EXECUTIVE SUMMARY

Since the mid 1980s, Latin America's political and economic renewal has been tremendous. After decades of dictatorship, economic protection and poor performance, Latin Americans have voted for reform. The four major Latin American economies of Brazil, Mexico, Argentina and Chile have led these reforms, although Argentina currently is mired in a serious crisis. These four economies account for 83 per cent of Latin American gross domestic product, GDP, and 90 per cent of Australian trade with Latin America; consequently, this report focuses on these four economies.

Australia's deepening engagement with these economies should yield mutual trade and investment gains, with substantial benefits from direct investment because of similar specialisations in commodity exports, especially mining and agribusiness. As well as encouraging closer commercial engagement, these export similarities support Australian and Latin American cooperation in World Trade Organization forums. Additionally, these economies are relevant to Australia's broader trade prospects. While Latin America's ongoing regional integration is, in some countries, increasing direct investment and helping to lock in reform, it also may reduce export opportunities for Australia. The Free Trade Area of the Americas, FTAA, to be negotiated by 2005, could threaten Australia's A$2.5 billion of agricultural exports to the US market.

LATIN AMERICA AND EAST ASIA

East Asia's importance for Australia's trade and investment makes comparing East Asia and Latin America useful. It helps indicate whether in future, Australia could enjoy a similarly deep relationship with Latin American economies.

The four major Latin American economies are slightly smaller than four of Australia's largest East Asian markets (excluding Japan), of China, the Republic of Korea, Indonesia and Thailand. These Latin American countries' populations are smaller but their higher average incomes and unequal income distributions imply their spending power is greater than the East Asian economies'. Thus, the size and income levels of the Latin American economies suggest significant trade and investment opportunities.

Opportunities are limited, however, because Latin American economies rely on primary commodity exports; like Australia, they competitively produce mineral and agricultural commodities. East Asian economies mainly export manufactures, and import a significant share of their commodity needs. Hence, Latin America's trade does not complement Australia's trade as well as East Asia's, constraining trade opportunities. Australia's trade with Latin America is only 2 per cent of its trade with East Asia. Distance and dominance of traditional North American, Latin American and EU trading partners, and their preferential access agreements, also reduce Australian trade opportunities in Latin America.

In the foreseeable future, Latin America will not become the pre-eminent trading partner East Asia is. However, Latin America could be an important direct investment destination; already, Australian companies have major mining investments there. Australian expertise in major sectors of importance to Latin America offers scope to invest in mining and mining supplies, agribusiness such as wine and food processing, infrastructure such as telecommunications and ports, and services where Australia has a competitive advantage. Trade in goods and services associated with such investments and other niche areas has good prospects.

BRAZIL'S ECONOMY READY TO TAKE OFF

Brazil is Latin America's largest economy, producing almost 45 per cent of its GDP and occupying almost half its land area. Brazil is resource rich and, in the 1990s, reforms substantially opened the economy. A floating exchange rate, low inflation, surging foreign direct investment, FDI, and an improving fiscal position make Brazil's fundamentals the best they have been for 30 years. Brazil appears set for strong future growth.

In the late 1980s, the Brazilian Government opened most sectors to FDI and in the early 1990s, launched major reforms including across the board tariff cuts. Its 1994 Real Plan brought down inflation dramatically, from 2 477 per cent in 1993 to only 6 per cent in 2000. Wide ranging privatisation in good regulatory environments dramatically reduced the Government's role in economic activity, and boosted productivity in key sectors.

In 1999, the Government floated the currency, the real, in response to capital flight during the Russian and Brazil crises, significantly increasing Brazil's competitiveness and prompting interest rate reductions; this drove GDP growth to 4.2 per cent in 2000. In the 1990s, Brazil overcame longstanding structural budget deficits, running primary surpluses in 1999 and 2000. The April 2000 Fiscal Responsibility Law should prevent future federal and state governments running structural deficits. By 2000, with confidence in reforms and growth improving, Brazil attracted almost US$31 billion in FDI, second only to China among emerging markets, and the sixth highest in the world.

