit for tat” retaliation may have quite another effect. It may change the dynamic within Brazil that otherwise could have placed pressure on the Cardoso Administration to implement the WTO panel determination that PROEX III must comply in actual practice, even though it may be compliant on a “*per se*” basis.

Brazil is attempting to integrate its industrial structure into a more open world economy, while attempting to maintain as much shielding as possible through Mercosur and other trade policies. It has always been sensitive to its role within world affairs, with a historical emphasis on being respected as a significant regional military power throughout the postwar era, at least until the restoration of democracy. Its support for the development of a domestic nuclear weapons capacity is one example of the importance attributed to a position in world affairs. It is now redefining its role to one of a regional power broker, supported by its dominance in Mercosur. It finds its expression in Brazil’s insistence that the FTAA will not be an expanded NAFTA and its initiative of negotiating an E.U.-Mercosur Free Trade Agreement as a counterweight to the FTAA negotiations. Its interest in world affairs is also underscored by its lobbying for a permanent seat on the United Nations’ Security Council, much to the chagrin of Argentina that believes that the seat should be rotated with it and other South American countries. Integration within the international community – and the respect thereof – can be expected to provide significant internal organizational and political pressure for Brazil to comply with the moral authority of a finding by an international tribunal.

These factors within Brazil seeking deeper integration into the world financial community and trade environment, likely would be in support of modifying the PROEX III program to satisfy the panel determination. As one example, support will likely come from within the Finance Ministry that may be seeking international financial support for the continuing current account deficits that threaten the financial viability of current stabilization programs and the continuance of market liberalization. The Finance Ministry

and central players of a similar persuasion would act as a counterbalance to the entrenched elite and business interests resisting amendment to the PROEX program.

It appears that these factors had some success due to the changes incorporated into the PROEX III program that provided the basis for it to be determined “per se” compliant with the *SCM Agreement*. It is recognized that the changes made in the PROEX program by Brazil were on a ‘no-costs’ basis and may have been mere window-dressing. If Canada had not adopted a policy of matching what it perceived to be WTO-illegal subsidies, an opportunity would have been provided to determine the PROEX III program to be WTO-illegal in its application in a specific situation, a logical next step that was identified by the WTO PROEX III Panel, if not endorsed by it. Such a determination would strengthen the factors within Brazil seeking compliance.

The provision of extraordinary financial support by the Canadian government in 2001 to Air Wisconsin and Northwest Airlines, tends to relieve the pressure to comply by weakening the position of these factors within Brazil. The initiation of the panel review of Canadian support for the Air Wisconsin contract diverted scrutiny away from the nature of PROEX support, to what Brazilians see as high-handed conduct by Canada – a developed industrial nation – in adopting what it concedes is WTO-illegal support against its interests as a developing nation facing the daunting challenge of upgrading its inefficient industrial structure. Instead of a WTO panel determination that would place additional pressure on Brazil to comply “in fact” and not only in the structure of the program, the Canada-Export Credits decision was released on January 28<sup>th</sup> finding that Canada is non-compliant and possibly vulnerable to retaliation.

The insight provided by Allison now becomes relevant. Canada’s policy in the form of “tit for tat” retaliation changes the mix of incentives and pressures on the factors within Brazil’s Administration that will determine the way in which Brazil might bring its PROEX program into compliance. It may compromise the most important factor in achieving meaningful compliance, and that is the pressure brought to bear by the international community through the finding that Brazil has not complied with its

international obligations. From this standpoint, the *WTO SCM Agreement* may be seen as relatively sophisticated in its reliance on international pressure to achieve compliance.

(C) *RETALIATION*

The third alternative is for each nation to impose punitive tariffs of up to 100 percent on imports from the other. Canada is in a position to impose such tariffs today and Brazil soon will be should the dispute not be settled. The imposition of duties must be seen as a strategy that is largely symbolic in nature, with little chance of proving effective in achieving compliance by either nation with the WTO determinations. Apart from the experience of the remedy thus far in the context of WTO jurisprudence, it is rendered further ineffective due to the relatively limited bilateral trade existing between Canada and Brazil.

