

Brazil's Slow and Uncertain Shift from Protectionism to Free Trade

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Introduction

Over the last two decades, Brazil's trade policy has centered on two main negotiations. At the regional level, Brasília has spent much of its time and effort trying to lay the groundwork for a common economic space in the Southern Cone of South America. Since 1991, Mercosur, the Common Market of the South, has been the centerpiece of that strategy. At the multilateral level, the focus has been on the World Trade Organization (WTO) and its rounds of negotiations to liberalize trade. Since the turn of the century, Brazil has been one of the main supporters of the Doha Round as it tries to reach an agreement with more balance between developed and emerging economies.

Progress on both fronts, however, has been limited. Disputes within the South American bloc continue or even escalate as member countries deviate from the process of building a common market. Since its inception, Mercosur has been bogged down by "temporary" exceptions to the free trade regime and customs union rules. The plan to expand the bloc's borders has gained a more salient political dimension but, increasingly, to the detriment of economic requirements. At the WTO, meanwhile, persistent disagreements between developed and emerging economies—mainly regarding agricultural trade, manufacturing tariffs, and intellectual property—have all but halted the Doha Round, which saw no major overtures between 2008 and 2013.

If internal problems weren't enough, Brazil's trade-related objectives will likely confront stronger headwinds from the global economy. In a context where there is advancement of incipient US-led global trade negotiations like the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) between the United States and the European Union, both Mercosur and the WTO tend to feel an impact. The success of these two potentially transformative trade arrangements will greatly depend on the Obama administration's ability to push negotiations. Nonetheless, talks on TPP and TTIP promise to dominate the global trade landscape over the next two years, obfuscating or even undermining Brazil's trade policy priorities.

To understand how policymakers in Brasília will respond to these challenges, one needs to understand the drivers of Brazil's trade policy in recent years. It is also important to have a comprehensive view of how trade policy ties into the government's broader economic policy goals. Brazilian leaders' perceptions about trade are largely determined (or limited) by a broader political and economic context.

The overarching hypothesis when it comes to economic policymaking in Brazil, and this premise includes trade policy, is that when economic and political restrictions become more salient, the government tends to respond in a more constructive fashion. Global economic expansion, powered mainly by a boom in commodities and Chinese growth, provided the conditions for sustainable growth in Brazil during much of the last

FOREWORD

In recent years, economic opportunities have become the main force driving relationships in the Western Hemisphere. While political cooperation has stumbled, robust trade and financial engagement has been shown to be the best foundation for stronger partnerships between the US and the region, as well as amongst Latin American countries themselves.

Though the United States' economic preeminence in Latin America has waned in relative terms, its commercial relationships with the region's countries continue to deepen. Between 2000 and 2013, US sales to Latin America more than doubled, as did the region's exports to US markets. The United States remains the first or second trading partner for nearly every country in the region, and provides upwards of 90 percent of the \$60 billion or so of remittance income destined for Latin America. The level of US foreign direct investment in Latin America is twice as high as it was a decade ago—notably in both Brazil and Mexico.

But Latin American trade today is also characterized by new players. The region itself has become a global exporter, while China, other Asian nations, and Europe are a crucial part of the economic landscape in many Latin American countries.

Latin American nations also now trade much more among themselves. Argentina, for instance, may soon replace the United States as Brazil's second largest trading partner. The Pacific Alliance, comprised of Chile, Colombia, Mexico and Peru, merits special attention on this score.

But Latin American countries face enormous challenges in strengthening their international competitiveness and assuring their position in global finance and trade flows. And while the United States can expect trade with the region to continue growing, they will have to work harder and harder to compete for the region's markets and resources. Further economic integration will require smart policy and an understanding of the complicated issues at play.

