The Bombardier-Embraer Dispute and its Implications for Western Hemisphere Integration

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Jonathan P. Doh[1]

Summary

Government subsidies are a pervasive problem for international trade and economic development. Subsidies distort investment decisions, generally squander scarce public resources, skew public expenditures toward unproductive uses, unfairly discriminate against efficient industries and firms, and prompt wasteful overconsumption of some products over others. Despite efforts to limit subsidies through trade and investment policy disciplines, subsidization remains a constant on the global trade policy and international business landscape.

One category of subsidy—export financing through export credit agencies (ECAs) to civilian aircraft companies—has generally fallen outside the purview of regional and global trade and investment agreements. This may be because aircraft companies are often involved in "dual-use" products that can be sold for both civilian and defense aerospace applications, creating a potentially legitimate national security justification for their exclusion from agreements that would otherwise impose limits on state support. In addition, the concentration of few firms within the industry and the "winner-take-all" aspect of contract awards invite politically motivated support by governments to ensure their national champions receive a fair share of contracts. Among the widely publicized disagreements in this area, the transatlantic dispute over subsidies to Airbus and Boeing has received considerable attention. However, a similar controversy is brewing in the Western Hemisphere.

[1] Erik Holt provided research assistance in the preparation of this paper.

Bombardier, one of Canada's largest and most successful national companies, and Embraer, Brazil's fast-growing producer of small jet aircraft, are engaged in an aggressive battle for global market share in the regional-jet market (see tables 1 to 4). Although Embraer entered this market relatively recently with its 50-seat ERJ135, it has become the fourth-largest aircraft producer in the world. Both companies—and their respective governments—have alleged that the other has benefited from generous taxpayer subsidies.

Embraer and the government of Brazil have long argued that Canada has offered Bombardier unfair subsidies that allow it to make more attractive offers to air carriers considering purchase of Bombardier's midsized jets. Canada has made the same arguments about Brazil's export credit program. Brazil lost a World Trade Organization (WTO) case filed by Bombardier alleging it was subsidizing Embraer. Brazil has since modified its export finance program in response to this ruling. However, it recently announced a $1-billion[2] deal with the country's national development bank to promote high-end technological exports, which has renewed Canada's concerns. The government of Brazil challenged Canada's export credits for Bombardier and recently won a WTO ruling and authorization to retaliate for the harm caused by those credits.

Given the problems plaguing the global airline industry—both from underlying economic weakness as well as the fallout from the 9/11 terrorist attacks—many airlines are no longer creditworthy enough to attract commercial lenders. Both Bombardier and Embraer are expecting increased demand in the regional-jet market as airlines begin to utilize smaller, more efficient aircraft, but in the meantime there is a raging battle in the skies for market share and regional and global dominance.

The dispute, and its ultimate resolution, has implications for two important companies, the governments of Brazil and Canada, and the ongoing debate regarding state subsidies and government support that is part of the WTO and Free Trade Agreement of the Americas (FTAA) negotiations. In the near term, there is little reason to expect substantial progress or comprehensive solutions because of the difficulty in limiting the beneficiaries of subsidy disciplines, slow progress in both regional and multilateral trade negotiations, and continued political pressure for governments to support important industries and to retain countervailing policies linked to subsidy disciplines.

[2] All currency in U.S. dollars unless denoted otherwise.

Table 1. Regional Jets Sales in the United States, 1995–1999

Year	# of regional jets	% of fleet	% of seats
1995	78	3.6	9.8
1996	90	4.2	10.6
1997	137	6.5	14.3
1998	259	12	24
1999	394	18	32

Source: Fairchild Dornier Corp.

Table 2. Forecast of Regional Jets Delivered, 2000–2020

Size	# of aircraft
25–44 seats	1,050
50–65 seats	2,018
66–85 seats	1,997
86–110 seats	2,206

Source: Fairchild Dornier Corp.

Table 3. Regional Aircraft Order Book, May 2002

	Delivered	Firm	Backlog
Bombardier CRJ Series			
CRJ 100/200	613	950	337
CRJ 700	31	195	164
CRJ 900	0	30	30
Total	644	1175	531
Bombardier			
Q100	298	299	1
Q200	94	94	0
Q300	189	209	20
Q400	53	74	21
Total	634	670	42
Fairchild			
328JET	75	132	57
728	-	118	118
928	-	4	4
Total	75	254	179
Embraer			
EMB 135	89	121	32
EMB 140	28	174	146
EMB 145	404	571	167
EMB 170	-	82	82
EMB 195	-	30	30
Total	521	978	457

Source: Manufacturer reports.