Risks and Outlook

Despite recent success reducing government deficits, Brazil's 2000 public debt reached almost 50 per cent of GDP; 20 per cent of this was US dollar denominated. Past defaults push up sovereign risk spreads, so financing this debt is expensive and exposes Brazil to interest rate and exchange rate volatility. Financing needs also crowd out private sector borrowing, reducing economic growth. Brazil needs further pension and taxation reforms to reduce fiscal pressures.

FDI could well fall from recent levels as Brazil's privatisation process tapers off. To finance future growth, Brazil needs a functioning banking system and deeper capital markets based on a stronger credit culture and insolvency regime, and better minority shareholder protection.

Brazil's income distribution is highly inequitable. The Government recognises the need to reduce poverty and income inequality to spread the benefits of growth, boost effective market size and maintain popular support for reforms. Left wing elements of the Opposition Workers Party, which could win the 2002 election, could tap into anti-globalisation sentiment and roll back reform although other elements of the party are more pro-business. Also, in 2001, power shortages due to prolonged drought, threaten short term growth prospects.

Despite these risks, Brazil's vigorous economic recovery in 2000 and competitive, flexible exchange rate bode well for continuing trade and deregulation reforms, which should underpin future growth. Brazil's robust economic outlook should generate significant trade and investment opportunities, if future governments maintain reform momentum.

Brazilian Business Opportunities

Brazil's market of 166 million people, dynamic economy and rich natural resources offer major opportunities for Australian investors and exporters. Brazilian imports grew a rapid 13 per cent per year during the 1990s, and while imports contracted during the 1998 and 1999 recession, they recovered strongly in 2000.

Brazil buys 45 per cent of Australia's exports to Latin America; during the 1990s, these exports grew by 19 per cent per year, reaching A$571 million in 2000. In 2000, exports of metallurgical coal reached A$297 million and cars reached A$56 million; other elaborately transformed manufactures, ETM, exports also increased with exports of measuring and controlling instruments worth A$22 million, pharmaceuticals worth A$11 million and telecommunications equipment worth A$8 million.

Reforms and trade opening boost these markets. For example, telecommunications deregulation is generating a A$2.5 billion telecommunications equipment market. Profitability pressures on Brazilian farmers and rising consumer expectations of quality products create opportunities for agricultural equipment suppliers. Brazil's expanding mining sector and growing FDI create opportunities to supply mining equipment and services. Privatised Brazilian mining giant, CVRD, the world's largest iron ore company, alone spends A$900 million annually on goods and services.

In 1995, only five Australian companies had invested in Brazil; in 2000, this had grown to 25. During the 1990s, Australian direct investment totalled A$420 million, measured on a project basis. In 2000, these firms sourced A$180 million of goods and services from Australia. As South America's integration deepens, Australian firms have stronger incentives to invest in Brazil, the largest regional market, from where they can access other markets using preferential trading arrangements. BHP Billiton leads Australian investment with a diverse mining and resources sector presence. Other major investments are in processed foods, financial services, infrastructure, construction, entertainment, education and training, and telecommunications technology and services. Infrastructure and bank privatisation is ongoing, with future sales and concessions planned for electricity, gas, ports, highways and sanitation sectors. Many related opportunities include supplying goods and services to newly privatised companies.

MEXICO'S ECONOMY BOOMING

After joining the North American Free Trade Agreement, NAFTA, in 1994 and recovering from its 1994-95 crisis, Mexico's economy boomed in the late 1990s, averaging over 5 per cent per year growth, and just under 7 per cent in 2000. Mexico's current account deficit now is well below pre-crisis levels; FDI provides strong capital inflows; and external debt is only 24 per cent of GDP. In 2000, inflation was relatively low, 9 per cent, and the fiscal situation sound by Latin American standards; government debt was 37 per cent of GDP. The new reformist Fox Government is the first change of party Mexico has experienced for 70 years, signalling its democracy is maturing.

Risks and Outlook

However, a credit crunch continues; in real terms, outstanding Mexican bank lending has fallen 40 per cent since the Mexican crisis and interest rates exceed 10 per cent. Banks prefer to hold low risk, high return government bonds than lend to the corporate sector. However, if well implemented, new bankruptcy laws passed in mid 2000 should strengthen creditor rights and encourage lending growth.