Drawing on distinguished policy analysts, government officials, and business leaders from across the hemisphere, the Dialogue is seeking to build a better understanding of the major trends affecting trade and foreign investment in the Americas, and to explore the emerging opportunities for enhancing economic cooperation. This paper by João Augusto de Castro Neves of the Eurasia Group explores the evolution of Brazilian trade policy. The Dialogue is deeply grateful to Liberty Mutual for its support of this project. For access to information on the Dialogue's work on trade issues, including other working papers and videos of our meetings, we invite you to visit our website (www.thedialogue.org).

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decade. This growth cycle led to a material increase in the standards of living and a broadened middle class. A political by-product of that growth cycle was years of strong presidential popularity, especially during President Luiz Inácio Lula da Silva's second term (2007–2010) and President Dilma Rousseff's first two years in office (2011–2013).

The economic super-cycle and the political super-cycle combined to generate incentives for complacency. A number of structural reforms were left on the back burner while the government increased its presence in some sectors of the economy. But now that the winds of the global economy have shifted, Brazil's economic expansion has slowed down, and Rousseff's approval ratings have dropped to more "normal" levels following widespread protests in June, complacency may give way to more constructive and proactive policies, albeit incrementally and not always consistently.

Under different administrations over at least the last two decades, the quality of policymaking has tended to improve when Brazil is faced with a harsher economic environment. (This is not an immediate or even a perfectly direct correlation; this process tends to be incremental and vary from sector to sector.) While it is safe to say that Brazil is entering a less promising phase under current forecasts for global and domestic economic growth, the country's political and economic structures are nowhere near the brink of collapse. Therefore, it is vital to put into perspective the current situation, especially given the country's history of political and economic upheavals.

How will Brazil's trade policy be influenced over the remainder of President Rousseff's term and beyond? A deteriorating economic environment will combine with emerging trade initiatives to expose the vulnerabilities of the country's current trade policy. As a result, adjustments are likely, although no paradigm shift is expected. In other words, while Brazil's proclivity toward protectionism is expected to unwind, it probably will not be redirected toward free trade. Any change, however positive, is more likely to be incremental. In addition, while next year's presidential election may help spur debate on Brazil's trade policy agenda, it may also punt more meaningful changes until a new administration takes office in 2015.

Brazil as an Ambivalent Global Trader

The first decade after the turn of the century proved a success story for Brazil. After hard-won battles to consolidate macroeconomic stability amid a succession of domestic and international financial upheavals in the 1980s and 1990s, the country entered the 2000s with solid political and economic foundations for more sustainable and equitable growth. The yearly rate of economic expansion went from 1.7 percent in the 1980s and 2.6 percent in the 1990s to 3.6 percent in the 2001–2010 period. GDP per capita also picked up considerably, moving from US\$4,200 in the 1980s to US\$5,600 in 2010.

Trade was a big part of this story. The import substitution regime that appealed to an overwhelming majority of the country's policymakers since the 1930s had reached its exhaustion point by the 1980s. The government responded by embarking on a process of economic reform that would gradually open Brazil's economy. It is worth noting that Brazil's adherence to liberal norms during that period was at most times half-hearted. Nevertheless, in the 1990s Brasília sought to prepare the country for globalization by first exposing the local economy to regional competition. Thus Mercosur was born, originally as an instrument to help modernize the Brazilian economy. An agenda of economic reform that included privatizations of state-controlled enter-

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prises, deregulation of sectors, stabilization of the economy, and trade liberalization remained active during the rest of the decade.

But it wasn't until the 2000s that Brazil started to feel the favorable winds of the global economy. China's impressive economic growth sparked demand for natural resources that pushed the price of commodities to record-high levels. This greatly benefited Brazil's export sector, as well as the broader economy, and transformed the country's trade relations. Asymmetries in the terms of trade aside, trade flows increased exponentially during the period, and China surpassed the United States to become Brazil's main trading partner by the end of that decade.