Table 4. U.S. Regional Jet Operators and Fleets, Winter 2001

Carrier	Code partner	Aircraft	In service	Firm orders	Conditional orders	Totals
Air Wisconsin	United	BAe 146-100/200/300	18	0	0	18
		CRJ-200LR	14	46	99	159
American Eagle	American	CRJ700	1	24	25	50
		EMB 135LR/140LR/145LR	109	126	42	277
Astral Aviation/Skyway Airlines	Midwest Express	EMB 140	0	20	20	40
		FD 328-300	8	4	10	22
Atlantic Coast	Delta, United	CRJ-200ER	55	41	80	17
		FD 328-300	28	35	83	146
Atlantic Southeast	Delta	CRJ-200ER	60	23	115	198
		CRJ-700	0	30	83	113
Chautauqua	America West, US Air	EMB 140LR/145LR	41	4	28	73
Comair	Delta	CRJ-100ER	110	41	112	263
		CRJ-700	0	27	82	109
Continental Express	Continental	EMB 135ER/145LR/145XR	134	141	100	375
Express Airlines	Northwest	CRJ-200LR	25	18	0	43
Great Plains	-	FD 328-300	2	0	0	2
Horizon	Alaska, Northwest	CRJ-700	7	23	25	55
		F28-4000	21	0	0	21
Mesa	America West, US Air	CRJ-200ER	32	0	20	52
		CRJ-700	0	20	20	40
		CRJ-900	0	20	20	40
		EMB 145LR	21	15	45	81
Mesaba	Northwest	Avro R185	36	0	0	36
Northwest Airlines	-	CRJ-200	0	75	175	250
Sky West	Delta, United	CRJ-100/200LR	32	69	148	249
Trans States	TWA (AA)	EMB 145ER	12	0	0	12
Total			766	802	1332	2990

Source: Manufacturer reports.

Table 5. Bombardier Key Financials, 1999–2002

	Dec 2002	Dec 2001	Dec 2000	Dec 1999
Bombardier Income Statement (in millions of C$)				
Revenues	$21,056.4	$15,274.2	$13,028.5	$11,024.0
Cost of goods sold	$18,954.1	$13,594.7	$11,700.9	$9,995.8
Depreciation and amortization	$322.1	$210.0	$218.7	$225.9
Interest expense	$182.0	$69.8	$61.2	$90.5
Interest income	-$35.1	-$43.6	-$48.3	-$72.5
Income taxes	$407.6	$460.9	$342.7	$255.4
Net income	$390.9	$975.4	$718.8	$554.0
Bombardier Balance Sheet (in millions of C$)				
Cash	$462.8	$1,358.8	$1,548.7	$1,706.3
Receivables	$1,590.7	$626.5	$570.7	$670.3
Inventories	$8,956.5	$6,413.7	$5,361.5	$4,576.2
Investments in and advances to BC	$1,363.0	$1,581.5	$1,531.2	$1,285.2
Other assets	$1,456.4	$421.6	$146.3	$148.3
Total assets	$19,851.0	$12,422.2	$10,991.9	$10,255.3
Short-term borrowings	$1,341.7	-	-	$49.3
Accounts payable/accrued liabilities	$7,360.9	$3,840.0	$3,125.2	$2,845.5
Advances	$3,019.0	$2,362.8	$2,636.8	$2,328.6
Long-term debt	$2,080.7	$879.4	$971.4	$1,121.7
Other liabilities	$1,958.7	$1,527.6	$646.7	$421.7
Convertible notes	-	-	-	$180.5
Preferred shares	$300.0	$300.0	$300.0	$300.0
Common shareholder's equity	$3,790.0	$3,512.4	$3,311.8	$3,008.8
Total liabilities and shareholder's equity	$19,851.0	$12,422.2	$10,991.9	$10,255.3

Source: http://www.bombardier.com.

Table 6. Embraer Key Financials, 1999–2002

	Dec 2002	Dec 2001	Dec 2000	Dec 1999
Embraer Income Statement (in U.S.$millions)				
Revenue	$2,525.8	$2,927.0	$2,762.2	$1,837.3
Cost of goods sold	$1,531.7	$1,769.2	$1,879.3	$1,248.7
Gross profit	$994.1	$1,157.8	$882.8	$588.6
SG&A expense	$524.5	$506.4	$420.7	$220.6
Operating income	$524.5	$506.4	$462.1	$368.0
Total net income	$222.6	$328.4	$320.7	$234.5

Table 6. Embraer Key Financials *(Contd.)*

	Dec 2002	Dec 2001	Dec 2000	Dec 1999
Embraer Balance Sheet (in U.S.$millions)				
Cash	$656.8	$749.3	$1,189.2	$304.1
Other current assets	$1,856.3	$1,816.0	$920.3	$987.0
Property, plant & equipment (net)	$436.7	$366.5	$255.0	$162.4
Other long-term assets	$1,335.6	$629.0	$528.9	$757.5
Total assets	$4,285.5	$3,560.8	$2,893.4	$2,210.9
Short-term debt	$244.5	$526.6	$365.0	$556.3
Other current liabilities	$1,397.4	$1,161.3	$967.3	$561.9
Long-term debt	$308.1	$245.2	$90.7	$80.6
Other long-term liabilities	$1,237.0	$599.2	$677.0	$647.3
Minority interest	$8.2	$8.2	$7.7	-
Total liabilities and equity	$4,285.5	$3,560.8	$2,893.4	$2,210.9

Source: http://www.embraer.com.