With the tax to GDP ratio only 10.7 per cent in 2000, and government revenue heavily dependent on volatile oil sector profits, the narrow tax base is a risk. Tax revenue is inadequate to fund new infrastructure to overcome looming shortages; inefficient and regressive subsidised tariffs for electricity and water exacerbate these shortages. Consequently, in early 2001, President Fox pledged to raise the tax to GDP ratio to 17 per cent by 2004.

The US slowdown is expected to dampen Mexican growth in 2001 to between 2 and 2.5 per cent. However, with Mexico's deepening integration with the US economy, over the rest of the decade, growth should rebound to 6 to 7 per cent per year, particularly if bank lending resumes. Moreover, continuing integration should discipline Mexico's inflation and fiscal and debt servicing performance, and encourage ongoing institutional reform, further boosting growth prospects.

Mexican Business Opportunities

Deepening integration with the United States and rapidly growing incomes expand export opportunities in Mexico and increase direct investment incentives. Between 1995 and 1999, each year Mexico's primary imports grew an average 12 per cent and manufacturing imports grew 21 per cent; 88 per cent of imports are manufactures. In 2000, primary products dominated Australia's total merchandise exports to Mexico of A$333 million, including non-bovine meat worth A$60 million, wool worth A$38 million, coal worth A$35 million, confidential items worth A$31 million, and milk and cream worth A$29 million. In 2000, major manufactured exports were starches, inulin and wheat gluten, worth A$15 million, with machinery, automotive parts and medicine growing rapidly from low bases. Since 1996, Australian imports have grown on average 29 per cent per year.

In markets where competitors like Canada and Chile, with preferential access, offer lower prices and a greater supply capacity, Australian commodity exports are limited. For example, Mexico's copper imports are growing rapidly but Chile, the world's largest copper producer, is close and has preferential access under a bilateral trade agreement. Similarly, Mexico can import powdered milk from Canada and Chile at no tariff, from the United States at a 3 per cent tariff or from Australia at a 10 per cent tariff (the most favoured nation rate). Despite this differential and higher transport costs, imports of Australian dairy products are growing well. Where tariff differentials are negligible, success is greater. For example, facing only a 3 per cent tariff on bituminous coal, a multinational company recently sourced coal from the Hunter Valley to win the initial contract supplying more than a million tonnes of thermal coal to Mexico.

Between 1994 and 2000, Mexico attracted US$68 billion in FDI, largely from the United States and Europe; Australia invested only US$39 million. However, the improved mining and overall FDI regimes provide opportunities for world competitive Australian resource companies to expand their presence. Mexico's infrastructure shortages and booming service sector also create many opportunities for increased Australian FDI in Mexico.

ARGENTINA'S ECONOMY IN RECESSION

In the early 1990s, Argentina reduced trade and investment barriers, overcame high inflation, privatised many state owned enterprises and deregulated extensively. The Government reduced inflation from over 3 000 per cent in 1990 to only 5 per cent in 1994 by pegging the currency, the peso, to the US dollar, and preventing the central bank from lending to the Government (printing money). These reforms spurred strong growth until 1996, over 6 percentage points higher than in the 1980s.

Risks and Outlook

However, by mid 2001, Argentina's economy was mired in a deep, three year long recession, and faced a major debt payment crisis. The significantly overvalued peso undermines Argentina's trade competitiveness and the fiscal deficit is chronic. Because Argentina's currency board system prevents it running independent exchange rate or monetary policies, external factors like the historically high US dollar and the Brazilian real's 50 per cent depreciation in 1999, contribute to the recession. GDP contracted by 3.4 per cent in 1999 and 0.5 per cent in 2000; it will continue to contract in 2001.

Despite the exchange rate peg's high costs, the Government is not considering floating the currency because the economy is highly dollarised and around 70 per cent of liabilities, including most household mortgages and business borrowing, are in US dollars. In June 2001, the Government introduced the euro into the peso's currency basket peg, on a 50:50 basis with the US dollar for trade transactions until the euro is on par with the dollar. This increases future flexibility, but limits immediate effects to an 8 per cent peso depreciation on trade related transactions.