Retaliation is a strategy that is unlikely to apply any further pressure on Brazil to comply with the *OECD Arrangement* than would be achieved through a policy of forbearance. The failure of a policy of retaliation would be in part due to the fact that it is unlikely to build a constituency for change within Brazil. There is strong political support for continued government support for Embraer within Brazil, in light of its economic and symbolic importance as a successful high-technology exporter. The imposition of duties would have the result of excluding Brazilian imports from the Canadian marketplace. The economic impact of punitive duties will be dispersed across a number of low-technology sectors, including agricultural products. Instead of building pressures for change within Brazil, it would more likely have the effect of vilifying Canada once again. Canadian products could once again be the subject of boycotts. Canadian potash and sulphur would be convenient targets, to the extent that agricultural organizations would feel the effects of the punitive tariffs. This would have the effect of building a constituency within Brazil against trade with Canada, which has the potential to increase over time, the longer the retaliatory duties remain in place.

The imposition of duties will likely be seen by Brazil as a cost of doing business, apparently as it was by the European Union in the *E.U.-Meat* and *E.U.-Bananas* disputes. Brazil may attempt to fit its PROEX support within the *OECD Arrangement* over time, but if it does, Brazil will do so as a result of pressure from the multilateral community, not as a result of the imposition of retaliation. In fact, the imposition of duties might indeed lessen pressure on Brazil to comply with the *OECD Arrangement*. The imposition of punitive tariffs might be seen as an acceptable *quid pro quo* by Brazil and certain sectors of the international community that believe that Brazil should be given some leeway as a developing nation attempting to create a high technology sector. The result is that the policy imposes marginal cost on the Brazilian economy, while doing little if anything to ameliorate the effects of the losses of further contract competitions.

The weakness of this option as a strategy to effect change, is further undercut by the fact that once imposed, it would be difficult for Canada to eliminate the punitive tariffs, short of compliance by Brazil with the *OECD Arrangement*. Canada would stand to lose credibility in the circumstances as the impact on Canadian exports to Brazil was realized over the long-term duration of the duties. As a result, this strategy is weak not only from the standpoint of effecting change within Brazil, but also with respect to establishing Canada's credibility within the multilateral community.

Canada's apparent abandonment of a strategy imposing retaliatory tariffs on Brazil is justified in the circumstances, as it would likely apply little pressure on Brazilian trade authorities to change its practices vis-à-vis Embraer. It would also harm Canadian trade interests. Retaliatory tariffs are impracticable in part due to the relatively limited level of bilateral trade which can be summarized as follows:

**TABLE FIVE:<sup>194</sup>**  
**BILATERAL TRADE ANALYSIS**

	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>
<i>IMPORTS FROM BRAZIL</i>	1,412,616	1,722,380	1,778,048	2,618,418	2,978,504
<i>EXPORTS TO BRAZIL</i>	<u>2,580,316</u>	<u>2,545,274</u>	<u>2,416,920</u>	<u>1,975,508</u>	<u>1,968,964</u>
<i>CDN TRADE BALANCE</i>	+1,167,700	+ 822,894	+638,872	-642,910	-1,009,540

Canada was authorized to apply countermeasures up to \$344.2 million per year and indicated that its first choice would be to impose 100 percent tariffs. Imports are insufficient to generate the authorized amount of revenue, and tariffs of more than 200 per cent would be required to collect the “countermeasures” on a yearly basis. A review of the list of imports indicates that that cannot be assumed. The following table provides a summary of the principal imports from, and exports to, Brazil, which appear on the retaliation list. Iron products, agricultural products, textiles and low technology products, are fungible, and Brazil should be able to clear these products through other international markets, in the light of the relatively limited quantities sold into Canada. While the elasticity coefficients of these products have not been researched, there is no reason to believe that the markets are inelastic in nature. As a result, a punitive duty of 100 percent can be expected to shut off trade in the majority of products imported from Brazil.

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<sup>194</sup> Summary of Appendices I and II

**TABLE SIX**  
**CANADA'S RETALIATION LIST, MAY, 2000**

<b>IMPORTS (\$Cdn mill)</b>			<b>EXPORTS</b>		
<i>HS Code</i>	<i>Product</i>	<i>Amount</i>	<i>HS Code</i>	<i>Product</i>	<i>Amount</i>
72	Flat-rolled products of iron	192,585	48	Paper & paperboard	235,444
20	Vegetables, fruit, nuts	115,210	31	Fertilizers,	212,483
9	Coffee, tea,	87,762	88	Aircraft spacecraft and parts	44,628
17	Refined Sugar	74,620	10	Cereals, milling, malt	37,407
64	Footwear,	67,402	11	Starches, wheat, oil seeds	22,797
47	Mechanical Wood Pulp	52,740	39	Plastics, leather,	21,700
44	Wood products	52,287	7	Edible vegetables, etc.	14,095
8	Edible Fruit, Nuts, citrus	34,340	47	Mechanical wood pulp	12,205
63	Ceramic products	24,664	30	Pharmaceutical products	5,969
62	Blankets, apparel & rugs	<u>23,165</u>	29	Organic chemicals	<u>5,542</u>
		724,775	(48.7%)		612,270 (62.7%)

