LATIN AMERICA – SETTING THE SCENE

KEY POINTS

- Brazil, Mexico, Argentina and Chile lead Latin American reform, and between them account for around 83 per cent of Latin American GDP and 90 per cent of Australian trade with Latin America. Hence, this report focuses on recent economic developments and opportunities in these four major economies.
- Latin America is embracing globalisation, leaving behind its failed protectionist and state led economic models of the 1960s and 1970s. All four economies have significantly reduced trade barriers and opened up almost completely to foreign direct investment, FDI. Hence, economic growth has increased, incomes are rising, trade is growing and foreign investment inflows are booming.
- The major watchpoints are progress in fiscal consolidation, external debt servicing commitments and capacity, and the growth in bank lending to the private sector.
- Australian business is responding to opportunities these reforms create. Some Australian companies already are leveraging their world class expertise in sectors they have in common with Latin America, particularly mining, agribusiness and services, developing Latin American investment opportunities. Others are exporting a range of commodities, manufactures and services.
- Surveyed Australian companies operating in Latin America are achieving good income growth and returns on their investment; however, they nominate bureaucratic problems as the main impediment to Australian investment.
- Latin America's deepening economic integration may reduce Australian opportunities in potentially important export markets. However, integration also could provide Australian companies investing in these four economies with better access to multiple markets.
- Australian business and Government need to monitor carefully whether regional trading arrangements are drawing Latin America (and the western hemisphere generally) away from multilateral market opening, how this would affect Australian interests, and what strategies Australia should adopt to address this, including developing free trade arrangements with key regional countries and groupings.

Since the mid 1980s, Latin America has undergone tremendous political and economic renewal, embracing trade liberalisation and opening its doors to FDI. Now, its indicators for civil and political freedom are higher than for any other developing region (Inter-American Development Bank, 2000).

This report focuses on the four major Latin American economies of Brazil, Mexico, Argentina and Chile. Not only are they market leaders in Latin American reform, but between them, they account for around 83 per cent of Latin American GDP and 90 per cent of Australian trade with Latin America. Brazil is the world's ninth largest economy and was the world's sixth largest FDI destination in 1999. Mexico's closer integration with the United States drove its economic boom in the late 1990s and 2000, and it continues to attract major FDI inflows. Chile is a Latin American, and even world leader, in economic reform, and already contains diverse Australian investment. Argentina currently is gripped by a debt crisis, but has rich natural and human resources, and significant long term potential, reflected in continued high FDI inflows.

Latin America's economic growth and market opening drive stronger regional trade and investment links with Australia. Bilateral trade with these four major Latin American economies grew 63 per cent between 1995 and 2000, 11 percentage points faster than Australia's overall trade growth. However, 2000 Australian trade with Latin America was still only A$2.7 billion, or 2 per cent of Australia's A$124.6 billion trade with Asia and less than 1 per cent of Australia's world trade. Distance, similar industrial specialisation, and US and EU dominance as traditional import suppliers means Australia is unlikely to become a major trading partner of these four major Latin American economies.

Australian investment in Latin America also is relatively small compared to Australian investment in Asia, Europe or North America. However, FDI could readily eclipse trade in bilateral commercial relations. Similar competitive strengths in mining, agriculture and resource based industries create potentially significant investment opportunities for Australian business, particularly as Australia's strong international competitiveness and advanced technological base in these sectors create strategic synergies.

Latin America's deepening economic integration also has important implications for Australia. By allowing multi-country access, integration increases the attractiveness of direct investment. Integration through the North American Free Trade Agreement, NAFTA, and some more advanced bilateral agreements, like that between Chile and Canada, may deepen reform commitment. On the other hand, as members of groupings like Mercosur (the successful free trade agreement between Brazil, Argentina, Paraguay and Uruguay) or NAFTA receive preferential access to each other and other Latin American economies, increasingly, Australia may find itself locked out of export opportunities in key markets. Looking forward, if a Free Trade Area of the Americas is negotiated successfully, Australia could lose its US market share to Latin American economies, particularly in agricultural products, and lose Latin American markets to the United States, Canada and other Latin American countries. This increases the rationale for Australia to negotiate a free trade Area with the United States and possibly, with New Zealand under the Closer Economic Relations, CER, agreement, to seek more formal links with Chile and Mercosur.

POLITICAL RENEWAL

Brazil, Argentina and Chile all endured dictatorships at some time between 1945 and 1989, while Mexico was governed by one party for 71 years until 2000. All four countries have progressed in achieving political freedom over the last two decades; now all four have vibrant democracies. Mercosur significantly contributes to this by requiring all members to be full democracies.

In the 1990s, democratically elected governments in Brazil, Mexico and Argentina opened up and comprehensively reformed their economies. Populations generally are benefitting from higher incomes and less poverty, so liberalisation has popular support. In Chile, military rulers started liberalising in the 1970s, but elected governments since 1990 remain committed to these policies. However, to ensure populations continue to support reform, all four governments need to progress substantially in boosting per capita income and reducing inequality.

ECONOMIC RENEWAL

For around four decades after the Second World War, Latin American economies pursued import substitution based industrialisation. High tariff and non-tariff barriers protected inefficient industries and exchange rates generally were overvalued. Initially, this led to a burst of growth, with Latin America averaging 4.2 per cent growth annually, in the 1970s. However, small domestic markets eventually capped growth, so import substitution policies failed. While these policies heavily discriminated against efficient export-oriented industries, principally agriculture and mining, inefficient industries absorbed investment. These policies, along with weak fiscal and social policies, also caused deteriorating income distribution and periodic balance of payments crises (Edwards, 1995). Incentives to invest in capital intensive production also depressed employment.

By the 1980s, growth stalled. Large fiscal deficits and external debt levels, characteristic of pre-reform Latin American economies, culminated in the 1982 debt crisis. Overstaffed and inefficient state owned industries dominated most Latin American economies. Weak fiscal policies with high budget deficits resulted in hyperinflation in Brazil and Argentina; inflation skyrocketed to thousands of per cent per year.

Latin America's New Economic Model

Debt defaults and ensuing economic crises in the early 1980s ultimately led governments to reassess their trade, industrialisation and macroeconomic policies. Chile's successful economic liberalisation and export-oriented East Asian economies provided Latin America with new models.

During the late 1980s and throughout the 1990s, the four major Latin American economies launched radical reforms, including reforming trade, making fiscal policies more prudent, reforming the financial sector, removing exchange rate restrictions, comprehensively liberalising FDI and undertaking large scale privatisations. While many reforms are ongoing, the reforms so far are creating more globally oriented, dynamic economies, with high levels of FDI and strong investor confidence. In the 1990s, GDP growth in the four major Latin American economies averaged 3.8 per cent, compared to only 1.9 per cent in the 1980s; poverty also declined (Table 1.1). However, inequality has not declined, despite increased social spending in some countries, like Chile.

Table 1.1

The Four Economies Growing Well, but External Debt and Inequality High

Major Indicators of the Four Major Latin American Economies

Indicator	Argentina	Brazil	Chile	Mexico
Population, 2000 (million)[a]	37.0	165.9	15.2	99.1
Surface area (thousands of square kilometres)	2 767	8 547	757	1 958
Gross domestic product, GDP, nominal, 2000 (US$ billions)	284.0	595.9	70.2	574.5
Sectoral structure of GDP, 2000 (per cent)				
Primary	7	9	21	4
Industry	24	34	26	28
Services	69	57	53	67
Real average annual growth in GDP, 1990-2000 (per cent)	4.1	2.7	6.5	3.5
GDP per capita, 2000 (US$)[a]	7 700	3 600	4 600	5 800
Gross fixed investment as a ratio of GDP (per cent)	16.0	19.4	22.3	20.8
Inflation, 2000 (per cent)	-0.9	7.0	3.8	9.5
Share of income earnt by top 10 per cent of population, 1995 (per cent)	na	47.6	46.1	42.8
Foreign goods and services trade, 2000 (US$ billions)				
Exports	30.8	64.5	22.2[b]	182.3[b]
Imports	32.6	72.7	21.2[b]	193.6[b]
Foreign trade as a ratio of GDP, 2000 (per cent)	22.3	23.2	61.8	65.4
Current account balance as a ratio of GDP, 2000 (per cent)	-3.3	-4.1	-1.4	-3.1
FDI inflows, 1994-99 (US$ billions)	53.8	97.2	21.2	64.0
Total merchandise trade with Australia, 2000 (A$ millions)	192.9	1 226.0	234.1	787.7
Rank in Australia's total merchandise trade, 2000	57	29	52	33
Unweighted average most favoured nation tariff, 1999 (per cent)	13.5	14.3	9.8	16.2
Public debt as a ratio of GDP, 2000 (per cent)	49.7	49.5	14.6	na
External debt as a ratio of GDP, 2000 (per cent)[a]	52.5	39.6	55.6	30.1

Note: a Economist Intelligence Unit estimate.
b Economic Commission for Latin America and the Caribbean estimate.

Sources: International Monetary Fund, 2001; Economist Intelligence Unit, 2001; World Bank, 2001; Economic Commission for Latin America and the Caribbean, 2000; Central Bank of Brazil, 2001; Central Bank of Chile, 2001; United Nations Conference on Trade and Development, 2000; Inter-American Development Bank, 2000; and Central Bank of Brazil, 2001.

Post-reform Performance and Challenges

While growth improved in the 1990s, it was volatile. In 1994-95, Mexico's devaluation triggered a crisis, hitting growth across the region. The 1997-98 Asian financial crisis, the 1998 Russian default and 1999 Brazilian crisis and devaluation, capital outflows and tight monetary policy produced another recession in Brazil, Argentina and Chile. In 2001, Argentina, with its pegged exchange rate, remains mired in recession and a major debt crisis.

Democratisation and economic liberalisation generated high expectations of rising living standards and improved equality. This pressures governments and creates the risk political 'backflips' that could decelerate or even reverse reform.

A further critical challenge is institutional strengthening. Latin American bureaucracies originated in Spanish and Portuguese colonial times, when administrations were unaccountable, cumbersome and prone to corruption (Hillman, 1997). Many regional bureaucracies still are dealing with these problems. Major ongoing issues include reducing discretion in institutional decision making and regulation, increasing public service and judicial independence, controlling corruption, improving respect for the law, clearly defining property rights and refining power sharing between the different levels of government.

AUSTRALIA'S BUSINESS INTERESTS IN LATIN AMERICA

In response to Latin America's growing openness and incomes, Australia's trade and investment links with the region are growing quite rapidly; the four Latin American economies' large populations, moderate per capita income levels and reform oriented policies create significant trade potential. In 2000, Australia exported merchandise worth over A$1.2 billion to these four economies and Australia imported items worth A$1.3 billion from them.[1] Australia's main exports include coal, non-bovine meat, motor vehicles, coated flat rolled steel, oil seeds and oleaginous fruits, crude petroleum, chemicals, wool, nickel, pharmaceuticals and dairy products. In addition, Australia exports services to Latin America, mainly tourism and education. Australia imports leather, fish, paper pulp, fruit juice, coffee, telecommunications equipment, computers and parts and a range of food products.

Reliable, comprehensive statistics on Australian investment in Latin American are not available. However, most Australian investment in Latin America is in mining and is strongly export oriented. In Chile alone, during the 1990s, Australian mining investment totalled US$1.1 billion, and BHP Billiton currently is expanding its massive Escondida copper mine. Australian companies have invested over US$1.1 billion in Argentina's mining sector and made major investments in Brazil. With large, prospective countries and progressive mining regimes, significant scope exists for more mining investment, particularly when mineral prices improve. Brazil, Chile, Argentina and Mexico all have strong potential, creating opportunities for mining services companies to establish a presence and participate in growth.

[1] Main imports are food products, telecommunications equipment, fruit juices, coffee and coffee substitutes, leather, computers, computer parts, food and live animals, general industrial machinery, fertilisers and automotive parts.

Given the similar production and export patterns of Australia, Brazil, Argentina and Chile, in primary commodities, investment opportunities also are strong in other sectors where Australia has world class expertise, including agriculture, agribusiness and wine. Moreover, growing incomes, high Internet usage, open financial sectors, strong frameworks encouraging the private sector to provide infrastructure, stronger competition policy and large markets create opportunities in sectors including information technology, communications, tourism, educational services, infrastructure, processed foods and automotive products.