Bombardier, Embraer, and Global Competition in the Regional Jet Market

Bombardier

Bombardier Inc., the world's third-largest aircraft maker behind Boeing and Airbus, is a manufacturer of regional aircraft, rail transportation equipment, and motorized recreational products. Bombardier is also the leader in the business jet segment with market share gains projected to expand until the end of the decade.[3] Founded in 1942 as a manufacturer of tracked vehicles for transportation on snow-covered terrain, Bombardier is now a leading supplier of aerospace and rail transportation equipment, recreational products, and financial services. Through its first 30 years of operation, Bombardier focused on snowmobiles, producing the popular Ski-Doo line. In 1974, it diversified into the transit equipment industry with a contract to build rolling stock for the city of Montreal subway system. Since that time, it has acquired a number of companies and assets in the mass transportation sector. Bombardier has also used its leading position in snowmobiles to enter the marine and personal watercraft business through the popular line of Sea-Doo. In December 1986, Bombardier acquired Canadair, the leading Canadian aircraft manufacturer. In June 1990, Bombardier created a new subsidiary, Learjet Inc., to acquire the assets and operations of Learjet Corporation, builder of the world-famous Learjet business aircraft. In March 1992, it acquired the assets and operations of Ontario-based de Havilland, manufacturer of the Dash 8 turboprop regional aircraft.[4] In the year ending December 31, 2002, Bombardier recorded sales of C$21.056 billion and a net

[3] Oliver Sutton, "Bizjets: Booming but Vulnerable," *Interavia* (July/August 2000).

[4] Bombardier, "History," http//www.bombardier.com.

income of C$390.9 million. Despite its overall sales growth, Bombardier's net income has fallen in each of the last three years (see table 5).

Embraer

Founded in 1969, Embraer began primarily as a maker of jet aircraft for the Brazilian Air Force. Since that time, Embraer has become one of the largest aircraft manufacturers in the world, focusing on specific market segments with high growth potential in regional, military, and corporate aviation. Embraer develops and adapts successful aircraft platforms and introduces new technology to lower acquisition prices. Embraer has consistently emphasized reduction of direct operating costs and delivery of reliable and cost-effective aircraft. As a result, Embraer's aircraft "provide excellent performance with day-in and day-out reliability, while being economical to acquire and cost-effective to operate and maintain."[5] Embraer ranks among the four largest commercial aircraft manufacturers in the world with a well-established family of regional airliners, ranging from the 30-seat EMB 120 Brasilia turboprop to the 37-seat ERJ 135, the new 44-seat ERJ 140, and the 50-seat ERJ 145 jetliners. Embraer has been successful in adapting and developing successful aircraft platforms and introducing new technology to create value by lowering acquisition price, reducing direct operating costs, and delivering high reliability. Moreover, the firm has been recognized for its comprehensive aircraft and after-sales support.

The Embraer 170 aircraft is the first member of a new family of commercial jets currently under development at Embraer. In addition to the 70-passenger 170, which was launched in June 1999, the family includes the 78-passenger Embraer 175, the 98-passenger Embraer 190, and the 108-passenger Embraer 195. First flight of the 175 took place in June 2003 with certification planned in the third quarter of 2004. First flight of the 195 is planned for the end of 2003 and of the 190 in 2004. Embraer has secured 244 firm orders and 309 options for the new family of aircraft. Customers include Alitalia, SWISS, GE Capital Aviation Services, US Airways, LOT Airlines, PB Air and Air Caraibes of Guadeloupe, and Jet Airways of India. At long-range cruise speed and with full passenger seating, the Embraer 170 has a range of 3,889 km. The aircraft is capable of operations between city pairs Dallas to Halifax, Paris to Moscow, Hong Kong to New Delhi, and Brasilia to Caracas. U.S. upstart carrier JetBlue recently announced it was ordering 100 Embraer 190s for delivery by 2011 and taking options on another 100, making it the official launch customer for the aircraft.[6] Herb Kelleher, the pioneering founder of Southwest, recently remarked that the 170/190 series "redefined" the scope of regional aircraft in terms of passenger load, cost efficiency, and range, suggesting Southwest may someday consider varying its exclusive use of Boeing 737s, at least for shorter-haul flights.[7]

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[5] Embraer, "Investor Relations," http://www.embraer.com.
[6] "JetBlue Airways Orders 100 EMBRAER 190 Jet Aircraft, with Options for an Additional 100," http://www.jetblue.com/learnmore/pressDetail.asp?newsId=179.
[7] Presentation to the Strategic Management Society Annual Conference, November 11, 2003.