Cutting off trade with Brazil would likely have a negligible impact in terms of compelling Brazil to alter its financial support for Embraer, as Canadian-Brazilian bilateral trade is limited largely to agricultural or other products involving relatively low technological content. Eliminating steel imports from Brazil might provide some welcome relief from the standpoint of Canadian steel producers, who are under significant international competitive pressure. However, cutting off trade may have some unintended consequences, including retaliation by Brazilians against Canadian products, in a manner that is not necessarily coordinated by the Brazilian government. In January, 2002, Canadian-Brazilian trade relations were further strained, when Canada placed a ban on Brazilian beef due to concerns arising from the so-called "mad cow disease".<sup>195</sup> Reaction was immediate and out of proportion to the expected limited duration of the ban. Canada was shocked to find itself subject to vilification by the Brazilian public, with demonstrations in the streets and boycotts against Canadian goods.

<sup>195</sup> Canada became concerned about the possible infection of the Brazilian herd due to the importation of cattle from Europe.

The treatment of Canadian potash<sup>196</sup> provides a case study of the impact of the boycotts within Brazil. Canada is the world's leading producer and exporter of the main potash product potassium chloride.<sup>197</sup> It is used as a fertilizer and as a plant nutrient, either on its own, or mixed with phosphate and nitrogen.<sup>198</sup> World production was approximately 42.3 million metric tons, in 2000.<sup>199</sup> The Canadian industry employed approximately 3,400 workers, and generated \$1.8 billion in sales,<sup>200</sup> with 95% of production concentrated in Saskatchewan, which enjoys a competitive advantage over its international competitors:

Saskatchewan's potash industry ranks as the world's most productive. Its productivity is more than 10 times that of the Russian industry and 3 times more than that of the European potash producers. The Saskatchewan potash industry accounts for 33% of world production and 33% of world capacity.<sup>201</sup>

The majority of Canadian potash sales are made through Canpotex, a producer-owned potash marketing company, the shareholders including Potash Corporation of Saskatchewan Inc. (Saskatoon), Agrium Inc. (Calgary), and IMC Global Inc. (Chicago).<sup>202</sup> Canpotex was incorporated in 1970 and has built an international reputation

<sup>196</sup> "The term 'potash' refers to a group of potassium-bearing minerals and chemicals. Potash includes potassium chloride (sylvite), potassium-magnesium chloride (carnallite), potassium sulphate, potassium-magnesium sulphate (langbeinite), and potassium nitrate." *Canadian Minerals Yearbook, 1999*, Potash, Michel Prud'homme, Minerals and Metals Sector, Natural Resources Canada.

<sup>197</sup> Prior to the break-up of the Soviet Union, Canada was the largest supplier of potash in the world. The former Soviet Union sells more potash than Canada does but at lower prices due in part to its poorer quality and selling methods. Canpotex Interviews, May 30<sup>th</sup>, 2001.

<sup>198</sup> *Ibid.*, at 41.2

<sup>199</sup> International Fertilizer Industry Association Figures (million metric tons):

NB/Sask	USA	China	Israel	Jordan	CIS	England	France	Germany	Spain	Total
0.8/14.3	1.3	0.5	2.9	0.5	13.5	1.0	0.5	5.6	0.9	42.3

<sup>200</sup> *Ibid.*, at 41.1-3

<sup>201</sup> "Production occurred at eight underground mines and two solution mining operations in Saskatchewan and at one underground mine in New Brunswick. Another operation in New Brunswick only used its compaction units after its underground mine flooded in 1997." *Ibid.*

<sup>202</sup> Canpotex is a Canadian export association, established pursuant to Section 45(5) of the *Competition Act*. It does not run afoul of North American cartel laws in part because Canpotex does not sell into either Canada or the United States. The companies handle their own sales in

for service, product quality, and timeliness, thus allowing it to charge a price premium in an intensely competitive market. It has invested in a state-of-the-art shipment infrastructure, including facilities in Vancouver and Portland. It has also invested heavily in market development in such locations as China, to educate farmers as to correct fertilizing methods. Canpotex is a “flow through” company, which arranges distribution, sales and deducts its costs after sale.<sup>203</sup>