Unfortunately, expansion of Brazil's trade flows had much less to do with Brasília's trade policy than with changes in the global economy. As mentioned previously, China and the commodities' super-cycle were the main factors driving Brazil's exports. Since Mercosur in 1991, Brazil has signed no major free trade deals, and Mercosur itself had begun to look like a collection of independent trade fortresses designed to protect member states from outside competi-

much in Brazil over the last two decades. Two figures help highlight the worrisome scenario. The first one relates to how open Brazil's economy is. With trade accounting for roughly 20 percent of its GDP, Brazil remains one of the most closed of the Latin American and G20 economies.

The second figure shows that the increase in Brazil's trade flows was just enough to keep pace with expanding global trade in the past two or even three decades. In 2010,

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It is against this backdrop that Brazil now confronts a more chal-

lenging global economic environment. The forecast that the global economy will probably grow at a slower pace over the next five years than it has in the past ten, and the impact that will have on commodities' prices, is of great concern to policymakers in Brasília.

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Figure 1. Merchandise Trade as a Percentage of Brazil's GDP

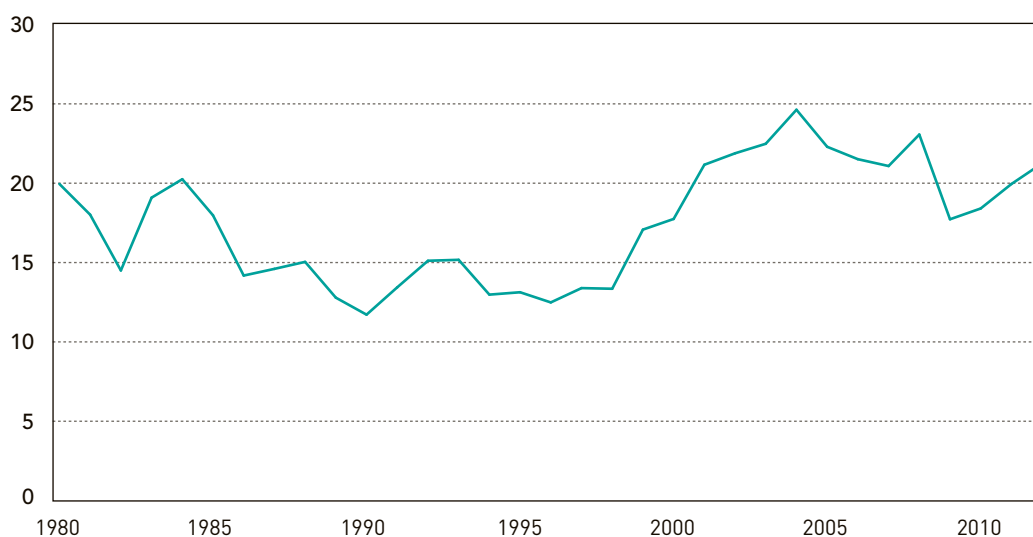
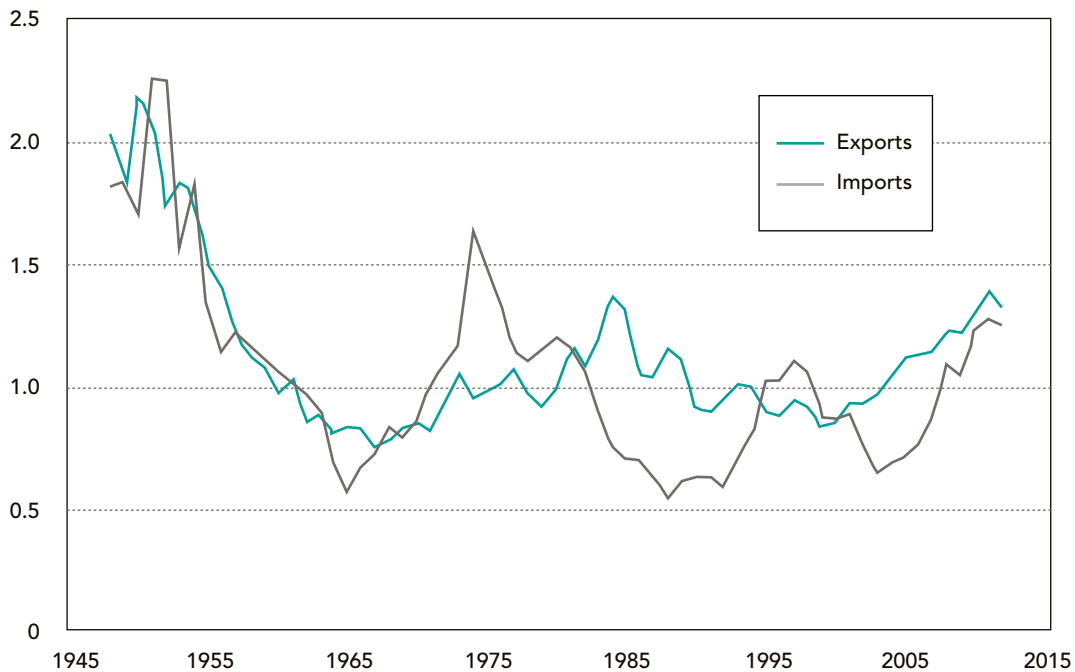