In the late 1990s, growth in public sector salaries, transfers to provinces and debt interest payments created chronic fiscal deficits, also constraining Argentina's economic performance by crowding out private sector borrowing. In 2000, all new bank lending went to the public sector via bond purchases, and the public sector absorbed 91 per cent of capital inflows. The Government initially pushed forward the new fiscal responsibility law's target date for a balanced budget to 2005, but in July 2001, announced it would cut public service salaries to reach this target immediately. However, fear the Government will default continues to isolate Argentina from international financing, provoking a foreign payments crisis and a run on reserves and dollar bank deposits.

Argentine Business Opportunities

Argentina's recession and overvalued exchange rate reduces current trade and investment opportunities. However, when the economic outlook improves, its liberal FDI regime, more open trade regime and a strong consumer base create potential to increase Australian trade and investment.

Australia's exports to Argentina in 2000 were A$101 million, down from A$135 million in 1998. Primary exports, driven by coal, peaked at A$53 million in 1998, then fell to A$45 million in 2000. Similarly, after growing from A$2 million in 1990 to A$48 million in 1998, ETM exports plunged to A$29 million in 2000, hit by Argentina's recession. Major Australian export opportunities lie mainly in ETMs, particularly in telecommunications and inputs for the agricultural and mining sectors. Once economic growth resumes, service sector opportunities should re-emerge boosted by middle class demand for tourism and education.

With liberal FDI regulations, Australian companies directly invested around US$1.4 billion between 1994 and 2000, dominated by MIM and Rio Tinto's US$1.1 billion investment in the Alumbrera copper and gold mine. Once Argentina resolves its crisis and metal prices recover, abundant resources again should attract FDI. For Australia, the major prospective area will remain mining, with mining services, leisure, the fully liberalised telecommunications sector and wine the other major sectors likely to attract attention.

CHILE'S ECONOMY LEADS THE WAY

In the 1970s and 1980s, Chile pioneered Latin American reform, globalising the economy, deregulating labour markets and privatising state enterprises and infrastructure. By the 1990s, the economy was averaging GDP growth of 6.5 per cent per year, despite the 1999 recession. Sound domestic fundamentals including strong fiscal balance, a functioning banking system and low public debt drive this growth.

Risks and Outlook

Chile's external sector is strong by Latin American and most emerging market standards; however, it remains a source of vulnerability with Chile's location exposing it to contagion. In the mid 1990s, high capital inflows appreciated the exchange rate, so the Government taxed volatile inflows. When capital flows reversed during the Asian and Brazilian crisis, the Government boosted interest rates, probably excessively, causing a recession. Moreover, copper accounts for 37 per cent of exports, exposing Chile to copper price fluctuations, and the capital account also is exposed to FDI volatility due to mining project lumpiness. Nevertheless, future economic prospects look very strong, given past and ongoing economic reforms and the recovering macroeconomy.

Chilean Business Opportunities

Chile's flat 8 per cent tariff, declining to 6 per cent by 2003, extremely liberal FDI rules, rapid income growth and web of free trade agreements attract trade and investment. Australian exports to Chile reached A$235 million in 1998, largely due to growth in coal and ETMs, but in 1999 and 2000, these items led the export decline to A$150 million. An ongoing switch to natural gas for non-hydro electricity generation and Canadian and Columbian coal's duty free market access underpin lower coal exports. ETM exports have more potential. Export opportunities lie in supplying equipment for Chile's expanding mining, wine and salmon farming industries and inputs for Chile's resource based manufacturing sector. Already, many Australian mining service companies have a Chilean presence, while other Australian companies sell supplies like innovative spray applicators and self adhesive wine labels.

Over the 1990s, Australian direct investment in Chile totalled a significant US$1.65 billion, dominated by BHP Billiton's investment in Chile's largest copper mine, Escondida. Chile's strong business environment, relative proximity to Australia and web of trade agreements have attracted around 45 Australian companies, more than any other Latin American country.