AUSTRALIAN INVESTOR VIEWS ON LATIN AMERICA

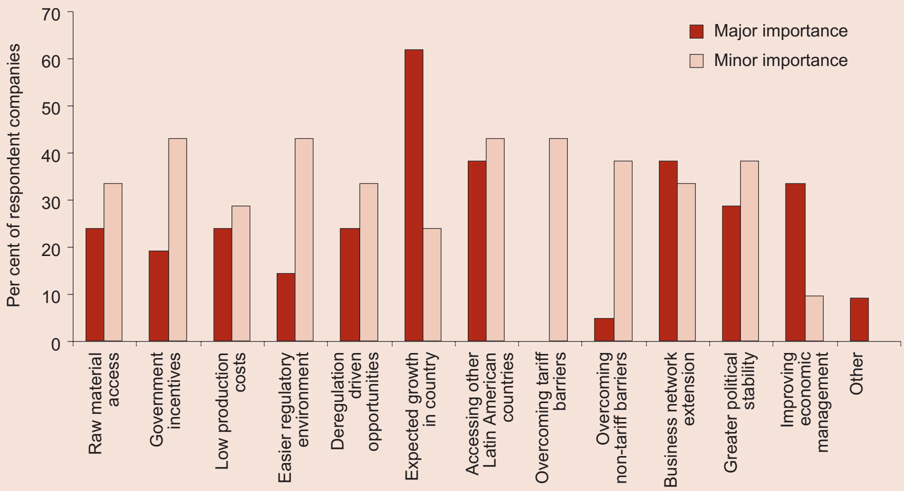
An Economic Analytical Unit survey of Australian investors in the four major Latin American economies showed that 45 per cent of Australian companies found the rewards of investing in Latin America outweighed the risks; 45 per cent found risks and rewards were evenly balanced and only 10 per cent said risks outweighed rewards.[2]

Australian foreign direct investors expect income growth from their Latin American investments; 62 per cent of survey respondents rated this of 'major importance' (Figure 1.1). The next most important factors were accessing other Latin American markets (38 per cent), extending business networks (38 per cent) and improving economic management (34 per cent). Interestingly, firms did not nominate overcoming tariff barriers as a major reason for their investment decision, although 43 per cent of firms saw this as a minor reason (Figure 1.1).

Figure 1.1

Australian FDI Seeks to Access Latin American Growth

Factors Driving Australian Companies' FDI Decisions in Latin America



Note: Survey respondents provided multiple responses, so percentages exceed 100.

Source: Economic Analytical Unit, 2001.

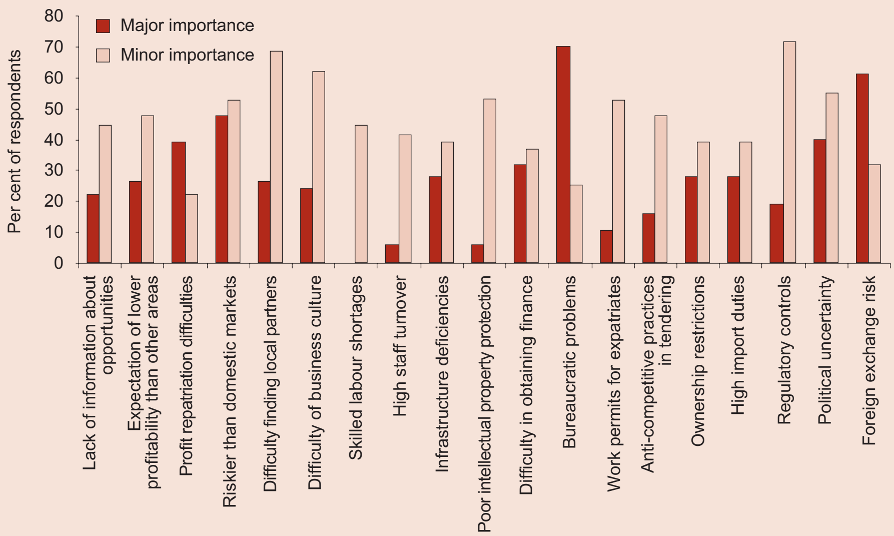
2 This survey in February and March 2001 sent out 32 questionnaires and received 22 responses, a response rate of 69 per cent.

Bureaucratic problems impede Australian investment in Latin America, according to 70 per cent of respondent companies (Figure 1.2). The next most important impediments were foreign exchange risk (61 per cent), higher commercial risk than in domestic markets (48 per cent) and political uncertainty (40 per cent).

Figure 1.2

Bureaucratic Problems Discouraging Investment

Factors Impeding Australian FDI in Latin America, 2001



Note: Survey respondents provided multiple responses, so percentages exceed 100.

Source: Economic Analytical Unit, 2001.

LATIN AMERICAN REGIONAL INTEGRATION

In the 1990s, trade liberalisation via regional preferential trading agreements suddenly took off in the western hemisphere. Most notably, NAFTA, effective since 1994, covers 30 per cent of world output and 18 per cent of world trade (Frankel, 1997), and Mercosur, created in 1991, plans to move from a free trade area to a full customs union by 2005.

Furthermore, the Free Trade Area of the Americas aims to conclude negotiations by 2005. This proposal covers 34 western hemisphere countries, all the independent countries in the western hemisphere except Cuba. If implemented, it would encompass over one-third of world output, and one and a half times the population and output of the EU. Many Latin American countries and groupings also have negotiated free trade arrangements with other countries and regions outside the western hemisphere. These include Mexico with the EU and Israel, and Chile with the EU and Canada.

NAFTA and Mercosur drive trade. Intra-NAFTA exports as a share of total NAFTA exports rose from 43 per cent in 1990 to 55 per cent in 1999. Similarly, intra-Mercosur exports as a share of total Mercosur exports rose from 9 per cent in 1990 to 20 per cent in 1999 (Inter-American Development Bank, 2000). Smaller bilateral agreements like the Chile-Canada agreement, minimally affect total trade flows, but can create costly trade diversion in specific markets; for example, Australia's coal trade with Chile suffered due to trade preferences Canadian and Columbian coal receive.

Issues for Australia

Australian business must assess whether these discriminatory regional trading arrangements signal Latin America (and the western hemisphere generally) will back away from multilateral market opening, and whether this will reduce significantly Australian exporters' access to these markets. This development would be serious and unwelcome. Australia could seek to protect its access by negotiating preferential agreements; however, even if it succeeded, the western hemisphere is developing a complex web of rules of origin, which could undermine many free trade benefits.

At present, North and Latin American preferential trading agreements could increase the rationale for, and return from, FDI in that hemisphere. However, investors must watch that new preferential agreements do not dilute Latin America's current openness to FDI from any country.

REPORT COVERAGE

This report focuses on emerging Australian business opportunities in Brazil, Mexico, Argentina and Chile.[3] It first compares Australia's economic relationship with these major Latin American economies with its relationship with major East Asian economies. It then analyses the economic performance, reform progress and prospects, and Australia's major emerging trade and investment opportunities in each of these four Latin American economies. It assesses the regional business environment and analyses the impact of regional integration in Latin America on medium term trade and investment opportunities. Finally it draws implications and makes suggestions for action for Australian business and governments.

3 The report complements several recent publications on Australia's trade and investment relationship with Latin America. These include Department of Foreign Affairs and Trade, 2001 and 1999; Joint Standing Committee on Foreign Affairs, Defence and Trade, 2000; and Austrade, 1997.

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LATIN AMERICA, EAST ASIA AND AUSTRALIA – COMPARISONS, COMPLEMENTARITIES AND COMPETITION

KEY POINTS

- Combined, the four Latin American economies of Brazil, Mexico, Argentina and Chile have only slightly less gross domestic product, GDP, than the combined economies of four of Australia's major East Asian markets, China, the Republic of Korea, Indonesia and Thailand; comparing market opportunities in East Asia and Latin American is highly relevant to Australia.

- While populations are smaller in Latin America than in East Asia, average income levels are higher, potentially creating more trade and investment opportunities.

- However, Latin American economies are major primary commodity producers and exporters, as is Australia, so they do not complement Australia's economy as well as most East Asian economies do. This constrains trade opportunities for Australia in Latin America. Latin America's distance from Australia and dominant traditional North American and EU trading partners, many of which have preferential access agreements, also reduce Australian trade opportunities in Latin America.

- However, the similarity of Latin American and Australian economies offers considerable scope for Australian direct investment in the region. Australia's comparative advantage favours investment opportunities in mining and mining supplies, agribusiness such as wine and food processing, infrastructure such as telecommunications and ports, and a range of other services.

Latin America will never be the pre-eminent trading partner for Australia that East Asia is, but could conceivably become an important direct investment destination. It also offers good prospects for trade in goods and services associated with such investments, and in many other niche areas. Latin American economies provide Australia with different trade and investment opportunities than East Asian economies, because they have quite different productive and trade patterns, regional integration initiatives and openness to trade and investment. Many major opportunities for Australian business in Latin America lie in directly investing in sectors where Australia and Latin America compete, particularly mining and agribusiness. A range of service sectors and privatising infrastructure, where Australia has strong expertise, also should provide profitable investment opportunities, but at present, Australian direct investments in Latin America are a fraction of those made in East Asia.

This chapter compares the output, incomes, trade and foreign direct investment, FDI, of East Asian and Latin American economies to identify the complementarities and competition between Australia, Latin America and East Asia. It assesses whether and where opportunities are likely to emerge in Latin America, and analyses lessons learnt from East Asia's development experience. It makes this task tractable by concentrating on the main emerging markets in each region. In Latin America, it analyses the four major economies of Brazil, Mexico, Argentina and Chile, hereafter called the four Latin American economies; these are compared with major non-Japan East Asian economies of China, the Republic of Korea, Indonesia, Malaysia, the Philippines and Thailand.

ECONOMIC CHARACTERISTICS

In the first instance, the overall sizes of East Asian and Latin American economies, their medium term growth rates and the wealth of their populations provide a guide to Australia's relative opportunities in the two regions.

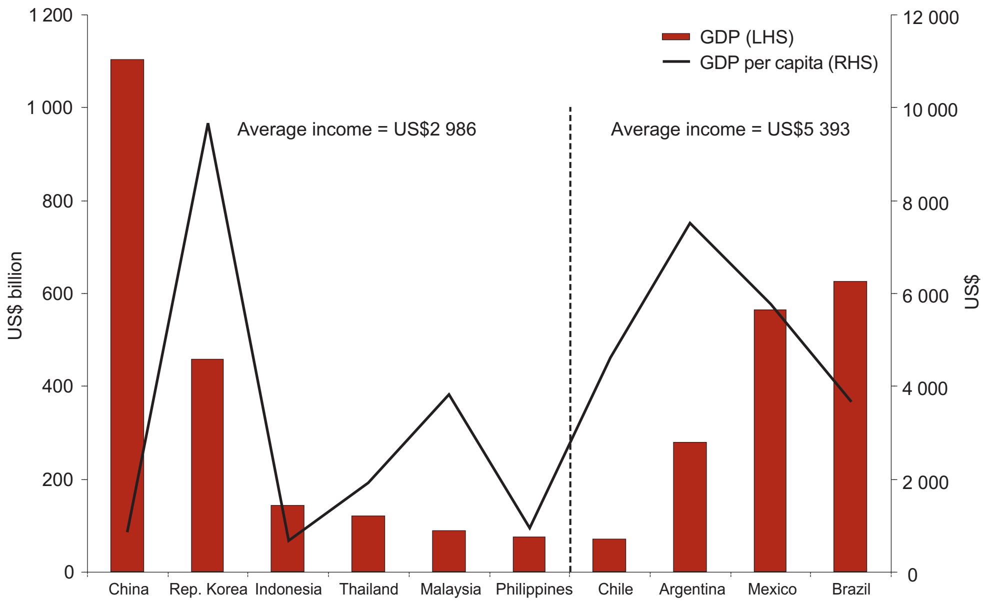
Economic Size

As a whole, the Latin American economies' gross domestic product, GDP, is almost as large as the four largest non-Japan East Asian economies' (Figure 2.1). The four major Latin American economies have a combined GDP of US$1 536 billion, compared to US$1 822 billion for the four largest East Asian economies (China, the Republic of Korea, Indonesia and Thailand). In 2000, China's economy was by far the largest in the two regions, with a GDP of US$1.1 trillion. This is almost twice the size of Brazil's, the largest Latin American economy, with GDP of US$625 billion. However, Brazil and Mexico are larger than all these East Asian economies except China, and Argentina is significantly larger than the four smaller Asian economies.

Figure 2.1

Latin American and East Asian Markets Are Similar Size

GDP and GDP per capita, 2000, US$ billions and US$



Source: Economist Intelligence Unit, 2001a.

On average, the Latin American economies have far higher per capita income than the East Asian economies. Across the two regions, the Republic of Korea has the highest income per capita, but it is followed by Argentina, Mexico, then Chile (Figure 2.1). In addition, due to Latin America's large populations and highly skewed income distributions, its upper and middle classes constitute a very large, affluent market.

Hence, while the economic size of the four Latin American economies is somewhat less than the major non-Japan East Asian economies examined, their consumer spending power is probably greater, indicating Australian business may find good opportunities there.

Growth Performance

Both regions' economies recorded high growth rates in many years of the last two decades. However, the East Asian economies have performed consistently better than the Latin American economies. With Latin America broadly supporting liberal market oriented reforms, rapid economic growth and stable democracy seemed achievable. In the 1990s, the region's four major economies grew by an average of about 3.3 per cent per year, considerably faster than the 1.3 per cent achieved in the previous decade. However, this was considerably slower than most East Asian economies. East Asian economies' average growth exceeded 7 per cent in seven years in the 1980s and eight years in the 1990s. By comparison, Latin America's growth exceeded 6 per cent in only one year in the 1980s and not once in the 1990s (International Monetary Fund, 2001b). Thus, Latin American economies' growth has been less robust than East Asian economies' in the 1990s; this may limit Australian trade and investment opportunities in Latin America.