Brazil represents one of the most important international markets for potash, due to its large agricultural sector and the importance of its meat industry both domestically and in terms of export concentration. It represents ten percent of world consumption, while producing only 540,000 tons of potash in 1999.<sup>204</sup>

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those markets, competing aggressively with one another. Information has been sought on three occasions from the European Community. Canpotex interviews, May 30<sup>th</sup>, 2001. *2000 Annual Reports*:

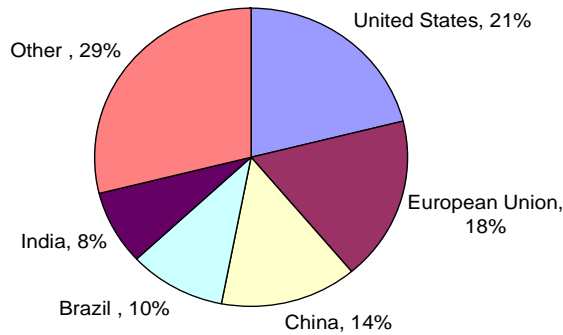
<i>Shareholder</i>	<i>Production (000 tons, KCI)</i>	<i>Location</i>
Agrium,	1,790	Vanscoy, Saskatchewan
Potash Corp	7,149	Cory, Patience Lake, Allan, Lanigan, Rocanville, Sask.
IMC Global	8,385	Belle Plaine, Colonsay, Esterhazy (2 mines), Sask

Agrium IMC Global’s interest in Canpotex is held by Canadian subsidiaries.

<sup>203</sup> It buys from the three shareholder companies at the mine, load, transport and sell the potash. An interim price is established for the potash and a final adjustment is made after final sale. Canpotex interviews, May 30, 2001.

<sup>204</sup> *Canadian Minerals Yearbook, op cit., supra*, note 196, at 1

**FIGURE ONE**  
**1999 WORLD POTASH CONSUMPTION**<sup>205</sup>



In 2000, Canpotex sold about 635,000 metric tons of potash to Brazil, representing 12 percent of total sales.<sup>206</sup> Sales to Brazil have almost doubled over the past five years and this increase is due not only to growing consumption, but also to the fact that Canadian potash is capturing a larger market share. Canpotex has a better and more concentrated sales force, primarily located in Canada but with strong local representation. This successful combination has led to product differentiation and brand-awareness of Canadian potash at the farm gate, which represents a substantial achievement,<sup>207</sup> given the fungible nature of potash generally. Notwithstanding this brand-awareness, Canada faces significant competition within the Brazilian market:

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<sup>205</sup> *Ibid.*

<sup>206</sup> Total Brazil Sales / Total Canpotex Sales (All grades)

	1998	1999	2000
	13%	9%	12%

<sup>207</sup> Canpotex interviews, May 30, 2001.

**TABLE SEVEN**  
**BRAZILIAN POTASH MARKET SHARES<sup>208</sup>**

<i>Supplier</i>	<i>Country</i>	<i>Total 1999</i>		<i>Total 2000</i>	
<i>Supplier</i>		<u><i>MT</i></u>	<u><i>%</i></u>	<u><i>MT</i></u>	<u><i>%</i></u>
Dead Sea Works/Israel		448,620	14.20	755,541	17.89
Kali Und Salz / Germany		660,443	20.90	742,098	15.58
Ameropa	CIS	659,165	20.86	651,166	15.42
Canpotex	Canada	440,340	13.94	635,924	15.06
PCS	Canada	476,798	15.09	626,697	14.84
Mekatrade	C.I.S.	345,346	10.93	514,661	12.19
Balance		128,767		295,998	
Total		3,159,479	100.0	4,222,085	100.0

The importance of Brazil in the potash market is also due to its location in the southern hemisphere. It provides an opportunity for Canpotex to complete the processing cycle for its shareholder corporations who fulfil their North American, Chinese and other northern hemisphere market requirements during the Winter and Spring. After a shutdown for holidays and maintenance, the companies then begin operations to fulfil the market requirements for the southern hemisphere including South Africa, Australia and New Zealand, but most importantly, Brazil. Any interruption in exports sales to Brazil, will have a disproportionate effect on the production cycles of potash mines within Saskatchewan, potentially leading to mine shutdowns and layoffs in this critically important market segment to the Western Canadian economy.<sup>209</sup>

There are seven different grades of potash that are sold by Canpotex. Some grades are manufactured in a granular form that it is good for mixing and bulk blending. From 1998-2000, 18-25% of Canpotex sales were accounted for by the granular grades, and 33-50% of these sales were to Brazilian customers. Granular sales accounted for 66%-84% of total sales to Brazil. Granular production is limited to certain mines within Saskatchewan