Figure 2. Brazil's Merchandise Trade as a Percentage of Global Merchandise Trade



to do with the country being able to keep up with growing global trade. Under a less favorable scenario where countries are seeking to redraw trade linkages, the opportunity cost of not having a more proactive trade policy will probably increase. That risk currently seems to be emerging in Latin America, where Brazil has focused much of its trade policy engagements.

A New Tordesillas in Latin America?

When it comes to trade relations, Latin America's divide has become starker in recent years. The rhetoric at regional summits may be bold, but actual integration remains relatively thin. Mercosur, despite advances to diffuse regional rivalries, is still beleaguered by constant trade disputes among its member states and outright violations of the bloc's rules. UNASUR, the Union of South American Nations, is a union in name only with no real impact on trade flows. Other integration platforms, such as the Andean Community and the

Bolivarian Alliance for the Americas (ALBA), are either near extinction or have never evolved from an embryonic stage.

In addition to Mercosur lacking institutional teeth and being plagued by disputes from within, regional blocs in Latin America are starting to drift apart on the currents of global trade. The impact of these emerging dynamics on Latin America and on Brazil's trade policy agenda is twofold.

Broadly, TPP and TTIP negotiations may make almost irrelevant existing multilateral trade negotiations at the Doha Round in its current format. By establishing new and more comprehensive rules for trade and investment (commonly referred to as WTO-plus obligations), the TPP and TTIP agreements will set a new standard for future global trade talks. In practice, this could push the WTO to launch another round of multilateral talks under more comprehensive terms. Until then, however, the opportunity costs for some developing countries to remain excluded from both accords will increase as the potential risk of trade diversion grows. Although Brazil will be motivated after claiming the

top post at the WTO, the new director-general will face an uphill battle in reviving multilateral talks.

More directly, these US-led global trade initiatives will exacerbate trends already emerging in the region. Primarily, the TPP will draw the Pacific Alliance members (Mexico, Chile, Colombia, and Peru) closer to its orbit. Countries from the Pacific Alliance bloc are regarded as more business-friendly and open to trade than their “Atlantic” counterparts represented by Mercosur (Argentina, Brazil, Paraguay, Uruguay, and Venezuela). Since most Pacific Alliance members have already signed free trade agreements (FTAs) with the world’s major economies (United States, European Union, and even China), their gradual adherence to TPP is close to a shoo-in. Chile and Peru are original members of TPP, Mexico formally joined last year, and Colombia, Costa Rica, and Panama have already started conversations to join the initiative. As negotiations pave the way for more trade

disputes in a context where Brazil is already frustrated by Argentina’s export restrictions.