Synergies between Australian and Chilean export-oriented mining and agribusiness sectors will drive future investments. Investment in mining, including other minerals beyond copper, and in agribusiness, wine, fish farming and processed food sectors are prospective. In addition, Chile's liberal FDI rules, growing incomes, expanding pension funds and private infrastructure programs create opportunities in infrastructure, financial and other service sectors.

LATIN AMERICA'S BUSINESS ENVIRONMENT

The business environment of the four Latin American economies improved significantly in the 1990s; many institutional reforms and business culture changes accompanied trade and FDI opening, privatisation, deregulation and macroeconomic reforms. Chile upgraded its business environment by eradicating bureaucratic, police and court system corruption, reducing red tape and bureaucratic inefficiency, and adopting international best practices in competition policy and intellectual property rights protection. Mexico, Brazil and Argentina started these reforms mainly in the 1990s, and they have not progressed as far as Chile, particularly in transparency, and bureaucratic and court system efficiency. Bureaucratic impediments constrain Australian businesses operating in Latin America from investing more in these economies. Intellectual property rights are difficult to protect in Brazil or in Argentina, on information technology matters.

Australian firms also need to be aware of other business environment issues. Apart from privatised state enterprises, large companies still are mainly family run. Minority shareholder protection and corporate government standards generally are weak. Business cultures tend to be rather formal and hierarchical, and relationship building is important. Foreign companies dealing with the court system and government, including those bidding for privatising assets, should secure good legal representation and well connected advisers. While unskilled labour is relatively cheap, skilled employees are not, and rigid formal labour markets endorse excessively generous labour benefits and redundancies. The banking systems in Brazil, Mexico and Argentina generally will not finance affordable working capital for small and medium businesses, so many firms delay paying accounts as a substitute to assist cash flow. However, lack of bank finance and shallow equity and bond markets may make foreign equity investments more acceptable.

LATIN AMERICAN INTEGRATION

The 1990s added vigour to Latin American integration initiatives. Mercosur was established in 1991; Mexico joined NAFTA in 1994; and negotiations are underway for a Mercosur-EU Free Trade Agreement, FTA, and a Free Trade Area of the Americas, FTAA, by 2005. Chile and Mexico negotiated many bilateral and regional free trade agreement links. FTAs like Mercosur helped entrench democracy, build trade policy capacity and globalise economies. However, these agreements can divert trade from the most efficient import source, as well as create new trade opportunities. Some FTAs undermine Australian market access to Latin American economies; if the FTAA succeeds, particularly if it gives Latin American economies preferential access to US agricultural import markets or increases preferential treatment for member country investment, in the absence of a free trade agreement between Australia and the United States, it would harm Australian interests.

AUSTRALIAN TRADE AND INVESTMENT PROSPECTS

Short term Australian trade opportunities in Latin America lie in commodity, ETM and services exports, but with the distances involved and high transport costs on commodities, in the longer term, ETM exports should be more prospective. Australia's specialisation in mining and agribusiness means it is a competitive supplier of many related goods and services these Latin American sectors require. However, traditional reliance on US, EU and other Latin American suppliers, in markets which value relationships and profile, means Australian businesses have to raise their market presence. Service suppliers usually need to establish a representative office, and in some cases, employ high profile local managers, but exporters should be able to use reputable local distributors.

Direct investment opportunities also are significant in mining, agribusiness and services where Australia is an international leader. Australian companies can leverage their technological, international marketing and managerial capacity in these sectors to invest profitably. Already, Australian mining investments are significant, particularly in Argentina and Chile, and mining supplies companies like Orica have a significant market presence. Wine production, food processing, leisure, infrastructure, financial and information technology service businesses also are investing profitably.

Latin America is a dynamic market; its opening markets and relatively high per capita incomes generate increasing trade and FDI inflows. Despite their distance, in future years, these economies should provide significant trade and particularly investment opportunities for Australian business. However, expanding preferential trade agreements and growing US and EU influence may disadvantage Australian exporters. Hence, the Australian Government will need to monitor closely new integration developments, and if possible, mitigate adverse affects on Australian interests. Most notably a future FTAA could threaten Australia's agricultural export markets, providing an additional rationale for negotiating a bilateral Australian-US FTA.