<sup>208</sup> Potafertz, share data, 2000 vs. 1999

<sup>209</sup> Canpotex Interviews, May 30, 2001.

and so the loss of the Brazilian market would have a disproportionate effect on these mines.<sup>210</sup>

Canadian potash sales to Brazil are vulnerable to disruption, if retaliation leads to a sharp reduction in imports from Brazil to Canada. This was demonstrated by the cancellation of orders for 60,000 tons of potash (\$8 to 9 million in revenue) that occurred in the January-February period. The cancellation reveals characteristics of the Brazilian market, and the manner in which Canadian exports may be affected by retaliation undertaken in the Embraer dispute. There had been no significant disruption in Canpotex's sales to Brazil as a result of any trade action, prior to the beef ban. Canpotex was aware of the Bombardier-Embraer trade dispute and considered that it would not represent a problem as long as it was kept focused on the aircraft industry. Buying patterns were unaffected and Canpotex did not receive any complaints about Canada, arising from the dispute. Once the beef ban was imposed, however, Canpotex's Brazilian customers indicated that they were experiencing problems, because farmers were angry at the Canadian trade action. The meat industry has a significant symbolic importance in Brazil and the reaction was an emotional one, that spun out of control and it was not coordinated by the Brazilian government. It was a grassroots protest that was partially a result of the success that Canpotex had achieved in establishing brand awareness. The vulnerability of Canadian potash was reflected in Brazilian news reports:

“I have been in contact with my suppliers of fertilizers and informed them that our plant will no longer use seasonings that contain Canadian potassium chloride.” *Jose Pessosa de Queiroz Bisneto, President J. Pessosa Group.*<sup>211</sup>

A similar pattern can be seen in the effect that the beef ban had on Canadian sulphur sales to Brazil. Sulphur is a key ingredient in fertilizer and Canada is a rich source of natural high quality sulphur. In 1999 and 2000, the Canadian sulphur industry was receiving reports from their sales agents in Brazil, that Brazilians were unhappy with the

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<sup>210</sup> *Ibid.*

<sup>211</sup> “Embaixada canadense ganha vaca brasileira,” GM, February 8<sup>th</sup>, 01. The J. Pessosa Group owns six sugar and alcohol plants in Brazil.

Canadian position in the *Aircraft from Brazil* dispute. This discontent flared into indignation when Canada imposed its ban on Brazilian beef. Brazilian longshoremen refused to unload Canadian products, including sulphur. The depth of feeling in Brazil was demonstrated by the fact that one of the major clients in Brazil – accounting for approximately one-third of sulphur purchases – gave an interview to a newspaper indicating that he would no longer purchase Canadian sulphur.

While the trade war remains in force, we (Ultrafertil) will substitute our Canadian sources of raw material for Polish, Middle Eastern, German or Russian sulphur ... We have already concluded with one alternative source ... I support 100 percent the actions that the workers of the Port of Santos are carrying on; I believe that other businessmen should do the same and change their suppliers.<sup>212</sup>

The effect of the beef ban was to suppress sulphur sales which, in the first six months of 2001, amounted to 544,000 tons, representing a reduction of 159,000 tons, or 23 percent, versus the same period in 2000.<sup>213</sup> Sulphur purchasers were diverted to California and the Middle East. A lingering effect of the reaction is that Brazilian purchasers have established longer term supply contracts with alternative sources. In 2000, Canada exported 1.126 million tons to Brazil, out of a total market consumption of 1.4 million tons. While it is unlikely that Brazil could eliminate Canadian sources of high-quality natural sulphur, an important Canadian market could be disrupted with a significant decline in sales if the dispute was to flare up again.<sup>214</sup>

The effect of retaliation in the context of the *PROEX* dispute can now be put in its proper context. Agricultural products are included among the imports that would be terminated if Canada was to impose a 100 percent punitive tariff as retaliation. There is reason to believe that the reaction within Brazil to this kind of retaliation would be similar to the reaction to the beef ban earlier in the year, in part due to the fact that beef products are

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<sup>212</sup> Ultrafertil suspende compra de productos químicos canadenses, Decisão da diretoria permanecerá enquanto durar o veto à carne brasileira

<sup>213</sup> *North America Sulphur Service – August, 2001*, at 6

<sup>214</sup> Based on interviews with Canadian sulphur industry officials, August 28, 2001.

included in the list of target products. A significant number of other agricultural products are included as well, and so the impact on the grassroots farming organizations should be the same.