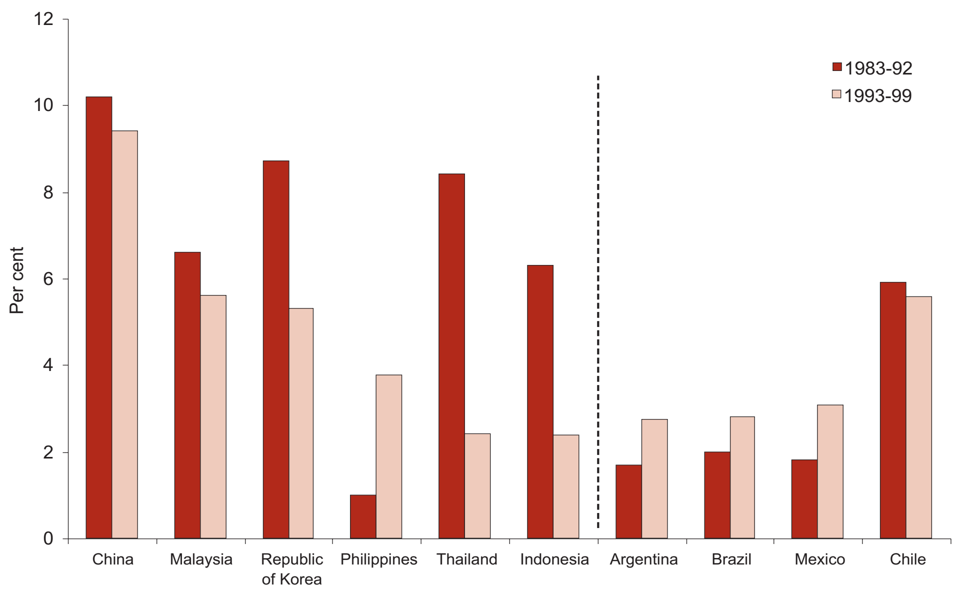
Except for the Philippines, the East Asian economies recorded outstanding growth between 1983 and 1992, far exceeding the four Latin American economies (Figure 2.2). The Asian crisis caused the two regions' growth performance to diverge less in the 1990s. However, China and Malaysia grew faster than the Latin American economies, with average annual growth rates of 9.4 per cent and 5.6 per cent between 1993 and 1999, compared to 5.6 per cent in Chile, the highest rate by far in Latin America (Figure 2.2).

However, except for China, East Asia currently confronts serious economic challenges associated with dysfunctional banking systems, excessively leveraged corporate sectors and high government debt. Over the next decade, these factors are expected to undermine growth prospects in economies like Indonesia, Thailand, the Philippines and, to a lesser extent, the Republic of Korea and Malaysia (East Asia Analytical Unit, 2000a; 2000b; 1999; and 1998). Hence, Australian exporters are looking to diversify into other regions, including Latin America.

Figure 2.2

Average Growth Higher in East Asian Economies

Regional Comparison of Average Annual Real GDP Growth, Per cent



Source: International Monetary Fund, 2001a.

Lessons from and for East Asia

East Asia grew faster than Latin America in the 1980s and most of the 1990s because it more thoroughly embraced export-oriented industrialisation. Most East Asian economies operated relatively liberal FDI regimes, at least in manufacturing, and operated responsible fiscal policies. The most successful economies, like the Republic of Korea, Malaysia and China, invested highly in infrastructure and human capital to support this strategy. In the 1980s and 1990s, until the crisis, East Asia's banks also intermediated large volumes of savings, supporting strong growth, but the Asian financial crisis ultimately proved their risk management strategies were inadequate.

While the Asian crisis was not typical of Latin American crises, which usually resulted from excessive public sector borrowing, especially from abroad, it was more similar to the 1994 Mexican crisis. In Mexico and East Asia, excessively optimistic foreign financiers and local investors built up unsustainable, private foreign debts, and asset bubbles in local real estate and share markets.

Significantly, both the Latin American and East Asian crises demonstrate the critical importance of developing a strong credit culture, built on functioning insolvency systems and strong prudential controls, so banks and financial markets can intermediate local savings efficiently and manage risk well. Brazil, Mexico, and to a lesser extent, Argentina have poorly functioning banking systems, the result of poor credit cultures and excessive government borrowing.

Before the crisis, financial systems throughout East Asia were heavily protected from foreign competition; hence most failed to adopt modern methods of credit analysis, risk diversification and hedging. While more foreign institutions are now present in the Republic of Korea and Thailand, the huge overhang of non-performing loans and insolvent borrowers has jammed the court systems. Insolvency regimes in Indonesia, Thailand and, to some extent, the Republic of Korea are not coping well. Strategic non-performing loans (viable debtors refusing to service loans) now are a phenomenon in these East Asian economies, and many borrowers are resisting thorough, realistic corporate restructuring, including by manipulating political systems.

Consequently, East Asian credit culture has deteriorated since the crisis. Banking systems, particularly in Indonesia but also in Thailand, are barely functional, and becoming more susceptible to long term Latin American problems. As in Latin America, most banks now prefer to hold high return, low risk government bonds, and are not expanding credit to the private sector. The number of creditworthy borrowers is not high, and banks are very wary of protecting their capital base. Lessons from Latin America are highly relevant to East Asia at this point; unless governments take a tough line on enforcing insolvency regimes and forcing realistic corporate restructuring, domestic financial systems will no longer support rapid GDP growth, which consequently will fall sharply.

Many Latin American economies are ahead of East Asian economies in privatising and liberalising the financial sector, undertaking reforms in the early 1990s instead of post 2000. However, the higher degree of foreign bank ownership in Latin America indicates foreign banks alone are not a panacea, as they may react to the same incentives as local banks. In Brazil and Mexico, the presence of foreign banks is not enough to drive private sector loan growth. However, once Latin American economies resolve problems with their insolvency regimes and fiscal problems, the strong foreign bank presence could underpin a well capitalised and prudent financial sector.

East Asian governments traditionally are much more fiscally responsible than Latin American governments, another reason East Asia grew more rapidly in the 1980s and 1990s. Most East Asian governments ran fiscal surpluses in many of these years, and so did not crowd the private sector out of credit markets, or run up large, unsustainable foreign debts. However, since the crisis, East Asian government debt has risen sharply after their financial system bail outs; East Asian debt to GDP ratios are now at or above Latin America levels. Hence, unless East Asian governments act quickly to bring budgets back into surplus, their economies could become susceptible to Latin American sovereign risk and private sector crowding out problems, which also will drag down growth.

Hence, Latin America and East Asia both have valuable lessons to learn from each other's growth and crisis experiences.

AUSTRALIA'S TRADE WITH LATIN AMERICA AND EAST ASIA

Although the Latin American economies are only slightly smaller than most non-Japan East Asian economies, Australia's trade with them is dramatically smaller. Australia's and Latin America's economies are less complementary; the distances to Latin American economies are much greater and transport links are weaker; also, Latin America's traditional relations with North American, EU and other Latin American trading partners include many preferential trading arrangements. Hence, in the forseeable future, Latin America is unlikely to become as important a trading partner for Australia as East Asia.

Australia's trade with Latin America is only about 2 per cent of its trade with East Asia.[1] The export gap between East Asia and Latin America is even more extreme. In 2000, Australia exported 47 times more merchandise exports to East Asia than to Latin America, A$61.2 billion or 55 per cent of total Australian merchandise exports, compared to only A$1.3 billion or 1.1 per cent of total merchandise exports (Department of Foreign Affairs and Trade, 2001a). The same pattern of trade occurs at the individual country level. Australian merchandise exports to non-Japan East Asia range from A$9 billion to the Republic of Korea down to A$1.5 billion to the Philippines. In contrast, Australian exports to Latin America range from A$571 million to Brazil down to A$101 million to Argentina (Figure 2.3). Australian exports to Japan are a massive A$21.8 billion.

However, in the 1990s, from very low bases, Australian exports to Brazil and Chile grew faster than to East Asia, in large part due to the Asian crisis (Figure 2.4).

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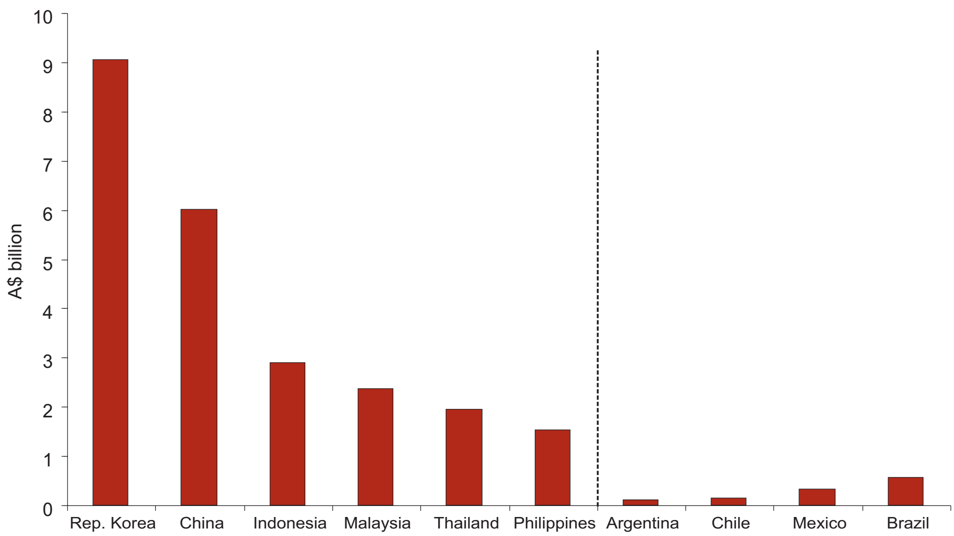
[1] In 2000, Australia's two-way merchandise trade with all Latin America (including all the economies of Central and South America) totalled only A$2.7 billion, or 1.2 per cent of total Australian merchandise trade, while total merchandise trade with East Asia (including the ten ASEAN economies and eight North Asian economies) reached A$111.7 billion, or 49.1 per cent of Australia's total merchandise trade (Department of Foreign Affairs and Trade, 2001a).

Figure 2.3

Australia Exports Much More to East Asia than to Latin America

Australia's Merchandise Exports by Destination, 2000, A$ billion

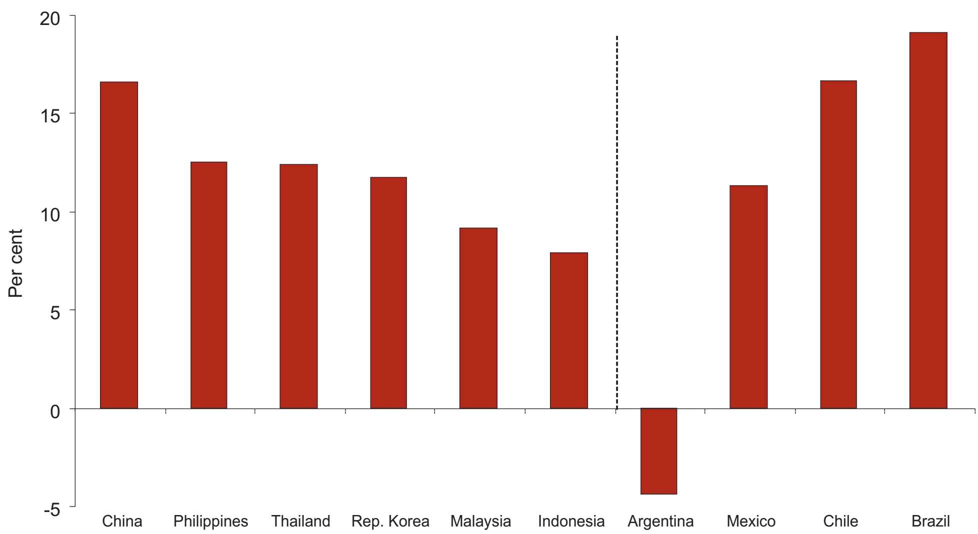


Source: Department of Foreign Affairs and Trade, 2001a.

Figure 2.4

Australian Export Growth Highest to East Asia in the 1990s

Australia's Average Annual Merchandise Export Growth by Destination, 1990-2000, Per cent



Source: Department of Foreign Affairs and Trade, 2001a.

Australia's significantly lower trade with Latin America is due to several factors, including the structure of trade in each region, openness to trade, distance and preferential trade arrangements. Examining these constraints should indicate whether in the 2000s, Australia's trade to Latin America is likely to grow as strongly as in the 1990s.