The U.S. market accounts for 67 percent of Embraer's commercial and business aircraft sales[8] (see table 4). Embraer was Brazil's largest exporter from 1999 to 2001 and the second largest in 2002.[9] It currently employs 12,161 people (data from September 30, 2002). In the year ending December 31, 2002, Embraer recorded gross revenue of U.S.$2.526 billion and net income of U.S.$222.6 million. Despite its much smaller overall size, Embraer's earnings now rival those of Bombardier (see table 6).

Global Competition in the Regional Jet Market

A decade ago, few would have guessed that Embraer of Brazil would have emerged as the main competitor to Canada's Bombardier in the regional jet market. Capitalizing on the growth in regional jet travel in the late 1990s, Embraer invested resources to develop sleeker and cheaper jets, attracting the attention of major airlines and gaining market share. Revenues in both firms remained sluggish amidst the aftermath of 9/11, and as a result, Bombardier and Embraer announced significant staff cuts in early 2002. However Bombardier's *overall* sales continue to outpace Embraer's by three to one. Recently, Bombardier has trimmed down operations to improve efficiency and focus on its core competency: making high-quality planes and trains. Although more technologically advanced than rival Embraer, Bombardier's premium pricing structure has opened the door to competition as the airline industry continues to struggle with costs.

When Bombardier introduced the CRJ900 at the 2000 Farnborough Air Show, no one could have predicted the economic upheaval 9/11 would produce and the severe interruption it would generate in the flow of financing for new airplanes in virtually every seat class.[10] Bombardier's CRJ900 reached the market more than a year before the scheduled certification of the 78-seat Embraer 175, its closest competitor in terms of seating capacity and weight.[11] However, the Embraer 175 offers a more spacious cabin and more baggage capacity, attributes that Embraer claims are essential for the longer routes it believes airplanes in that seat class will serve. In a reaction to competitive pressures, Bombardier last year modified the CRJ900 to increase its maximum range to 1,914 nautical miles. Dubbed the CRJ900LR at the Farnborough Air Show, the new model has a maximum take-off weight of 84,500 pounds, 4,000 pounds more than the standard CRJ900 and 2,000 pounds more than the mid-range CRJ900ER. Bombardier vice president Barry McKinnon explained that the company arrived at the extra range by "apportioning the higher take-off weights, thus expanding the airplane's payload-range envelope without modifying the airframe."[12]

[8] Embraer, "Investor Relations," http://www.embraer.com.
[9] Embraer, "Company Profile," http://www.embraer.com.
[10] Alan Freeman, "Bombardier Questions Blockbuster Embraer Deal," Reuters, June 21, 2001.
[11] Sandra Cordon, "Bombardier Nets $1.2B in Loan Assistance," Canadian Press, July 24, 2003.
[12] Bombardier, "Investor Relations," http://www.bombardier.com.

National Development Policies and the Canada-Brazil Disputes

Development, State Support, and Export Promotion in Canada and Brazil

Like most countries in the Western Hemisphere, both Canada and Brazil provide generous subsidies to a range of agricultural and industrial sectors. Canada's system of public forest management, fisheries policies, and grain management has long been the subject of subsidy allegations by the United States and other countries. Canada has also been a generous financier of Canadian exports, helping Canadian companies such as Northern Telecom to compete for large infrastructure projects around the world.

Brazil has also provided heavy subsidies to encourage development of vast forest and agricultural lands, helping to support Brazil's position as a major exporter of products made from commodities such as oranges and sugar cane. Brazil was one of the most active subscribers to the import substitution industrialization policies of the 1960s and 1970s, using trade protection and government assistance to build up its domestic computer, automotive, and electronic assembly production, with sometimes mixed success.

In an attempt to recover from the global recession of the early 1980s, Brazil sought extensive private investment, some prompted by Brazil's trade policies that favor companies with substantial direct investments in property, plant, and equipment over those who seek to export to the country. Brazil's trade policies have long been a source of frustration to foreign companies and governments. Specifically, Brazil's industrial development schemes, lack of comprehensive intellectual property protection, and other policies have been characterized by some as protectionist. The government of Canada and Canadian manufacturers have been rapidly expanding trade and investment ties in South America. The government of Canada and Canadian manufacturers have aggressively pursued formal trade and investment agreements. They have worked to increase penetration by Canadian capital equipment and other manufacturers in Brazil to ensure that Canadian firms like Bombardier can compete successfully with Embraer for multibillion-dollar contracts in the aircraft industry throughout the region and around the world.[13]

Dispute 1: Canada's Case against Brazil

PROEX, Brazil's export financing agency, provides export credits to Brazilian exporters either through direct financing or interest equalization payments. In 1998–1999, Canada challenged the subsidies granted under PROEX to foreign purchasers of Embraer aircraft. The WTO panel report agreed with the Canadian position that the subsidies granted under PROEX were not consistent with article

[13] Freeman, "Bombardier Questions Blockbuster Embraer Deal."