Brazil’s strategic patience with Argentina over the past decade has been largely sustained by favorable trade flows. The situation, however, has become less favorable to Brasilia over the past year, with diminishing trade flows and more frequent monthly bilateral trade deficits than in the past. While this alone may not undermine bilateral relations, it may well heighten Brasilia’s growing concerns over the country’s deteriorating trade balance. In 2013, Brazil is expected to register its first trade deficit (or a very small surplus) in nearly fifteen years. Trade with other Mercosur countries still provides Brazil with a significant surplus, but the overall importance of the bloc for Brazil’s exports has diminished consistently from a peak of 19 percent of total exports in 1998 to less than 12 percent in 2012. While much of this shift has to do with growing Chinese demand

for Brazilian products, Brazilian exports to Mercosur countries also face increased competition from countries outside the region. Recent studies indicate that Brazilian products are losing market share in Argentina to Chinese goods.

Despite these setbacks,

Mercosur will continue to exist and even grow in the near future. Last year Venezuela was admitted as a full member; Bolivia and possibly Ecuador are expected to join the bloc by next year. Instead of adding strength, however, new members will ultimately reduce Mercosur’s negotiating capacity. Every decision made by the bloc, including those on FTA negotiations, requires unanimity from its members. Thus far, disputes between Brazil and Argentina alone have been enough to lead to the failure of Mercosur-EU talks in 2004, and they explain the absence of any major trade deals. (Mercosur has signed only three FTAs outside the region: with Israel, Egypt, and the Palestinian Authority.) The addition of the even more disparate economies of Venezuela, Bolivia, and Ecuador, could leave the decision-making process more susceptible to the ideological whims of country leaders. At the same time, the interest asymmetries will surely intensify, diminishing the bloc’s external negotiating capacity. The as-yet-unresolved issue of Venezuela’s entry during Paraguay’s suspension last year underscores the

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and investment opportunities, other countries in the region may be encouraged to follow suit.

With these shifting trade dynamics and a more challenging global environment, fissures within Mercosur will deepen and become more visible, starting with the bloc’s two largest economies. Recent disagreements between Argentina and Brazil are the more obvious example of this trend. Squabbles between the two countries have been frequent and even expected, but there are reasons to believe that bilateral trade relations may be approaching an inflexion point. A strong indication that the two countries have diverged from a common trade policy is Argentina’s reluctance to open its automotive trade regime with Brazil. Currently, quotas manage auto trade between the two countries but the bilateral regime establishes a liberalization period that will ultimately lead to free trade. The timeframe for this process has been postponed numerous times by Buenos Aires over the last decade, exacerbating trade

types of challenges facing Mercosur as it pushes for horizontal expansion (adding new members) while avoiding the challenges of vertical integration (deepening ties among existing members).

These tensions point to two possible outcomes. The first would be growing, unresolved tensions that lead countries to opt out of the union and, possibly, join the Pacific Alliance or even the TPP initiative. Smaller countries would be more likely to consider this option, which was touted by Uruguay when it was considering an FTA deal with the United States. Currently, Uruguay is signaling that it may resume a more proactive trade policy, and Paraguay has become an observer to the Pacific Alliance. The second, and more likely, outcome would be more flexibility in the rules governing Mercosur. Eliminating restrictions that preclude member states from signing bilateral trade agreements would be the most significant change. In theory, this would set a precedent that would facilitate trade negotiations with any other country outside of Latin America. In practical terms, however, a deviation from the common trade policy would also mean the end of Mercosur as a customs union.

While shifting global dynamics will deepen Mercosur's deficiencies as a trade bloc, the good news is that those shortcomings do not undermine the success that is Mercosur from a geopolitical perspective. Trade disputes aside, Brasília and Buenos Aires agree more than they disagree when it comes to geostrategic issues (i.e. nuclear and military cooperation). Ultimately, a clearer differentiation between the economic dimension and the political dimension of Mercosur would set the stage for a more pragmatic trade policy within and outside the bloc.