Trade Structure

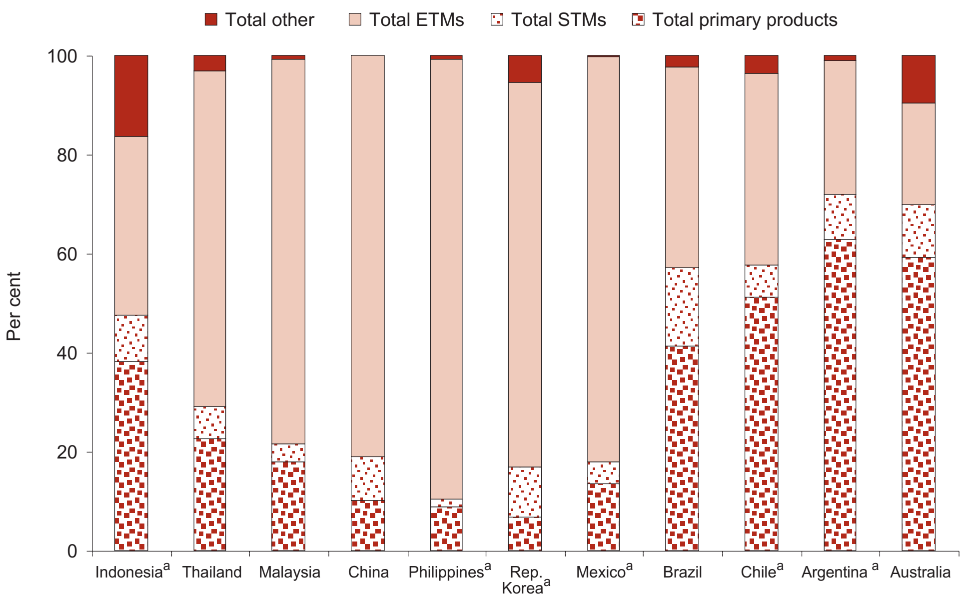
Trade structure influences trade patterns, because it indicates if economies are essentially competitors or complementary. Latin America and Australia generally have quite similar patterns of exports, with a high weighting on commodity exports; Mexico is the exception with its large export-oriented manufacturing sector. In 2000, 62 per cent of Australia's exports were primary commodities. This means Latin American economies and Australia compete in export markets. On the other hand, East Asian economies export mainly manufactures, indicating Australian and East Asian economies are complementary (Figure 2.5). This in large part explains Australia's strong exports to East Asia; Australia supplies the minerals and agricultural commodities needed by Asia's industries and populations.

Both East Asian and Latin American imports are skewed towards manufactures, on average. However, reflecting Latin America's greater competitiveness in commodity exports, an average of only 15 per cent of Latin America's imports are primary commodities compared to 21 per cent of East Asia's (Figure 2.6).

Figure 2.5

Latin American Exports Focus on Primary Commodities

Merchandise Exports by Country, 1999, Per cent



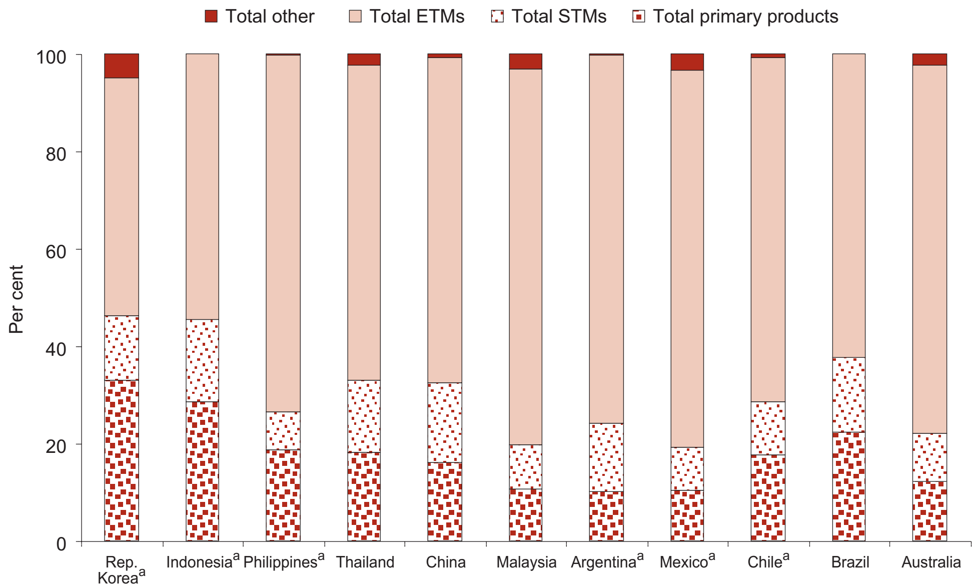
Note: a indicates 1998 data.

Source: Department of Foreign Affairs and Trade, 2001b.

Figure 2.6

Manufactures Comprise a Large Share of Imports

Merchandise Imports by Country, 1999, Per cent



Note: a indicates 1998 data.

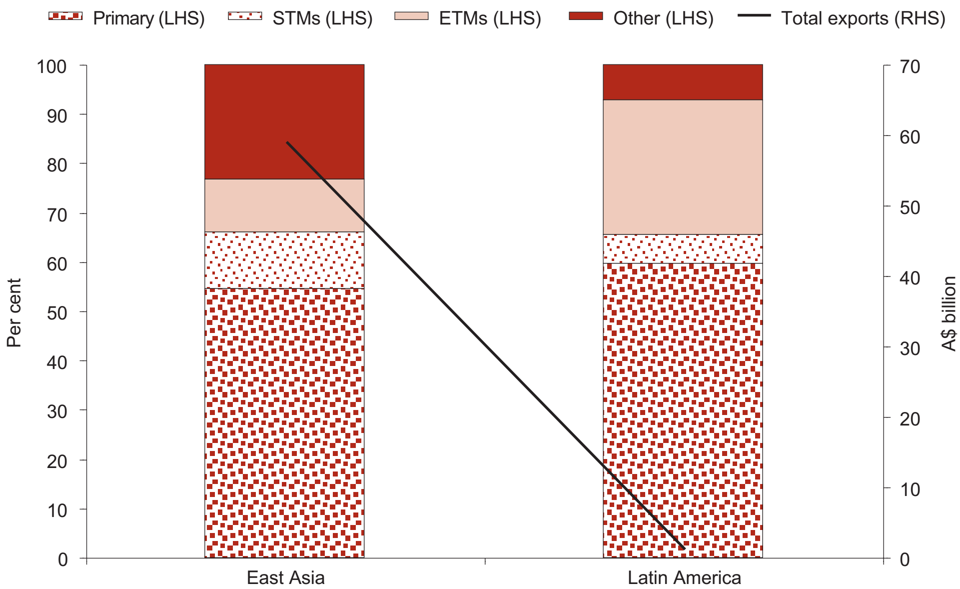
Source: Department of Foreign Affairs and Trade, 2001b.

Australia mainly exports primary commodities to both East Asia and Latin America; commodities account for 55 per cent of Australian merchandise exports to East Asia, and 60 per cent of merchandise exports to Latin America (Figure 2.7). However, proximity to markets is much more important for commodity exporters than for manufactures exporters, as the ratio of transport costs to free on board, fob, value typically is higher for primary commodities than for manufactures. Consequently, Australian primary exports to Latin America are only 2 per cent of those to East Asia, explaining why overall Australian exports to Latin America are much lower than to East Asia, and are likely to remain so for the foreseeable future (Figure 2.7). The lower transport component in manufactured exports, particularly ETMs, implies more opportunities should exist for Australian manufactures exports to Latin American, particularly in niche markets. While Australia remains primarily a commodity exporter, its natural markets will remain mainly in East Asia, but as Australia continues to expand ETM exports, Latin American markets should become more important.

Figure 2.7

Australia Supplies Commodities to Both Regions

Total and Composition of Australian Exports to Latin America and East Asia, 2000, Per cent and A$ billion



Note: Other items are mainly confidential export items, which typically also include many commodities like wheat, sugar and alumina.
Source: Department of Foreign Affairs and Trade, 2001a.

Trade Openness

Trade openness and intensity in Latin America and East Asia, measured by the ratio of goods and services exports plus imports to GDP, also affects Australian trade patterns to the two regions. Size of economies, liberality of trade regimes, and the pattern of exports determine trade intensity. For example, large economies generally have lower trade intensity than small ones, and manufactures assemblers have far higher trade intensity than primary commodity exporters. The East Asian economies, except for the large economy of China, have greater trade intensity than Latin American economies (Figure 2.8). This is both because East Asian economies specialise more in manufactures assembly and have more open trade regimes. Greater trade intensity in East Asia implies Australia should have more trading opportunities there than in Latin America. However, openness has increased in both regions over the last three decades, as they have reduced trade barriers.

Distance

Distance to markets is a major determinant of the level of trade between countries; Australia's proximity to East Asia favours that relationship. Most of the South American continent is on a longitude further east than Miami in the United States. Thus, even Mexico and Chile on the Pacific seaboard are around

12 000 kilometres from the east coast of Australia; Brazil and Argentina on the Atlantic seaboard are around 13 600 kilometres from both the east and west coasts of Australia. In contrast, the distance to markets in East Asia range from around 5 500 kilometres to Indonesia to 8 300 kilometres to the Republic of Korea. Hence, the higher transport costs to Latin America make Australian exports to that region less competitive than those to East Asia, particularly for lower value commodities which form a large share of Australian exports; the disadvantage for higher value manufactures is less significant.

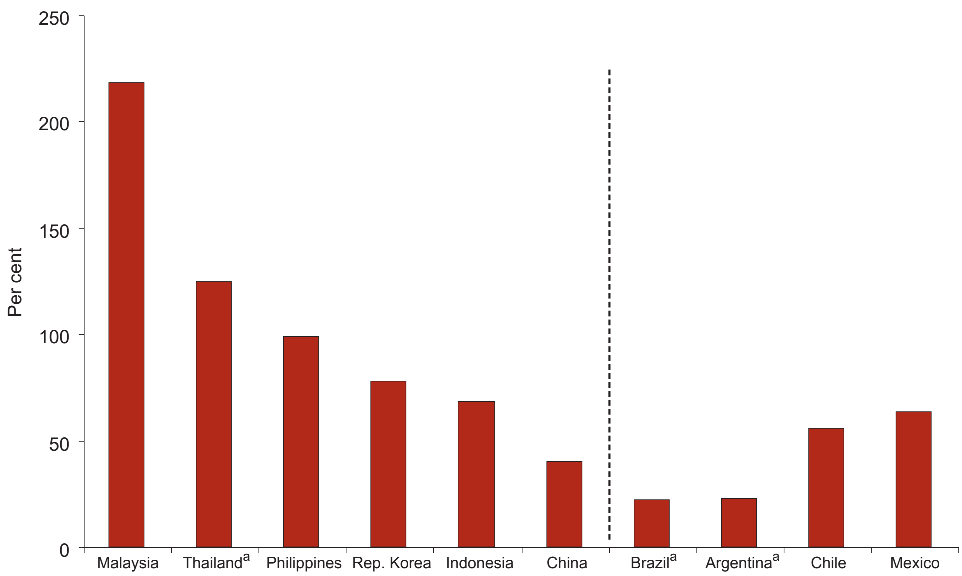
Preferential Trade Arrangements

The multitude of Latin American preferential trade arrangements also reduces Australia's trade opportunities in Latin America. (See Chapter 12 - *Regional Integration*.) Since 1980, Latin America has launched more than 25 new regional preferential trade arrangements, ranging from bilateral and regional free trade areas to customs unions. On the other hand, except for the ASEAN Free Trade Area, AFTA, East Asia has entered few preferential trade arrangements, although increasingly, it is considering new bilateral and regional agreements.[2]

Figure 2.8

Trade Intensity Far Higher in East Asia

Goods and Services Trade as a Ratio to GDP, 1999, Per cent



Note: a means 2000 data.

Source: International Monetary Fund, 2001a.

[2] These include the New Zealand-Singapore, Singapore-Australia and Japan-Singapore bilateral free trade agreements, as well as a range of other feasibility studies. The Asia-Pacific Economic Cooperation, APEC (Australia, Brunei, Canada, Chile, China, Taiwan, Hong Kong, Indonesia, Japan, Republic of Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Philippines, Singapore, Thailand and United States) is not a preferential trade arrangement, as all tariff reductions are on a most favoured nation basis.

Major Latin American agreements include the North American Free Trade Agreement, NAFTA, and Mercosur. A range of other regional and bilateral agreements are in place, with Chile and Mexico being most prolific negotiators. In addition, negotiations currently underway could expedite free trade in the whole of North, South and Central America, except Cuba, through the proposed Free Trade Area of the Americas, FTAA. (See Chapter 12 - *Regional Economic Integration*.)

Major integration initiatives in the Asia-Pacific include AFTA and the Australia and New Zealand Closer Economic Relations, CER. AFTA, a free trade area, aims to reduce intra-regional tariffs to 0 to 5 per cent and eliminate non-tariff barriers for most merchandise trade by 2003 (East Asia Analytical Unit, 1994).[3] The CER is a WTO-consistent free trade area between Australia and New Zealand, covering trade in services and including rules of origin; it eliminated all tariffs and quantitative restrictions on trade by June 1990.

Impact of intra-regional trade

Partly because Latin American trade liberalisation is more biased towards preferential trade arrangements, Latin America's intra-regional trade has grown more rapidly than East Asia's. Proximity, economic liberalisation, improving transport links and growing incomes also explain Latin America's expanding intra-regional trade. This may imply Latin American markets have fewer opportunities for extra-regional exporters like Australia, particularly as Australia has no preferential agreements with Latin America.