4 of the WTO Agreement on Subsidies and Countervailing Measures.[14] Canada was granted authority to impose up to C$2.1 billion (U.S.$1.4 billion) in retaliation on Brazilian imports as a result of Brazil's failure to comply with the August 1999 WTO ruling against the PROEX program. Canada, however, has declined to impose the sanctions, saying it prefers a negotiated solution to the aircraft subsidy dispute.

Brazil has argued that this financing program was similar to a $1.2 billion loan guaranteed by the Canadian government to Northwest Airlines to purchase aircraft from Bombardier.[15] With interest equalization, Brazil grants the financing party an equalization payment to cover the difference between the interest charges contracted with the buyer and the cost to the financing party of raising the required funds.[16] As a result of this ruling, argued Brazil, the Canadian government's subsidy of Bombardier was also inconsistent with WTO rules.

Dispute 2: Brazil's Case against Canada

The most recent chapter in the dispute started when Bombardier and Embraer began competing for an estimated $2 billion contract to sell 75 midsized passenger jets to Air Wisconsin Airlines, a United Airlines affiliate. The Canadian government agreed on January 10, 2001, to provide Air Wisconsin up to $1.1 billion in low-interest financing to help Bombardier secure the deal. Brazil's Foreign Ministry quickly shot back by threatening to retaliate with unspecified "appropriate measures." By supplying the loans, it said Canada had "admitted what it has always denied—that it uses illegal subsidies." Canada defended the move as a way to counter Brazil's below-market financing to Embraer's own family of regional jets and said it was simply mirroring Brazil's subsidies. Canada said the financing was in response to a similar below-market offer made by Embraer and backed by the Brazilian government. Michael Hart, a former Canadian trade negotiator, added that his government did not break any international trade laws. "Under the [WTO's] subsidies agreement, you can clearly match subsidies offered by somebody else."[17]

In February 2002 the WTO's Dispute Settlement Body (DSB) adopted a panel ruling that found that the aid that the Canadian government used to secure the sale of aircraft produced by Bombardier constituted an illegal subsidy. Furthermore, the WTO has also found Canada guilty of providing illegal subsidies to buyers of Bombardier jets through the Canada Account, which was subsequently restructured.[18] Bombardier had used the support to secure purchasing deals for its

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[14] Daniel Pruzin, "WTO Gives Brazil Green Light to Impose Sanctions in Canadian Aircraft Dispute," *International Trade Reporter* 20, no. 13, March 27, 2003: 564.
[15] Ibid.
[16] Tim Padgett, "Dogfight," *Time Europe Magazine*, May 26, 2003.
[17] Debra Lau, "The Bombardier Family," *Forbes*, January 15, 2001.
[18] Keith McArthur, "Canada Hit with WTO Sanctions," *The Globe and Mail*, December 24, 2002, p. B2.

medium-range jet aircraft with Air Wisconsin, Comair, and Spanish-based Air Nostrum Lineas Aereas del Mediterraneo.[19]

In December 2002, a WTO arbitrator gave Brazil the right to impose sanctions in response to the subsidized financing, although the amount authorized—$250 million—was considerably less than the $3.36 billion Brazil had originally requested.[20] At its March 2003 meeting, the DSB formally authorized Brazil to impose the sanctions.

Representatives from Brazil and Canada told the WTO that they would bolster efforts to negotiate a mutually acceptable solution to the dispute and avoid resort to sanctions. Canada's ambassador to the WTO, Sergio Marchi, said he believed that the dispute can "only be resolved at the negotiating table."

Recent Developments

In July 2003, Canada announced the new offer of $1.2 billion in loan assistance to purchasers of Canadian-made regional aircraft. The loans would be offered under the controversial Canada Account administered by Export Development Canada. Critics have claimed that this account is for the exclusive purpose of providing aid to Bombardier. Trade Minister Pierre Pettigrew steadfastly disagreed: "We are absolutely not subsidizing Bombardier with this." He added that the federal government would actually earn money in its financing of the company's jet sales. Pettigrew said the assistance is designed to help sell more Canadian-made aircraft around the world but structured in such a way as to meet the requirements of the WTO. That means the loans offered under the Canada Account must be repaid under commercial terms. Pettigrew said that he presented the new loan assistance program to help bolster the aerospace industry in general through rough economic times.[21] In the past, the Canadian government has used the account to underwrite Bombardier deals with Northwest Airlines and other buyers in competition against Embraer. Funding provided under the Canada Account must first be authorized by the federal cabinet.[22]

In September 2003, Embraer announced a $1-billion deal with the country's national development bank to promote high-end technological exports. It assured Canada and its other trading partners that this initiative would be consistent with all of Brazil's international trade and investment agreements and obligations.