Will two parallel schemes continue to dominate Latin America's trade landscape for the foreseeable future? Part of the answer lies in the currents of the global economy and trade policy initiatives that originate in the developed world. In the case of Latin America, US actions will be especially salient. How domestic politics unfold within countries of the region will also be relevant. The divide between open and closed countries has been growing starker for quite some time. However, in a scenario with relevant political shifts in Paraguay, Argentina, and Chile, among other countries, the idea of a permanent dividing line in the region becomes relative. In other words, the dividing line is crossable.

The region will remain a relevant starting point for Brazil's trade policy. But intermittent attempts to revive and even expand Mercosur will compete with the increasing need for a more proactive trade policy outside the region. As a result, the bloc may become bigger, yet weaker, in the coming years.

A Slow and Uncertain Shift from Protectionism to Free Trade

While policymakers' perception on shifting dynamics in global trade is likely to become more relevant to Brasília's trade policy decision-making, domestic variables will influence how proactive that trade policy becomes. Over the years, trade policy has had a discrete place in Brazil's political landscape. It has also been subordinate to competing economic policy goals, chiefly industrial policy. Other variables, such as the government's concern with inflation, also frequently interfered with a coherent trade policy.

The favorable economic environment of the last several years bolstered Brasília's penchant for more active industrial policies. Rather than being driven exclusively by the ideology of a left-wing government, much of the country's more activist industrial policy had to do with incentives generated by the economic success of 2003–2010. With the economy expanding at above average rates and domestic vulnerabilities significantly reduced, policymakers had room to pursue a small dose of resource nationalism and more active industrial policies in key sectors. This led to more protectionism. With no real need to court private investment, a certain amount of hubris has also prevailed in policy circles.

Recent protectionist measures have been driven by government concerns about industrial competitiveness. For example, targeted protectionism occurred in 2012 when Brasília published a list of 100 products that saw their tariffs rise for at least a year. The list mostly included auto parts, furniture, plastics, steel, and inputs for the pharmaceutical and chemical industries. Average tariffs rose 25 percent, from 12 to 14 percent. The hike impacted approximately 4 percent of the country's total imports (\$5 billion of \$130 billion in total imports). However, these figures could have easily risen more since the government was considering adding another 100 products to the list. Earlier that same year, the government announced tax hikes on imported cars, a measure designed to benefit the local automotive industry.

Soon after, Brasília reviewed its automotive trade deal with Mexico, ultimately limiting auto imports from that country.

The recent proclivity for more protectionism also has much to do with the government's response to powerful domestic industrial groups, such as the auto sector. Protectionist measures have appeared in other sectors as the government sought to develop a nascent industry or revamp a more traditional one while creating jobs. In a well-known example, restraints in the oil industry brought about local content rules. And in the telecom sector, international carriers complain about import restrictions in a local content clause governing the 4G wireless airwave auction held in 2013.

Economic policy priorities have placed some limitations on protectionism. Since one of President Rousseff's main

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policy goals was to aggressively lower Brazil's perennially high interest rates to single digits, it was reasonable to expect that the government would respond to inflationary pressures by relaxing some import restrictions. In fact, those protectionist measures were accompanied by a mechanism to monitor domestic prices of the products. In the likely event that inflation remains dangerously close to the upper threshold of the target, price fluctuations could prompt the government to review the measures it adopted. Indeed, when inflation started to pick up pace early in 2013, the government started to reverse some protectionist measures that had been announced. The growing political impact of a rising cost-of-living on an emboldened middle class also has affected protectionism, which is likely to be limited as long as inflation doesn't move far from current levels—a reasonable forecast for the remainder of Rousseff's term.

As the government grapples with worsening economic conditions, it is expected to respond by making needed adjustments rather than doubling down on interventionist policies. Part of this appraisal stems from recent

developments such as the government's launch of an ambitious transport infrastructure concessions package, among other constructive measures.¹ Absent the favorable economic conditions previously described, incentives change. Policymakers will feel a greater need to work with the private sector to spur growth and investments. That will most likely translate into a growing debate over the need for long-shelved growth-enhancing economic reforms and more attractive terms for private investment in key sectors. Trade policy, although currently not at the core of that debate, will likely be influenced in a more constructive way.