While AFTA has boosted intra-ASEAN trade in recent years, East Asia still has more diverse markets than Latin America and relies less on intra-regional trade. In the 1990s, Latin America's intra-regional exports grew nearly 50 per cent faster than extra-regional exports. Most of Latin America's trade is with other Latin American countries, followed by North America and Europe. In contrast, East Asia's intra-regional exports are relatively low (especially if Hong Kong, Chinese and Taiwanese trade is excluded) and grew more slowly than total export growth.

Areas of Future Competition

In general, to enter the Latin American market behind the barriers regional agreements and transport costs present, Australian exporters must find niche markets where they have strong expertise and traditional trading partners are less competitive. Australia's exports of elaborately transformed manufactures, ETMs, to Latin America have grown over the decade. Given the lesser importance of transport costs to these generally higher value products, ETMs may provide better opportunities to access Latin American markets in future.

Increasingly, Latin American economies are looking to Asia to diversify and expand their export markets. This trend may generate areas of competition between Latin American and Australian exporters. For example, this applies to Brazilian exports of iron ore into Japan, Australia's major export market.

[3] AFTA covers Brunei, Cambodia, Indonesia, Laos, Malaysia, Burma (Myanmar), the Philippines, Singapore, Thailand and Vietnam.

FDI IN LATIN AMERICA AND EAST ASIA

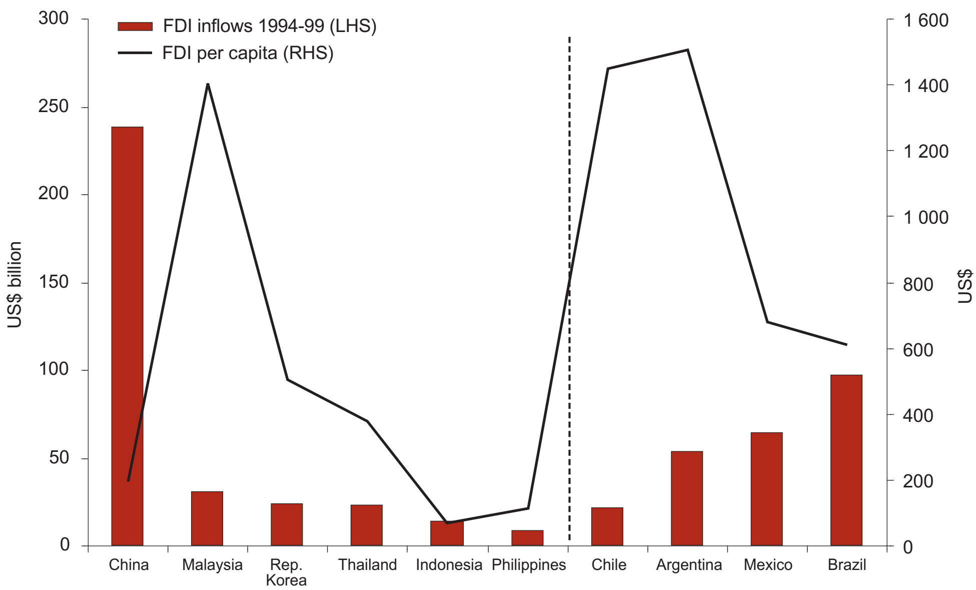
Both Latin America and East Asia attracted large FDI inflows in the 1990s, demonstrating investors believed both regions offered good growth prospects and opportunities. However, between 1994 and 1999, per capita FDI flows to the four Latin American economies were 59 per cent higher than to the six East Asian economies (Figure 2.9).

For example, in 1999, China received the highest FDI inflows of all emerging markets, over US$40 billion, but Brazil, with less than one sixth of the population, was the second largest recipient, receiving US$31 billion (United Nations Conference on Trade and Development, 2000). Due to the Asian crisis, 1999 FDI inflows to Indonesia, Malaysia and the Philippines were below 1994 levels. In contrast, 1999 FDI inflows to all four Latin American economies were higher than 1994 levels (Figure 2.10).[4]

Figure 2.9

Latin America Attracts More FDI than Most of East Asia

FDI Inflows and Per capita, 1994-99, US$ billion



Note: 1997 population figures used in calculating per capita FDI flows over the period 1994-99.

Source: United Nations Conference on Trade and Development, 2000.

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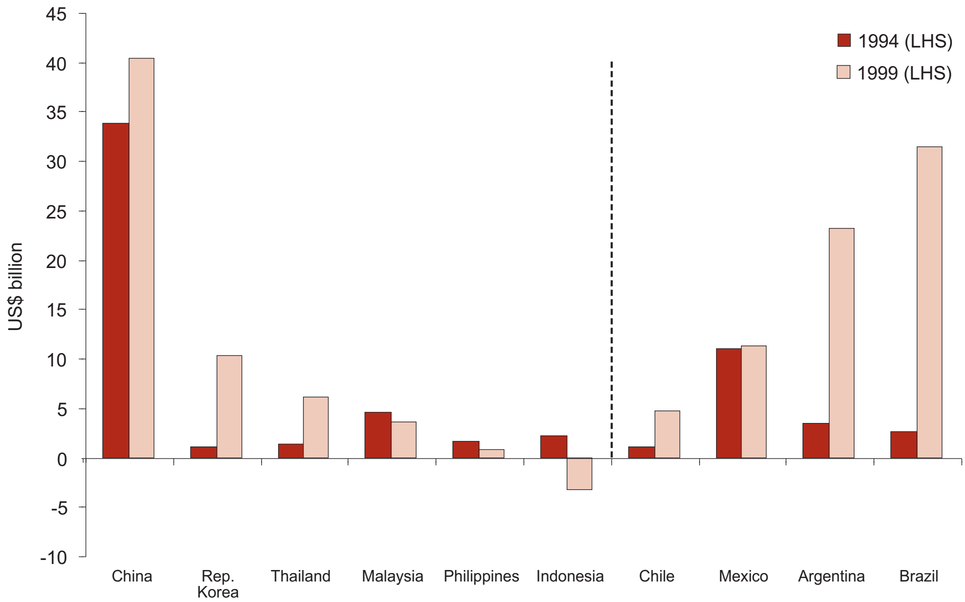
4 However, 1999 Argentine FDI was a major outlier, at over three times 1998 levels, because of the sale of its state owned petroleum company to a Spanish company.

Figure 2.10

Latin America Increasingly Attractive FDI Destination

FDI Inflows to East Asia and Latin America, 1994 and 1999, US$ billion



Source: United Nations Conference on Trade and Development, 2000.

AUSTRALIA'S INVESTMENT IN LATIN AMERICA AND EAST ASIA

East Asia is a major investment destination for Australia, after North America and Europe. In 1999-2000, official Australian Bureau of Statistics, ABS sample data indicated over 13 per cent of the total stock of Australian foreign investment, or A$49 billion, was located in East Asia, with Japan, Singapore, Hong Kong, Indonesia and China the main destinations (Australian Bureau of Statistics, 2001). By contrast, ABS data indicate Australian investment in Latin America is minor, A$2.4 billion, or around 0.6 per cent of total stock of Australian investment abroad in 1999-2000. However, sample data do not capture Australian investment in Latin America (or East Asia) made from third countries or reinvested profits; survey based data indicate Australian FDI in the four Latin American economies is over A$7.4 billion. (See Chapter 4 - *Brazilian Business Opportunities*, Chapter 6 - *Mexican Business Opportunities*, Chapter 8 - *Argentine Business Opportunities* and Chapter 10 - *Chilean Business Opportunities*.)

The divergence in Australian FDI flows between the two regions is less than between trade flows, indicating scope for Australian FDI in Latin America may be greater than for trade with the region. For example, Australia has a significant comparative advantage in the mining sector, and Latin America has large mineral reserves. All four Latin American economies have liberalised or are reforming mining regulations to attract increased investment in mineral exploration and extraction. Major

Australian mining projects in Latin America include Minera Alumbrera in Argentina (Rio Tinto and MIM) and Escondida in Chile (BHP Billiton). Australian companies also have invested in agribusiness, including wine, food processing, financial, information technology, ports, logistics and leisure industries; Australia has a comparative advantage in all these sectors.

Australia also has major direct investments in East Asia particularly in the mining, port, media and financial sectors. However, many East Asian economies like China, Thailand and the Philippines still have very restrictive mining regimes, limiting further investment in this sector at this stage. Furthermore, Australia is not a major player in world home or office electronics industries, or other labour intensive manufacturing industries like clothing and footwear, which are the major sectors receiving FDI in non-Japan East Asia.

FDI Regulations

During the 1990s, around the world, regulations on foreign capital flows were relaxed, with Latin America leading the removal of capital flow regulations. The four major Latin American economies have very few regulations or limits on foreign investment in most sectors, with most giving national treatment to foreign investors (See Chapter 4 - *Brazilian Business Opportunities*, Chapter 6 - *Mexican Business Opportunities*, Chapter 8 - *Argentine Business Opportunities* and Chapter 10 - *Chilean Business Opportunities*.)

In 1998 and 1999, some East Asian economies, including the Republic of Korea, Thailand and Indonesia sought economic recovery by relaxing restrictions on FDI, including increasing openness to cross-border mergers and acquisitions (East Asia Analytical Unit, 1999, 2000a and 2000b). However, many limitations remain on FDI inflows to East Asia. For example, although Thailand liberalised its foreign investment regime to a minor extent, it kept many restrictions on sectors open to minority and majority participation foreign investment, and now is reversing earlier liberalisation (East Asia Analytical Unit, 2000a). Even in the Republic of Korea, which has liberalised significantly its FDI regime since the crisis, several business categories remain restricted to FDI (East Asia Analytical Unit, 1999). Malaysia, China and the Philippines retain significant barriers to FDI including in the financial, infrastructure and mining sectors.

Latin American FDI reforms reinforce the expectation FDI will provide Australian business with more opportunities in Latin America than trade.

Privatisation

In the 1980s and 1990s, Latin America also pioneered wide scale privatisation of state owned industries and infrastructure, which drove large FDI inflows. In contrast, most East Asian economies, except China and Japan, only started privatisation in earnest after the Asian crisis; and the Indonesian and Thai Governments now face political pressure to stall announced programs. Until recent sales of some nationalised banks in Thailand and the Republic of Korea, privatisation has not generated major FDI inflows to East Asia. Slow East Asian progress in this area limits its FDI inflows compared to Latin America.

FOREIGN DEBT AND SOVEREIGN RISK

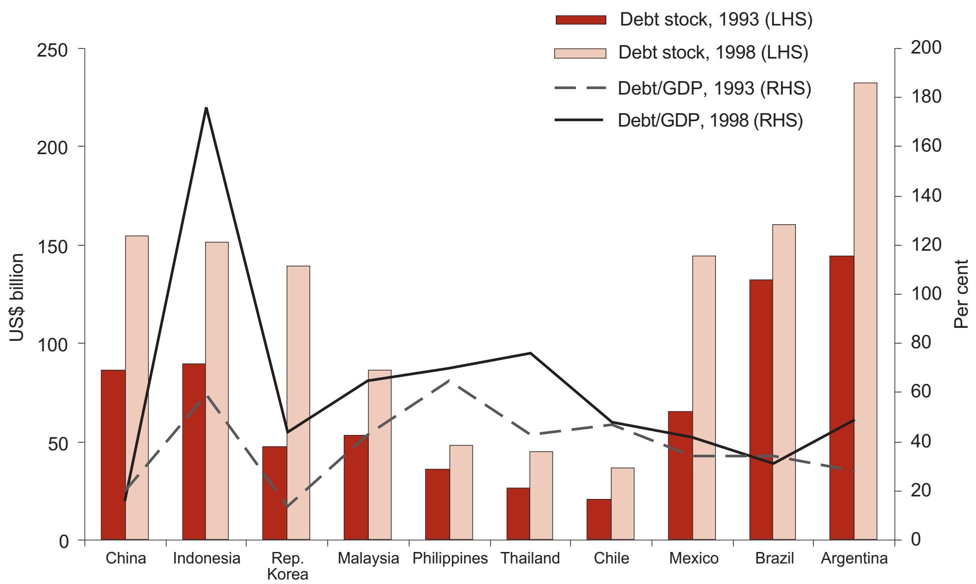
In the 1990s, the four Latin American economies raised external debt levels, including public debt, exposing them to market volatility; East Asian economies generally had low levels of public debt but increasing private external debt. However, since the Asian crisis, East Asian economies' public debt has risen significantly, and now are generally higher than Latin America's as a share of GDP (Figure 2.11).

In countries like Argentina and to a lesser extent Brazil, high public and external debt and past default history is reflected in high sovereign risk spreads (the difference between Latin America government bond rates and US treasury bond rates). These reflect market views of the higher risk of lending to governments in this region.

Figure 2.11

Latin American Foreign Debt Lower Share of GDP

Latin American and East Asian External Debt Stock Values and as a Ratio of GDP, 1993 and 1998, US$ billion and Per cent



Source: World Bank, 2000.