In an ironic twist, Air Canada, which is in bankruptcy protection, recently announced it was likely to choose a foreign producer—probably Embraer—over Bombardier for a pending multimillion-dollar jet purchase. The airline is bargaining together with its commercial partners (who include Star Alliance members Lufthansa AG, Scandinavian Airlines, and Austrian Airlines) in a joint purchase of up to 200 jets. Bombardier has a disadvantage over its foreign rivals when it comes to Air Canada's purchase because Bombardier cannot line up

[19] Bombardier, "Investor Relations," http://www.bombardier.com.
[20] McArthur, "Canada Hit with WTO Sanctions."
[21] Cordon, "Bombardier Nets $1.2B in Loan Assistance."
[22] Ibid.

financing for Air Canada. Export Development Canada (EDC), which regularly finances millions of dollars of sales by Canadian exporters like Bombardier to foreign buyers, cannot assist the transaction in this case because Air Canada is a Canadian company.[23]

The Global Policy Context: Subsidies and State Support in the WTO and OECD

The OECD Arrangement on Export Credit

The Organization for Economic Cooperation and Development (OECD) oversees an arrangement among its 30 member countries that governs the conditions and rates under which export financing may be offered. The agreement sets minimum premium rates (also called exposure fees) for country and sovereign risks. The latest agreement took effect on April 1, 1999, after a two-year transition period and applies to all officially supported export credits with a repayment term of two years or longer provided by direct financing, refinancing, insurance, or guarantees. The agreement does not apply to non-OECD countries such as Brazil, and official export credits for ships, aircraft, and agriculture are all excluded.

WTO Subsidies and Countervailing Measures (SCM) Agreement

The World Trade Organization, successor to the General Agreement on Tariffs and Trade (GATT), includes a comprehensive Agreement on Subsidies and Countervailing Measures (SCM). The WTO also includes a comprehensive dispute-settlement mechanism (DSM) in which panels rule on the consistency of government policies with the code and on government actions designed to respond to the trade distortions created by those subsidies (countervailing measures).

Currently, WTO members can subsidize exports, including Canada and Brazil, but only for products on which they have commitments to reduce the subsidies. Those without commitments cannot subsidize agricultural exports at all. Most developing countries argue that their domestic producers are handicapped if they have to face imports whose prices are depressed because of export subsidies, or if they face greater competition in their export markets for the same reason. These nations object in particular to the fact that developed countries are allowed to continue to spend large amounts on export subsidies, while developing countries cannot because they lack the funds and because only those countries that originally subsidized exports are allowed to continue subsidizing (albeit at reduced levels).[24] Poorer nations argue that they should be able to retain high tariff barriers or to adjust their current limits in order to protect their farmers unless export subsidies in rich countries are substantially reduced. Further

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[23] Nicolas Van Praet, “Airline Leans toward Embraer: Air Canada Says EDC Rules Give Competitor Edge over Bombardier,” *Ottawa Citizen*, September 12, 2003, p. D3.
[24] “Embraer Claims Victory in Export Credits War with Bombardier,” *Airwise News*, July 27, 2001.

arguments counter that the barriers would also hurt developing countries that want to export to fellow developing countries.

In the Uruguay round of multilateral trade negotiations, the GATT subsidies code was revised. The new WTO subsidies agreement that emerged from those negotiations identifies subsidies by "boxes" that are given the colors of traffic lights: green (permitted), amber (slow down, reduce), red (forbidden). At least 34 WTO members, including Canada and Brazil, have agreed to reduce their uneven domestic trade supports in the "amber box." In order to qualify for the "green box," a subsidy must not distort trade, or at most, cause a minor distortion. These subsidies have to be government funded and must not involve price support. They are generally subsidies that do not preference specific products or individual companies, but rather are "generally available."[25] The government of Canada has been a strong supporter of limiting the use of all boxes, believing that some of the green box subsidies have an influence on production and prices, and more restrictions are therefore necessary and desirable. Brazil has also argued for reduction and elimination of subsidies, most recently as part of the Doha round of multilateral trade negotiations in which Brazil led a group of 20-plus countries arguing for elimination of agricultural subsidies.

The Relationship of the SCM Agreement to the OECD Arrangement

Part I, article 1 of the WTO SCM Agreement defines a "subsidy" as when there is (a) a financial contribution by a government or any public body; and when there is (b) a benefit conferred.[26] Export credit support provided by a government agency, department, or private entity on behalf of government, falls under the definition of financial contribution in (a) but may or may not confer a benefit as referenced in (b). If a government provides a credit to a borrower on the same terms and conditions as available to that borrower from a private source of finance, this would not be considered a subsidy. Part III, article 3 defines a "prohibited subsidy."[27]Article 3.1 (a) refers to subsidies contingent on export performance, and points to annex I, which is an illustrative list of "prohibited export subsidies." Articles 1 and 3 define the type of export credit support that is