The result is that trade in both Canadian potash and sulphur would likely be side-swiped by the implementation of a punitive 100 percent tariff by Canada. The same emotional reaction can be predicted, in response to Canadian retaliation in the *PROEX* action. The duration of the interruption in Canadian-Brazilian trade will likely be much longer in the circumstances of the imposition of retaliation. A disruption of rather short duration caused a loss of ten percent of potash sales to Brazil. Retaliation in the *EU-Bananas*<sup>215</sup> and *EU-Meat*<sup>216</sup> disputes, indicates that the imposition of retaliation in the *PROEX* dispute might last indefinitely resulting in a significant reduction in Canadian exports, while alternative sources of supply strengthen their sales relationships with Brazilian customers. In the case of Canadian potash, this trade action would disrupt Canpotex sales to the southern hemisphere and cause problems with respect to production scheduling in Saskatchewan mining and processing operations.

Turning to Allison's analysis, it must be recognized that the business groups and elites within Brazil are important factors in the determination by Brazil how to comply with WTO determinations and respond to Canadian retaliation. They exercise their influence through the myriad contacts that they appear to have within the Brazilian government departments that are formally involved in the development of Brazilian economic strategy. An earlier trade dispute serves to illustrate the nature of the relationships between business, Congress and the executive within Brazil. The United States and Brazil were involved in a trade dispute that lasted almost 15 years involving pharmaceutical patents.<sup>217</sup> In the late 1980s, the United States was involved in a dispute with many developing nations, with the United States alleging that they provided inadequate

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<sup>215</sup> *EU-Bananas, op cit., Supra*, Note 149

<sup>216</sup> *EU-Meat, op cit., Supra*, Note 149

<sup>217</sup> Thomas O. Bayard, Kimberly Ann Elliott, *Reciprocity and Retaliation in U.S. Trade Policy*, Institute for International Economics, 1994, at 187.

intellectual property protection for the research and development expenses implicit in the marketing of new drugs. Brazil was seen as one of the leading opponents of this initiative.<sup>218</sup> In the late 1980s, the United States targeted Brazil for retaliation through the Super 301 trade remedy and imposed punitive tariffs on Brazilian goods,<sup>219</sup> that had unintended consequences, resulting in a counterproductive reaction by both the executive and the Congress.<sup>220</sup> The trade dispute died down in the early 1990s with promises of legislative action by President Collor and Cardoso but by 1994, the U.S. was again frustrated by Brazilian inaction and the U.S. threatened retaliation.

The Brazilian Congress rejected U.S. threats. The president of the Senate, Humberto Lucerna, observed that “no one votes on this kind of matter under international pressure” and warned that the Senate might water down the proposed legislation.<sup>221</sup>

Once again, retaliation did relatively little if anything to contribute to the resolution of this dispute. Bayard and Elliott suggest the lesson to be learned is that “it is exceedingly time consuming and difficult to achieve effective IPR protection in developing countries in which powerful groups oppose it.”<sup>222</sup> It is notable that aspects of this intractable dispute continue to this day, with a recent iteration and threat of trade action being resolved in Spring 2001, with the announcement of a bilateral agreement that resulted in the United States dropping its complaint before the WTO. The settlement requires Brazil to notify the United States “if it plans to apply a provision of Brazilian law that would

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<sup>218</sup> *Ibid.*

<sup>219</sup> The United States imposed 100 percent tariffs on \$39 million worth of Brazilian exports. The products targeted included \$27 million in paper products, \$11.9 million in nonbenzenoid drugs, and \$100,000.00 in consumer electronics, “reportedly to pre-empt Brazilian exports in this sector.” *Ibid.*, at 197-8

<sup>220</sup> “The U.S. announcement of retaliation may have provoked a counterproductive reaction in Brazil. President Sarney reportedly rescinded an order to Brazil’s patent and trademark office to draft amendments to product pharmaceutical processes but not products. And the Brazilian Congress inserted provisions (later removed) in the draft constitution to prohibit even process patents.” *Ibid.*, at 198

<sup>221</sup> *Ibid.* at 199

<sup>222</sup> *Ibid.*, at 200

force U.S. patent holders either to start manufacturing in Brazil or license local manufacturers to manufacture the product.”<sup>223</sup> The U.S. and Brazil are required to consult in a special bilateral session to resolve the issue, although neither has waived their right to bring the dispute once again before a WTO tribunal.<sup>224</sup> The United States has determined in this dispute – after a long and protracted struggle involving threatened retaliation on two occasions – that negotiation is a better alternative.