KEY AREAS OF COMPLEMENTARITY AND COMPETITION

The large, reforming and increasingly affluent Latin American markets present opportunities for Australian business. However, Latin America cannot provide the trading opportunities of East Asian markets because of much greater distances and transport costs, and because most major Latin American economies are competitive commodity exporters like Australia, rather than major importers of commodities. Preferences to members of regional groupings also make some Australian products less competitive. However, Australian companies are finding niche markets in Latin America's differentiated manufactures and resource markets, particularly as incomes increase, industrialisation deepens, trade and foreign exchange regimes liberalise and trade expands.

With expertise in many sectors in which Latin America specialises, Australia should have better business opportunities directly investing in Latin America. Australian investments in mining and agribusiness and related goods and services, food processing and a range of service sectors are most prospective. Other significant benefits to Australian companies entering Latin American markets via direct investments include circumventing trade barriers resulting from the preferences members of regional groupings receive, and gaining access through these preferential trade agreements to a range of large markets in the Americas.

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BRAZIL'S ECONOMIC PERFORMANCE AND PROSPECTS

KEY POINTS

- During the 1990s, Brazil undertook far reaching micro and macro-economic reforms which dramatically improved both its economic fundamentals and performance; these now are probably the best they have been for 30 years.
- The 1994 Real Plan successfully controlled Brazil's hyperinflation, repairing fundamental fiscal and financial system dysfunction and hence, sustaining strong growth. In the late 1990s, fiscal discipline increased and the real was floated. Major areas of remaining macro volatility include a large stock of government debt and a high ratio of exports to external debt payments.
- Major micro reforms include tariff and quota reductions, privatisation and market deregulation; however, a heavily regulated formal labour market and a complex taxation system continue to constrain foreign investors. High 'Brazil cost' also hinders exporters.
- Strong foreign direct investment, FDI, inflows and the real's float reduce the danger of external crisis.
- However, potential risks include slowing world growth, fiscal weakness associated with inadequate tax and social security reform, possible reform policy reversal associated with a change of government and a looming energy crisis due to drought.

Brazil is geographically and economically large and diverse. It is the world's fourth largest FDI recipient. Over the last decade, lower trade barriers, deregulated markets, privatisation and improved economic management and performance have stimulated these large inflows.

This chapter briefly surveys the key aspects of Brazil's economic performance and prospects most relevant to foreign investors. First, it outlines 1990s structural reforms and the Real Plan, then growth performance. Next it highlights public finances, the banking sector, the domestic savings deficit and the external sector. Finally, it assesses Brazil's other economic challenges, including alleviating poverty and expanding exports, and examines Brazil's growth prospects. (For details on trade and investment liberalisation and trends, see Chapter 4 - *Brazilian Business Opportunities*.)

BRAZIL'S STRUCTURAL REFORMS

For the five decades before 1990, Brazil pursued import substitution policies, aiming to diversify away from primary industry and build a modern industrial sector. It intensified trade barriers; maintained the exchange rate at an artificially high level; and increased the state's role as producer and regulator. It diversified, but at the cost of recurrent external debt, intermittent balance of payments crises, high inflation and a highly inefficient industrial sector increasingly dependent on imported inputs.

In 1990, Brazil's first directly elected president for over three decades, President Fernando Collor de Melo, began an ambitious economic reform program geared to integrating Brazil into the global economy. This program featured trade liberalisation, privatisation, market deregulation and fiscal reform.

Privatisation

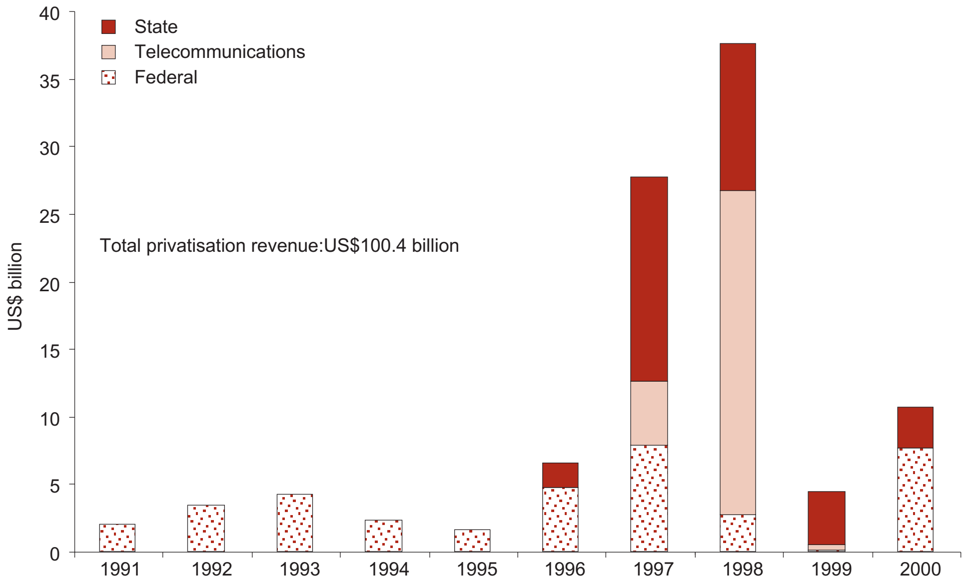
The privatisation process began in 1988, but accelerated substantially from 1990; by the time President Collor was impeached in 1992, most former state owned steel and petrochemical companies were privately owned.[1] After 1992, the Franco Government developed ambitious plans to privatise further sectors, including telecommunications and electricity. This required constitutional amendments, finally passed in 1995, so private investors, both foreign and domestic, could enter these sectors. The telecommunications sector now is entirely privatised and open to competition; electricity privatisation is underway; state banking sector privatisation is well advanced; and in the mining sector, Brazil's main state owned company, Companhia Vale do Rio Dôce, CVRD, the world's largest iron ore producer, was sold in 1997.

[1] In September 1992, after a congressional inquiry, the Chamber of Deputies overwhelmingly voted to impeach President Fernando Collor on corruption charges. Vice President Itamar Franco then became president.

Figure 3.1

Privatisation Peaks in 1997 and 1998

Privatisation Revenue and Debt Transfer Results, US$ billion



Source: National Economic and Social Development Bank, 2001.

Overall, between 1991 and 2000, privatisation yielded revenue and debt transfers totalling US$100.4 billion; activity peaked in 1997 and 1998 (Figure 3.1). While privatisation in ports, highways, insurance and sanitation is ongoing, this process is expected to slow markedly over the next two to three years as most assets are sold.

Market Deregulation

Under President Cardoso (1995-), market deregulation accelerated sharply in many areas. In 1995, the government opened the oil, gas and mining sectors to both domestic and foreign private sector investors. Moreover, legislation accompanying telecommunications and electricity distribution and generation privatisation allowed new companies to enter these markets. For example, during the successful telecommunications deregulation process, considered world best practice, state owned company, Telebras, was split into 12 regional companies; each region and each major sector, such as local, long distance and mobile, has at least two competing service providers.[2] Most infrastructure sectors have special regulatory agencies to ensure markets are competitive and the playing field is level for all investors.

2 Initially, each region and market segment had only one service provider. Competition soon will be allowed in the international phone sector.

Since 1988, spurred by the need to attract foreign capital into privatising industries, the Government has permitted 100 per cent foreign ownership in all sectors, except restricted or strategic sectors, such as the media, air transport, banking and coastal shipping. However, in banking, foreign investment proposals are considered case by case, and foreign banks now wholly own many large privatised banks.

Labour markets still regulated

Despite this deregulation, the government has made little progress in reforming Brazil's rigid labour market regulations. Extensive legal provisions govern working hours, dismissal and redundancy; compliance is costly. However, in the large informal labour market, workers receive little protection and few non-wage benefits. Most small and medium sized Brazilian companies operate in the informal sector, reducing the cost for them of complex labour laws; few of these companies or their workers pay tax. However, foreign investors must operate in the formal sector, where labour laws add 45 to 70 per cent of direct wage costs to the total cost of employing staff (Bahia Guimarães, 2001). In addition, unless employers agree to (expensive) voluntary redundancy packages with unions, they usually face costly litigation when firing staff (da Costa e Silvia, 2001). (See more detailed discussion in Chapter 11 - *Business Environment*.)

REAL PLAN

Despite deepening microeconomic reforms in the early 1990s, before the Cardoso Administration introduced the Real Plan in late 1993, hyperinflation constrained Brazil's macroeconomic performance. Annual inflation peaked at about 2 500 per cent in 1993 (Figure 3.2). However, by July 1994, the Real Plan slashed inflation and nominal interest rates by:

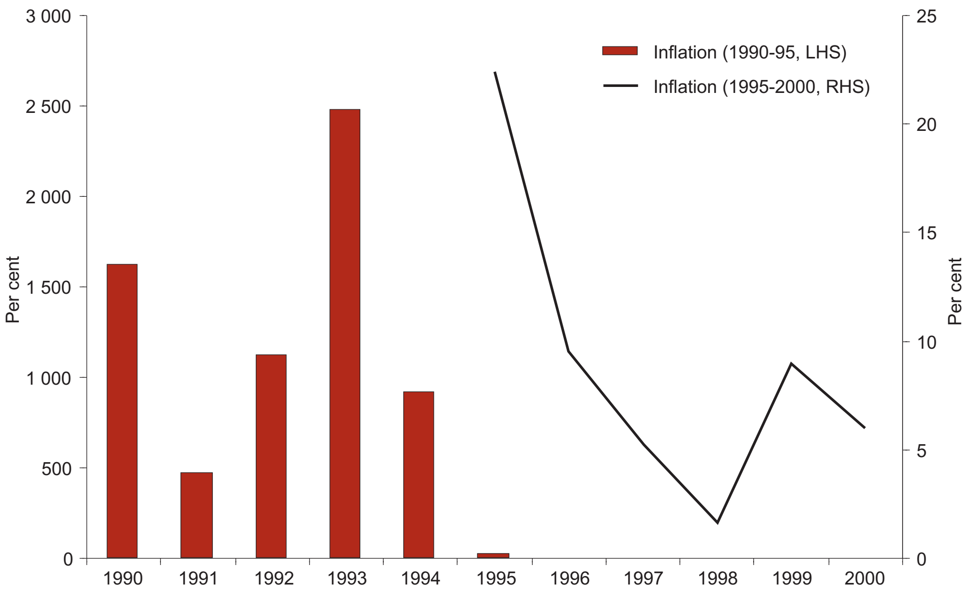
- cutting spending by US$7.5 billion (around 2 per cent of total expenditure) across the board, and increasing tax rates by 5 per cent (boosting revenue by around 7 per cent)
- limiting the Government to financing the fiscal deficit by issuing bonds
- progressively abolishing the wage and price indexation system between mid 1993 and late 1994
- introducing a new currency, the real, pegged initially to the US dollar at a rate of R$1:US$1
- tightening monetary policy, to constrain demand side inflationary pressures and maintain the real's value (Amann and Baer, 2000).

With tight monetary and fiscal policy, the indexation system dismantled and a US dollar linked currency driving down import prices, inflation fell to 22 per cent in 1995 (Figure 3.2). Nominal interest rates dropped in line with this fall.

Figure 3.2

Real Plan Dramatically Reduces Inflation

Annual Inflation 1990-2000, Per cent



Note: Inflation index used is the Consumer Wholesale Prices Index.

Source: Banco Central do Brasil, 2001a.

GROWTH PERFORMANCE OVER THE 1990s

Over the 1990s, Brazil's economic growth was extremely uneven (Figure 3.3). Between 1990 and 1992, with inflation rampant, output contracted or stagnated. Stabilisation efforts failed as they emphasised short term monetary freezes and drastic but unsustainable public spending cuts.[3] Furthermore, Brazil's elaborate system of wage and price indexation remained stubbornly intact.

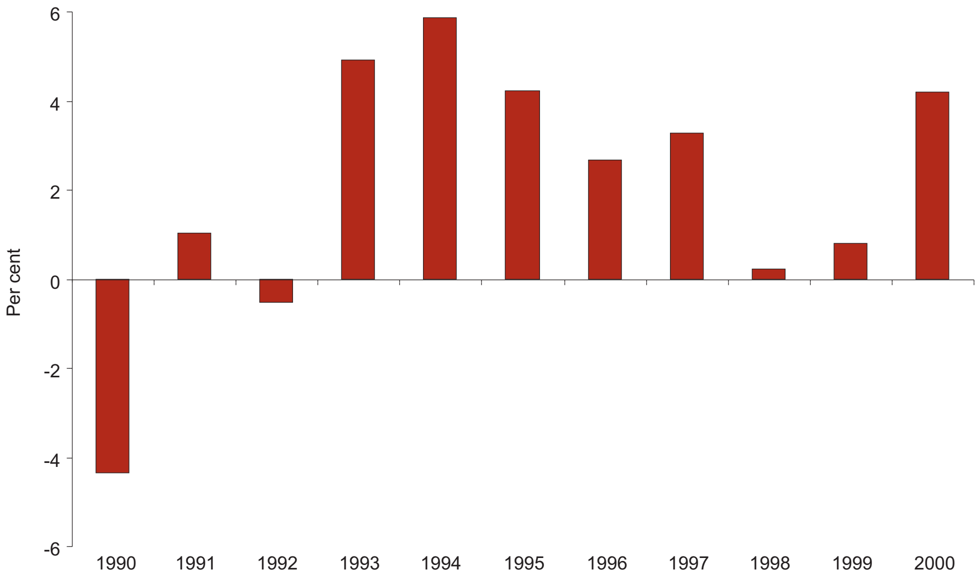
Between 1993 and 1997, dramatically falling inflation increased confidence and stimulated consumption and investment. However, Brazil's economy slowed sharply in 1998 and 1999, as the Asian financial crisis and Russian debt moratorium undermined confidence in emerging markets, and market analysts focussed on the obviously overvalued real. In 1998, the government tried to maintain the real's value and stem capital flight by cutting public spending, and raising interest rates and taxes.