[25] McArthur, "Canada Hit with WTO Sanctions."
[26] WTO, *Legal Texts: Agreement on Subsidies and Countervailing Measures*, available at http://www.wto.org/english/docs_e/legal_e/legal_e.htm#goods.
[27] Most subsidies, such as production subsidies, fall in the "actionable" category. Actionable subsidies are not prohibited. However, they are subject to challenge—either through multilateral dispute settlement or through countervailing action—in the event that they cause adverse effects to the interests of another member. There are three types of adverse effects. First, there is injury to a domestic industry caused by subsidized imports in the territory of the complaining member. This is the sole basis for countervailing action. Second, there is serious prejudice. Serious prejudice usually arises as a result of adverse effects (e.g., export displacement) in the market of the subsidizing member or in a third country market. Thus, unlike injury, it can serve as the basis for a complaint related to harm to a member's export interests. Finally, there is nullification or impairment of benefits accruing under the GATT 1994. Nullification or impairment arises most typically where the improved market access presumed to flow from a bound tariff reduction is undercut by subsidization. See WTO, *Subsidies And Countervailing Measures: Overview,* available at http://www.wto.org/english/tratop_e/scm_e/subs_e.htm.

defined as a prohibited export subsidy, and annex I lists examples of export subsidies.[28] This language tracks OECD Arrangement definitions which refer to the provision by governments of export credit guarantee and insurance programs at premium rates that are inadequate to cover long-term operating costs and losses of the programs.

Within the OECD Arrangement, ECAs and their governments have chosen to understand the WTO obligations to mean that programs must break even. However, it is not clear whether export finance programs that break even over the long term may not be considered an export subsidy. Moreover, it is not clear whether the test of whether the program does not break even is on a transaction basis or an agency basis. In addition, the definition of long-term operating costs is ambiguous.

Within the SCM Agreement, an illustrative list of export subsidies makes reference to the OECD Arrangement, indicating that "…if in practice a Member applies the interest rates provisions…an export credit practice which is in conformity with those provisions shall not be considered an export subsidy prohibited by this Agreement." In other words, if an ECA complies with the interest rate provisions of the OECD Arrangement, it is given a safe haven in terms of being "WTO-proof." This haven is available to OECD participants and other countries that follow the OECD Arrangement guidelines. Footnote 5 of article 3.1 (a) says that measures referred to in the illustrative list of export subsidies as not constituting export subsidies shall not be prohibited under this or any other provision. An open issue is whether this includes item (j): pure cover operations (i.e., where an ECA provides only credit insurance cover or guarantees but no support of the interest rate).

The establishment of the WTO in 1995, following the GATT, raised the profile in Geneva of the OECD Arrangement, as suddenly 138 WTO members had language in their agreement—item (k)—that they needed to understand. As a result, the WTO Secretariat requested observer status at OECD Arrangement meetings to gain a greater insight into the details of the WTO code.

The Ruling in the Brazil-Canada Dispute

The Brazil-Canada dispute has put the issue of export credits and the WTO firmly on the radar screen. As Brazil is not a participant in the OECD Arrangement, Canada had no other recourse but to challenge Brazil at the WTO. Brazil counter-challenged Canada's support, including the use of the Canada Account and EDC's National Interest Account. In hearing the case, the WTO panel and appellate body had to interpret the meaning and define precisely what "interest rate provisions" mean in reference to the arrangement.

The panel ruled that export credits can benefit from the safe haven of item (k) if they are in the form of direct credits financing, refinancing, or interest rate

[28] Australian Department of Foreign Affairs and Trade, *International Developments in Export Credit and Finance Services* (Canberra: Department of Foreign Affairs and Trade, September 16, 2002), available at http://www.dfat.gov.au/trade/efic_review/int_dev/section_11.html.

support and apply the special fixed interest rates under the OECD Arrangement—the so-called commercial interest reference rates (CIRRs)—as well as the other terms and conditions of the arrangement. This ruling could have important implications for pure cover (i.e., ECA insurance cover against political/commercial risks but no involvement or support for the funding) operations, which therefore might not enjoy this safe haven and would be subject to the full disciplines of the SCM Agreement. In addition, there is a potential impact on floating rate financing and matching.

The ruling also has important implications for the interpretation of footnote 5 and also for so-called market window operations. Market window transactions would first be tested against the definition of a subsidy to determine whether a benefit has been conferred. If no export subsidy has been given, there would be no requirement for a safe haven. Therefore, in WTO terms, the validity of a market window operation should be defined by whether the institutions that provide such financing are truly acting as market players in the eyes of the borrowers. From the WTO's perspective, it is not, therefore, a "competition" issue of whether or not the institution or program pays taxes, etc., but rather whether the support provided is more generous than that offered by the private sector.

Implications for Western Hemisphere Integration

Economic integration efforts have a long history within the Americas. The treatment of subsidies—and the related issue of application of countervailing import restrictions in response to them—has generally deferred to multilateral efforts under the GATT and WTO. However, the regulations pertaining to responses to those subsidies—countervailing measures—have frequently been included in regional agreements, such as the U.S.-Canada FTA (CUFTA), the North American Free Trade Agreement (NAFTA), and other bilateral and regional agreements in the hemisphere. Both CUFTA and NAFTA provided the option of binational panel review of countervailing and antidumping duty final determinations. In the current Doha round of multilateral trade negotiations, both the United States and the European Union have explored the elimination of export subsidies on products of interest to developing countries.