Embraer can be expected to have close connections with several federal ministries within Brazil, particularly Industry and Finance. These departments will be populated by officials with close connections with power elites supporting Embraer as an important national champion. They also exercise their political power through the contacts they have within the Administration and their continuing support may be perceived as crucial to maintaining democratic institutions and the Administration’s neo-liberal trade agenda. It is apparent that no countervailing group has emerged in Brazil to oppose the policies that offer financial support for Embraer.

Should Canada retaliate by imposing punitive tariffs, the role of the elites within Brazil can be expected to be involved in fashioning a response. It is expected that a significant proportion of the processing, distribution and/or consumption of imported potash and sulphur within Brazil is by large scale agriculture interests. These interests will be closely connected to the Brazilian political elites. Consequently, their motivation and behaviour will likely be highly affected by political considerations, and not necessarily linked to strict economic rationality. In the case of Embraer, these elites will be highly vocal in the support for President Cardoso’s policies to sustain as a national champion. Decisions

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<sup>223</sup> U.S., *Brazil End WTO Case On Patents, Split On Bilateral Process*, June 29, 2001, [www.insidetrade.com](http://www.insidetrade.com)

<sup>224</sup> The reason given for American support for the accord is notable:  
“Informed sources said the U.S. backpedaling from the WTO panel, which it had requested in February, reflected unwillingness on the part of U.S. Trade Representative Robert Zoellick to give opponents of trade liberalization a red-hot issue that appeared to give credence to the idea of the WTO interfering with poor countries' health policies.”

One significant issue that would be part of the dispute would be the access that developing countries should have to HIV/AIDS related drugs. *Ibid.*

about sourcing potash and sulphur, may become closely connected with the political priorities of the Cardoso Administration.

As a result, it is not sensible to limit the analysis to a game theory analysis of costs and benefits based on economic incentives. The broader framework provided by Allison lends support to bottom line arguments that a policy of punitive tariffs against Brazilian exports is undesirable from a Canadian point of view.

#### **V. CONCLUSION: FORBEARANCE WITH AN EXPEDITED ARBITRAL MECHANISM THE SUPERIOR STRATEGY**

It is our conclusion that in the circumstances of the *Aircraft from Brazil* dispute, forbearance with the introduction of an expedited arbitral mechanism is Canada's best option. This is superior to matching subsidies or imposing retaliatory duties. The nature of the dispute is such that arbitration would be suitable to determine, on a timely basis, whether a government offer of financial support complies with the *OECD Arrangement* while a specific contract competition is still open. It would be ideal if the arbitral determination was binding upon the parties and enforceable in the domestic courts by adopting the *New York* or *Inter-American Arbitral Conventions*. However, it is unlikely that the parties can agree to a binding mechanism and one that is *enforceable* in this manner. It is possible that the determination will be binding only in the sense that it can be adopted as a *WTO Dispute Settlement Body* report and "enforceable" through the moral suasion of the multilateral community.

A policy of matching subsidies is the most aggressive remedy that Canada can adopt and may well be an effective strategy from the standpoint of attempting to influence behaviour within Brazil. However, it carries a significant cost, in terms of damage to Canada's international reputation. It is a self-help remedy within a legal framework that frowns upon the utilization of such remedies, due to the experience with the American Section 301 mechanism. It is generally perceived that should the utilization of self-help remedies become pervasive, the WTO dispute settlement mechanism will become discredited and weakened. The justification for utilizing such a self-help remedy becomes

somewhat opaque as a result of the finding that the Canadian and Brazilian programs are compliant with the *WTO SCM Agreement* on at least an “as such” basis. There is no longer a “bright line” determination that financial support extended pursuant to these programs *ipso facto* are non-compliant in a manner justifying some form of retaliatory response within the context of the WTO. “Matching” a “subsidy” in such circumstances gives rise to a likelihood that the self-help remedy will be found non-compliant by a WTO panel in much the same way as the *Canada-Export Credits* determination.

In the circumstances of the Air Wisconsin transaction, Canada determined that it was important to “buy” the contract by providing support that it must have known would be characterized as a prohibited export subsidy that was not consistent with the *OECD Arrangement*. The utilization of a self-help remedy by Canada in the circumstances has provided an opportunity for Brazil to deflect WTO attention away from itself and onto Canada.