[3] The two main stabilisation plans between 1990 and 1993 were Collor I and Collor II.

Figure 3.3

Brazil Grows Strongly after 1992

Real GDP Growth, 1990-2000, Per cent



Source: Banco Central do Brasil, 2001a; and Fundação Getúlio Vargas, 2000.

In January 1999, economic difficulties and capital outflows escalated when Minas Gerais' Governor froze his state's debt payments to the federal government. After a controlled 8 per cent devaluation of the real failed, the central bank floated the currency; by February 1999, the real had depreciated 70 per cent against the US dollar relative to its 1998 close, and by July 2001, 140 per cent.

Contrary to initial fears, the real's float in January 1999 did not generate strong inflationary pressures. Since mid 1994, the macroeconomy had stabilised and the economy generally was more efficient. In fact, four main factors strengthened growth in 1999 and 2000:

- the real's devaluation increased the competitiveness of export and import competing sectors
- looser monetary policy due to low inflationary pressures helped the overnight interest rate, the Selic, fall steadily from 43 per cent in March 1999 to 15 per cent in January 2001
- consumer and business confidence increased when the Law of Fiscal Responsibility was passed unexpectedly in 2000
- agricultural output surged with good climatic conditions.

PUBLIC FINANCES

Despite reforms after 1994, fiscal pressures continue to constrain Brazil's growth. Major fiscal pressures came from:

- the end of hyperinflation; during hyperinflation, the government contained chronic fiscal deficits by deliberate delays between receiving revenue and spending it
- the 1988 constitution; this decentralised major spending functions to state and municipal governments, who increased unfunded spending, blowing out public debt[4]
- generous pension entitlements to retired civil servants (untaxed pensions of 100 per cent of retirement salary); the new constitution guaranteed these, even though they created enormous liabilities.[5]

Despite these problems, and the rising foreign currency debt due to the real's devaluation in January 1999, fiscal consolidation dramatically reduced the public sector's borrowing requirement and interest payments after 1994 (Inter-American Development Bank, 2001a). In 1999, by tightly controlling expenditure and increasing taxation rates and enforcement, the government ran a primary surplus (before interest payments) of 3.2 per cent of GDP, and again in 2000 of 3.5 per cent of GDP (Figure 3.4).[6]

Fiscal Reforms

In November 1998, with the real under speculative attack and rising sovereign risk spreads sharply increasing interest payments on government debt, the government adopted an IMF-approved program of rapid fiscal reform. This program included crucial reforms to financial relationships between federal and sub-national governments, and social security.

Fiscal Responsibility Law

The Fiscal Responsibility Law, approved in April 2000, limits the federal government's obligation to transfer resources to state and municipal governments; prevents the federal government from taking on new debts accumulated by these governments; and stringently limits payroll costs at all levels of government.[7] Complementary legislation, approved in October 2000, established criminal penalties for breaching this law; required public officials and politicians at all levels of government to comply with agreed public debt accumulation targets; and mandated governments could initiate new expenditure programs only when public revenues existed to cover their costs.

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4 State government bail outs were necessary because, as part of the devolution process, 26 states issued bonds, which state development banks had to take on as 'assets'. When the states realised in the early 1990s that they could not honour these bonds, the federal government had to assume the debts.

5 By 2001, transfers to retired public servants were about 10 per cent of total federal and state government spending and about 2.1 per cent of GDP (International Monetary Fund, 2001c).

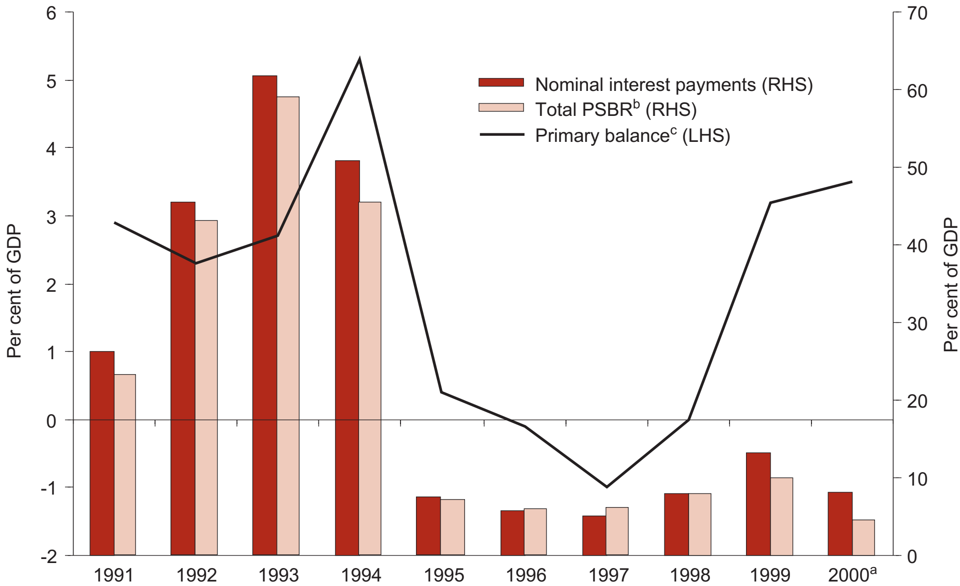
6 These outcomes exceeded IMF targets. Major tax increases included raising tax on financial transactions from 0.3 to 0.38 per cent, and the labour charge from 2 to 3 per cent. However, better tax implementation also raised revenue.

7 Salaries are limited to 50 per cent of federal government revenue and 60 per cent of state and municipal government revenue.

Figure 3.4

Responsible Fiscal Policy Helps Growth

Primary Budget Deficit, Public Sector Borrowing and Public Interest Payments, 1991-2000, Per cent of GDP



Note: a denotes 12 months to November.

b PSBR stands for public sector borrowing requirement and represents the borrowing requirement of all levels of government and public sector entities.

c Primary fiscal balance is the government's budget situation before interest payments; a negative number represents a deficit.

Source: Inter-American Development Bank, 2001b.

Social Security Reform

The key social security issue is the public pension system's weak contributor base relative to existing and expected future claims. Legislation approved in November 1998 imposed a minimum retirement age of 65 for public sector workers, directly linked contributions to benefit entitlements and tackled fraud. These rules should improve the flow of social security contributions while restricting the scope of social security spending. Follow-up legislation approved in November 1999 extended the concept of linking contributions to benefits to the private sector social security system.[8]

Implications and Future Imperatives

Fiscal reform efforts should help sustain primary account surpluses. The Government increased the primary surplus target for 2002 from 2.7 per cent to 3 per cent of GDP, and has maintained this target for 2003 and 2004 (International Monetary Fund, 2001a). Nonetheless, the fiscal reform process is

8 This system provides benefits for unemployed private sector workers and retirees; contributions come from a payroll levy; its scale varies with income.

incomplete; Brazil still has a large stock of public sector debt, an inefficient tax system and a costly social security system. High subsidies to the inefficient sugar industry in north eastern states also drain the budget (Saraiva et al, 2001).

Public debt stock

The 2000 net public sector debt of R$563 billion (49.5 per cent of GDP) dates back to the oil shocks of the 1970s and 1980s, and to debts acquired in the early 1990s when the federal government bailed out the states. This debt makes Brazil vulnerable to interest rate and exchange rate fluctuations, as around 20 per cent of public sector debt is US dollar denominated. Debt servicing costs are very high and rose significantly during the Brazilian crisis in 1998-99. While the share of federal debt linked to the overnight interest rate fell over the last two years as confidence increased, domestic and foreign bond holders still attach high sovereign risk to Brazilian debt, due to its debt default history. Increasing spreads of Brazilian government debt over US treasury bonds blew out public sector debt from 35 per cent of GDP in 1997 to 49 per cent in 1999. Brazil also suffered a recent loss of domestic and international investor confidence, and rising spreads, due to the crisis in Argentina.

Furthermore, in 2001, 36 per cent of bank lending was expected to be to the public sector, so public debt financing still crowds out bank lending to the private sector. Furthermore, banks prefer to hold high yield, lower risk public debt than lend to corporates and small and medium sized enterprises.[9]

Taxation

By developing country standards, Brazil's ratio of federal and state tax revenue to GDP is relatively high at 30.9 per cent in 2001 (International Monetary Fund, 2001b). However, the tax base is narrow, with Brazil's improving fiscal balance since late 1998 largely due to temporary levies, such as the financial transactions tax. These inefficient levies will expire in the next few years (Inter-American Development Bank, 2001a).

The Government proposes to unify indirect tax rates across products and provinces to increase significantly the indirect tax system's efficiency, reduce fiscally damaging tax competition between states and reduce the size of the informal sector. However, for the Government to achieve this objective, Congress must amend the constitution; at present this is not likely. The Government also seeks to simplify the corporate tax system to boost corporate tax registration and reduce compliance costs.

Social security

Despite reforms, Brazil's pension system drains public finances, with a total deficit equal to 4.6 per cent of GDP in 1999. In particular, public sector social security reform is a priority. Despite contributing only 11 per cent to Brazil's retiree pool, the public sector accounts for nearly 80 per cent of the total social security deficit (Inter-American Development Bank, 2001a).[10]

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9 Amendmens to the weak bankruptcy law have been before Congress for 8 years, exacerbating this situation, by making banks reluctant to lend to small and medium enterprises. (See Chapter 11 - *Business Environment*.)

10 The main problems remain excessively high public sector pension benefits compared to contributions; tax free pensions; and fierce congressional opposition to reform. In the long term, ongoing efforts to convert many public sector bodies into agencies which hire new civil servants under more flexible private sector labour and pension regimes may reduce the problem.

THE BANKING SECTOR

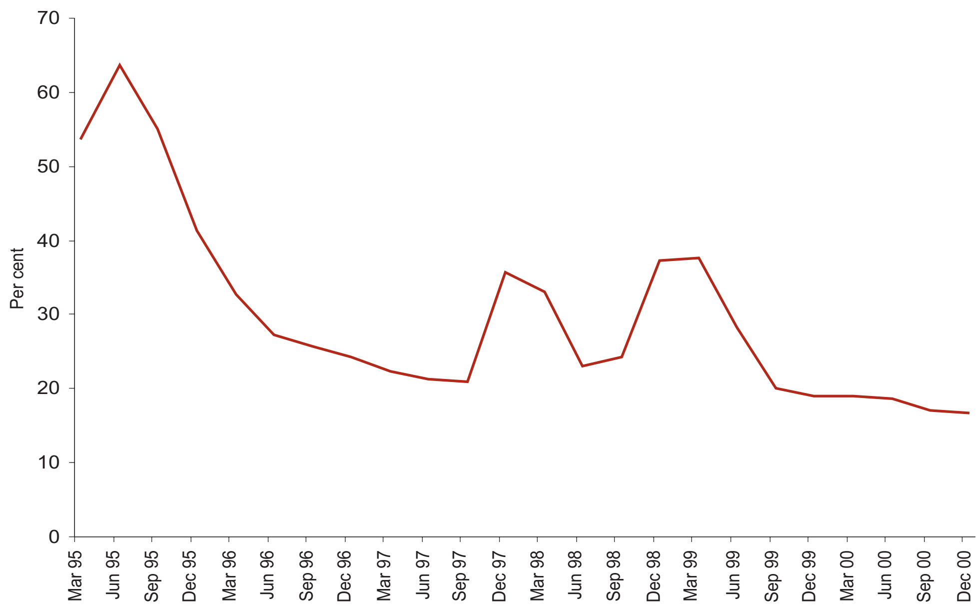
The end of high inflation in 1994 shocked the Brazilian banking sector; it made huge profits from hyperinflation. Concurrently, the sector faced foreign competition, privatisation and regulatory strengthening. Banking sector privatisation began in 1995 and largely involved selling state government financial institutions.[11] FDI was permitted, case by case. (See Chapter 4 - *Brazilian Business Opportunities*.) For example, in November 2000, Brazil's largest state bank, the São Paulo based BANESPA, was auctioned to Banco Santander Central Hispano of Spain for R$7.05 billion (US$3.5 billion).

Overall, the banking system is strongly provisioned, with capital adequacy requirements well above those mandated by the Brazilian central bank and the Basle Accord, and is strongly hedged for exchange rate risk. Consequently, the banking sector did not contribute to Brazil's 1999 crisis, nor was it very adversely affected by it. However, high interest rates, wide spreads between deposit and lending rates, and weak lending growth all constrain the banking sector's contribution to economic activity.