Although there are no obvious solutions to the issues of subsidies in civilian aircraft or more broadly, this case does point up a number of problems in the current subsidy regime and constraints to further disciplining subsidies within the Western Hemisphere and globally.

- *The "free rider" problem in subsidies disciplines makes regional approaches difficult, leading to limited scope and coverage in broad, multilateral agreements*. Countries are reluctant to engage in specific subsidy disciplines in regional trading agreements. This is because it would be difficult to limit the impact of commitments within a region; if a country eliminated or reduced a subsidy, all countries with which it trades would receive like benefits.[29] Hence, the very nature of subsidy issues suggests that they be addressed mainly in the WTO multilateral negotiations. Because the WTO "single undertaking" understanding requires that all countries sign on to all agreements, however, the outcomes of multilateral subsidies agreement are less ambitious than they might otherwise be among fewer, more like-minded countries. Nevertheless, in accordance with the mandate for FTAA ministerial meetings, Canada has indicated willingness to explore options for deepening subsidy disciplines, including the possibility of hemispheric initiatives to advance WTO negotiations in this area.[30]

- *The linkage between subsidies and countervailing measures creates political problems for a number of countries*. Many developing countries link their willingness to reduce subsidization to developed countries' (like the United States') commitments to limit the application of antidumping and countervailing duty measures. Due to domestic politics and the role of specific industry sectors in the U.S. political system, the U.S. administration is very reluctant to do anything to undermine access to these remedies. This reluctance was part of the reason why the current Doha round of multilateral trade negotiations broke down at the September 2003 ministerial meeting in Cancun. Indeed, the United States has proposed that the subsidies, countervailing, and antidumping agenda be excluded from the FTAA negotiations in favor of considerations under the Doha round of multilateral negotiations.
- *The role of sub-federal actors complicates the ability of governments to make comprehensive commitments to subsidies disciplines*. Many subsidy programs in the United States, Canada, Brazil, and elsewhere are administered at the sub-federal level by states and provinces. Hence, it is difficult politically for these national governments to force subnational actors to agree to end subsidization practices. More broadly, governments have long used subsidies as a tool of industrial development and are reluctant to permanently give up that right.
- *Regional progress in the FTAA on all fronts has been slow*. Even if there were ways of tackling the subsidies problem at the regional level, FTAA progress has been sluggish. At a November 2003 FTAA ministerial meeting chaired by the United States and Brazil, ministers of the 34 participating governments appeared to backtrack on the ambitious program they had originally laid out, instead agreeing to only a minimum

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[29] For example, within the FTAA process, modification made to prohibited subsidy disciplines would also benefit countries outside the hemisphere. Similarly, strengthened hemispheric subsidy disciplines could subject the goods of FTAA partners to more stringent treatment, putting them at a disadvantage when competing with non-FTAA goods in the hemispheric market.

[30] Canadian Department of Foreign Affairs and International Trade, *Trade in Goods: Antidumping, Subsidies and Countervailing Measures: Rules—Canada's Position in WTO and FTAA Negotiations* (Ottawa: Department of Foreign Affairs and International Trade, July 2003), available at http://www.dfait-maeci.gc.ca/tna-nac/TG/rules-en.asp.

of common obligations that would give individual countries discretion as to whether to make additional commitments. Some observers also believe the original 2005 deadline for completion of the negotiations will have to be postponed.

- *The policy that it is acceptable for governments to match financial assistance provided by others leads to a bidding spiral.* The policy by most governments that it is justifiable and necessary to "match" assistance provided by others leads to a process in which governments anticipate the next move of others and, in so doing, contributes to an out-of-control spiral, as was demonstrated in the volleys between Canada and Brazil over Embraer. This race to the bottom constitutes a negative sum outcome, as governments spend precious taxpayer resources, crowd out private investment, and distort purchasing decisions.
- *The precarious position of the global airline industry makes continued public financing likely.* The weak financial condition of the major airline carriers in the post-9/11 environment suggests that private financing will be scarce as airlines carefully add new planes to their fleets. The U.S. airline industry recorded operating losses of about $1.5 billion in 2002, and few of the major carriers are considered creditworthy customers. Hence, demand for government-sponsored financing will continue to be strong, and disputes over export financing and subsidization will likely recur.

In sum, disputes such as the one described here are likely to remain part of the international trade and investment terrain for the foreseeable future. Only through renewed momentum in trade agreements and negotiations generally, and greater willingness by countries to make painful commitments in subsidies and countervailing agreement in particular, is the region likely to reduce the number and intensity of disputes and disagreements over the role of government financing in industrial development and export promotion.

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