The least attractive of the three alternatives is the imposition of duties in a WTO-authorized form of retaliation. It carries with it at best a modest chance of successfully influencing Brazilian support for Embraer. It more likely will be seen as a cost of doing business within Brazil and a relatively modest one given the political and symbolic importance of Embraer. Experience with the implementation of retaliation suggests that it adds little, if anything, to the pressure applied to bring the program in question into compliance, by multilateral surveillance pursuant to the provisions of the WTO DSM. This form of retaliation also carries with it a significant risk that the dispute will escalate in an uncontrollable fashion due to an emotional, popular reaction to the closing off of Brazilian exports in the context of earlier trade irritants between Canada and Brazil. The case studies presented above, involving potash and sulphur, indicate that trade action by Canada may lead to a boycott of Canadian goods. As a result, the objective of building a constituency within Brazil to force compliance may backfire and indeed build a broad coalition with the objective of punishing Canadian trade interests.

The parties should realize that the introduction of an arbitral mechanism is in their interest especially if the competitive landscape of the regional jet market changes as a result of new market entrants. Throughout the dispute, the parties appear to have characterized the dispute as a two-party game. Embraer has already begun to forge links with Europe. Bombardier's market position is at risk due to a higher cost structure than either Brazil or Russia (hence the structure of the Boeing/Russian venture). Brazil similarly enjoys a lower cost structure, with a highly skilled engineering and industrial workforce and so, may enjoy a better confluence of competitive factors. The possibility of new market entrants with "deep pockets" should support the introduction of an arbitral mechanism. The purpose of the *WTO SCM Agreement* and the *OECD Arrangement* is to limit such "competition of treasuries" and the adherence to such limits may provide welcomed relief, especially if the new entrants include the European Union and Boeing with their deep pockets.

The importance of the changing competitive landscape is caught in Michael Porter's theory of competitive advantage and the limited role that government should play in the development of business clusters.<sup>225</sup> Porter's theory indicates that competitive advantage is essentially a function of the quality of certain dynamic factors within the national economy. The primary agent of competitive advantage is the concept of a "business cluster", which is defined as "groups of industries connected by buyer-supplier relationships or strong interrelationships in terms of products and technology ... involv[ing] end products, specialized inputs used in these products, specialized machinery employed in making them and associated services."<sup>226</sup> Porter identifies the business conditions essential to the growth of business clusters in proposing his paradigm of a "diamond" of factors interacting on one another which is crucial to continual upgrading in an industry. The four main determinants are: factor conditions; demand conditions; related and supporting industries; and firm strategy, structure and rivalry. In addition to these determinants, the role of government and chance are also important

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<sup>225</sup> Michael E. Porter, *Canada at the Crossroads, The Reality of a New Competitive Environment*, The Monitor Company, 1991, at 22

<sup>226</sup> *Ibid.*

determinants. Together these determinants form a system which dynamically produces competitive advantage:

Each of the four determinants of competitiveness ... influences the capacity of a nation's industry to innovate and upgrade. Together they constitute a dynamic system that is more important than its parts. Over time, the determinants tend to be mutually reinforcing or mutually undermining.<sup>227</sup>

The elements that promote competition will reinforce upgrading which may lead to sustainable competitive advantage. Those which do not reinforce competition are problematic. This leads to an analysis of the role of government:

Government has a less decisive role than is implied in much of the current writing on competitiveness. Government policy toward the economy is often framed as a choice between laissez-faire and direct intervention in industry. This dichotomy is inaccurate. The role of government policy is best understood by looking at how it influences the diamond. Government at all levels can improve or impede national advantage through, for example, its investments in factor creation, through its role as a buyer or influencer of buyer needs, through its role in related and supporting industries, through its influence on the goals of individuals and firms, and through its competition policies.

The proper role of government is to improve the quality of the inputs (factors) firms can draw upon, and define a competitive environment and rules of the game that promotes upgrading... Its appropriate role is an indirect, rather than direct, one. Government's proper role is as a catalyst and challenger. It is to encourage or even push, companies to raise their aspirations and move to higher levels of competitive performance, even though this process may be unpleasant and difficult. Government's job is to make firms feel wanted but uncomfortable and in need of improvement, not to forge cosy business-government "partnerships", relax pressures on industry, or to seek to eliminate risks.<sup>228</sup>

The singular focus by Canadian trade representatives on Brazil's PROEX program, might contribute to a lack of attention to more important competitive factors to the future of Bombardier's competitive advantage such as the change in the competitive landscape and the flexibility it might need in meeting this competition.

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<sup>227</sup> *Ibid.*, at 63

<sup>228</sup> *Ibid.*