Recent trends may not signal a full-blown reversal of protectionist measures or a wholesale shift toward a more liberal trade negotiation agenda in the near term, but they

strongly suggest that protectionism is waning as a major policy option, at least during the remainder of Rousseff's first term. For the government that takes office in 2015, trade policy will depend on how global trade initiatives unfold and the shape of the Brazilian economy.

A good bet is that free-trade support in Brasília will be stronger than it is today. Competing trade initiatives in a more challenging global economic environment point in this direction, as do political and economic drivers at the national level. None of the three major candidates heading into next year's presidential election is advocating heterodox economic policies. Quite the contrary. Rousseff is slowly shifting to more constructive policies; presidential hopefuls Aécio Neves and Eduardo Campos would also implement more constructive changes. That is good news for future trade negotiations, even though a pure free trade agenda is unlikely to take shape.

This ties into the evolving domestic debate surrounding trade policy. Historically, much of the support for free trade in Brazil has rested in the agricultural sector, which has become very competitive in the last twenty years. But

¹ In addition to the transport concessions package announced in 2012, the government has resorted to a tighter monetary policy to control inflation, enacted modest measures to reduce spending, and announced its desire to rein in public banks to reduce uncertainties about the trajectory of Brazil's debt.

now even Brazil's traditionally more protectionist industrial sector is calling for trade negotiations.² This is an important step toward the development of a significant pro-free trade lobby in Brazil.

Conclusion

What would a more proactive or constructive trade policy agenda for Brazil look like? At the multilateral level, despite persistent skepticism in the near term, Brazil is showing a newfound interest in reviving Doha Round talks. Now with a Brazilian diplomat at the helm of the WTO, Brasília may have a stronger sense of responsibility for the success of the negotiations. Even more promising is Brazil's recent signaling that it may seek to join talks on a trade in services agreement (TISA), an initiative launched by the United States in 2012 and currently covering fifty countries, including the world's major economies. If confirmed, such a move could trigger wider changes to Brazil's trade policy.

In the region, a wholesale shift in trade strategy by Mercosur remains unlikely in the medium term. However, a more challenging economic environment and likely progress on TPP and TTIP have already prompted priority shifts among the bloc's members. In fact, most Mercosur countries seem keen on resuming free trade talks with the European

Union. In October, Brasília decided to dust off its offer to the EU, signaling a willingness to be more flexible in reaching a deal. (An accord was almost reached in 2004, but disagreements between Brazil and Argentina prevented consensus within Mercosur and created an impasse.) The Rousseff government appears willing to present an offer affecting 90 percent of Brazil's total trade with the EU; the offer includes rules on procurement, services, and investments. Success of the talks will hinge on the EU's counteroffer, but Brasília appears prepared to calibrate its terms independent of its Mercosur partners. Ultimately, a Mercosur-EU deal will take the shape of a series of bilateral deals, with each country negotiating at its own pace.

When it comes to the world's two largest economies and Brazil's two major trade partners, no meaningful changes are expected in trade relations in the near term. Brasília's concerns about possible negative externalities of the bilateral exchange with China will remain high. In addition to persistent asymmetries in the terms of bilateral trade, China, with a more aggressive trade policy abroad, has become a threat to Brazilian manufactured goods in third markets, especially Latin America and the United States. With the United States, the path to an overarching bilateral economic partnership, which would include talks on services, investments, and trade, has been negatively affected by recent disclosures about US government eavesdropping. Nevertheless, private sector cooperation between the two countries has increased considerably in recent years and a roadmap for a trade agreement is likely to surface, although probably after next year's presidential election in Brazil.

² http://en.mercopress.com/2013/09/26/brazil-s-main-manufacturing-lobby-calls-for-urgent-resumption-of-trade-talks-with-eu?utm_source=newsletter&utm_medium=email&utm_campaign=daily



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