Figure 3.5

Interest Rates Remain High

Money Market Interest Rates, 1995-2000



Note: Money market rates are the rates at which banks lend to each other.

Source: International Monetary Fund, 2001b.

[11] To March 2001, financial privatisations raised US$5.98 billion in privatisation revenue (National Economic and Social Development Bank, 2001).

Interest Rates and Interest Spreads

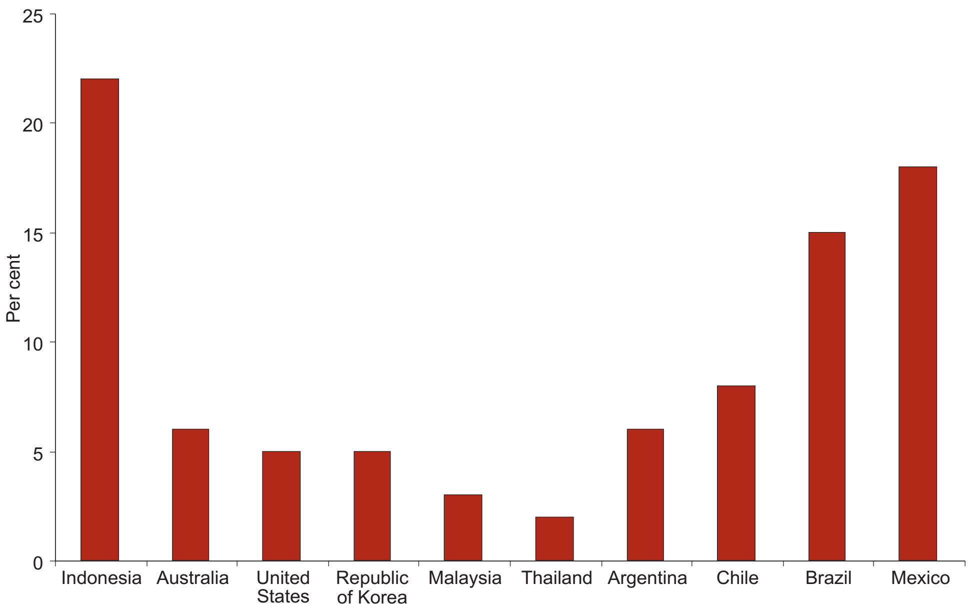
Nominal interest rates fell dramatically after the Real Plan was introduced, although they rose again in late 1997 and late 1998, reflecting central bank efforts to defend the currency (Figure 3.5). However, compared to industrialised and East Asian economies, Brazil's interest rates remain high (Figure 3.6). Typical lending rates are increased further by high margins and risk premiums for private sector lending. Average lending rates for small and medium enterprises were 85 per cent in December 1998, falling to 62 per cent in December 1999 and 51 per cent in January 2001 (Inter-American Development Bank, 2001b).

The interest rate fall since December 1999 is partly due to a 10 percentage point fall in the difference between banks' lending rates and their cost of funds between December 1999 and January 2001. The Brazilian central bank enabled this fall by cutting deposit reserve requirements in 1999 and 2000, and strengthening competition and disclosure requirements. However, further reductions cannot occur until creditors' rights are increased and Brazil's rather weak credit culture is strengthened. For eight years, Congress has had before it a bankruptcy law that attempts to do this.[12]

Figure 3.6

Brazil's Interest Rates High Compared to East Asia

Money Market Interest Rates, February 2001, Period average



Note: Money market rates are the rates at which banks lend to each other.
Data for Malaysia are for January 2001.

Source: International Monetary Fund, 2001b.

[12] Currently debtors can sue for bankruptcy, receive an automatic, two year stay of execution on debts at highly concessional interest rates, then have the bankruptcy order dissolved if they pay the debts back after two years (Bunce, 2001).

Lending Growth

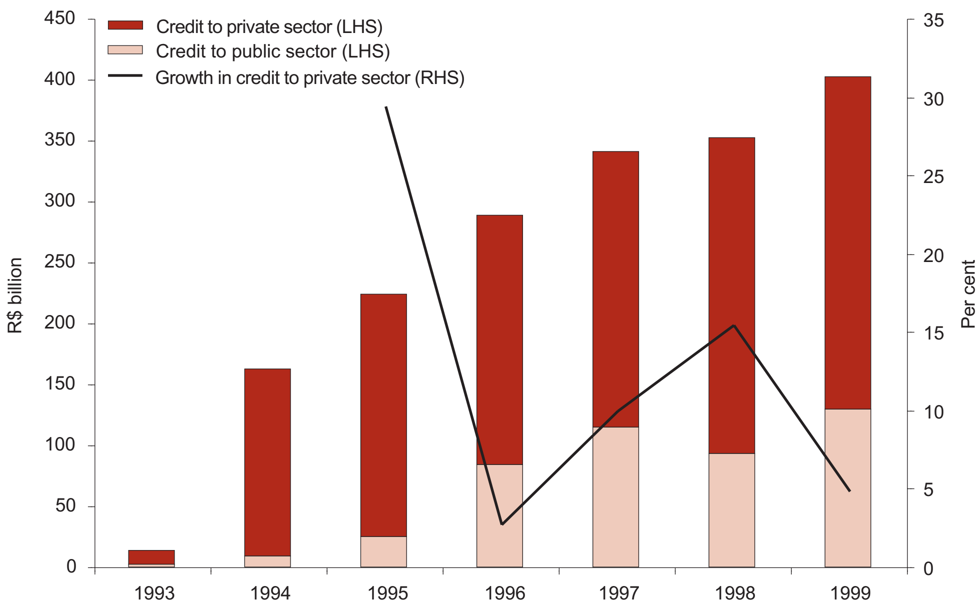
Despite generally falling interest rates, private sector lending growth has slowed steadily since the mid 1990s, as the public sector call on funds has increased and the recession reduced demand (Figure 3.7). However, in contrast to Argentina and Mexico, private sector credit still is growing. At the sectoral level, the picture is uneven. Between June 2000 and January 2001, credit for buying cars, supplied mainly by manufacturers, grew by over 100 per cent, and credit for buying other consumer durables grew by over 50 per cent, both from low bases. However, mortgages and working capital for small and medium businesses virtually do not exist, in large part because these borrowers are deemed a poor credit risk (Bunce, 2001).

For most businesses, tight credit and high interest rates make retained earnings the principal source of finance, with late payment used as a partial substitute for working capital. (See Chapter 11 - *Regional Business Environment*.) However, some small and medium businesses in selected sectors can access subsidised credit lines from the government owned Brazilian Economic and Social Development Bank, BNDES.[13]

Figure 3.7

Lending Growth Slows

Financial System Loans, 1993-2000, End of Period Balances, R$ billion



Source: Banco Central do Brasil, 2001a.

[13] A levy on all payrolls funds these loans.

Monetary Policy Reforms

The Government's counter inflationary strategy involves the central bank using formal inflation targetting, a method Chile pioneered. During the target's first year of operation, 1999, authorities set a consumer price inflation target of 8 per cent, with a plus or minus 2 per cent margin for error. They reduced the target to 6 per cent in 2000, and to 4 per cent in 2001 (International Monetary Fund, 2001d). Before 2001, authorities experienced little difficulty in meeting these targets, but in 2001, they probably will not meet their target, mainly due to imported inflation as a result of the real's depreciation.

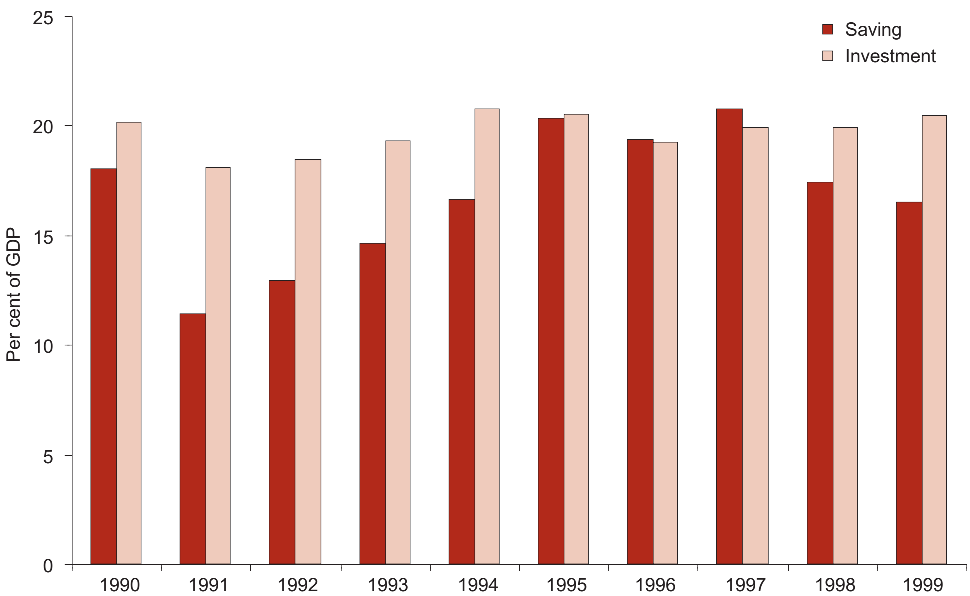
SAVINGS AND INVESTMENT

Like many Latin American economies, Brazil has low household and public savings, and a substantial savings gap, with investment generally exceeding saving levels (Figure 3.8). Thus, Brazil depends on foreign investors and creditors to meet domestic capital requirements. The most important steps to raise savings rates include ending public sector deficits, introducing a fully funded public sector pension scheme, and building deeper, more liquid capital markets based on a stronger credit culture.[14]

Figure 3.8

Domestic Financing Gap Remains

Saving and Investment, 1990-99, Per cent of GDP



Source: Banco Central do Brasil, 2001a.

[14] The Government is attempting to strengthen corporate governance standards by, inter alia, establishing a new bourse with higher standards for firms.

EXTERNAL SECTOR

Historically, the external sector contributed significantly to the Brazilian economy's vulnerability, with periodic balance of payments crises during the import substitution period. Trade and foreign exchange regime reforms in the 1990s increased resilience to external shocks, with Brazil avoiding major crises from the 1994-95 Mexican peso crisis, the 1997 Asian financial crisis and the 1999 Russian crisis. A major boost to Brazil sustaining its external position is growing FDI. However, growing external debt remains a concern.

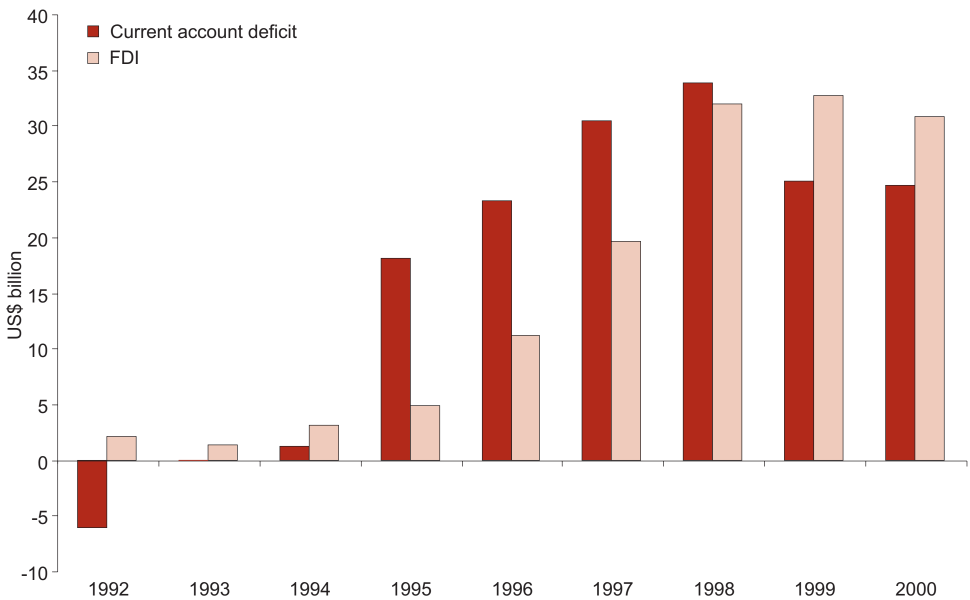
Growing FDI Reduces External Vulnerability

FDI inflows increased dramatically from US$3.5 billion in 1995 to US$30.5 billion in 2000 (International Monetary Fund, 2001b). In 1999 and 2000, these inflows more than fully financed the current account deficit (Figure 3.9). Strong FDI flows also bolstered international confidence in the economy and reduced vulnerability to declining portfolio and banking inflows which plagued many emerging markets, particularly in Asia. In 2000, even with net outflows of other investments, largely bank lending, of US$7.9 billion and portfolio inflows of only US$6.9 billion, net capital inflows were still US$29.6 billion, due to FDI inflows (Figure 3.10).

Figure 3.9

FDI Finances Current Account Deficit since 1999

Current Account Deficit and FDI, 1992-2000, US$ billion



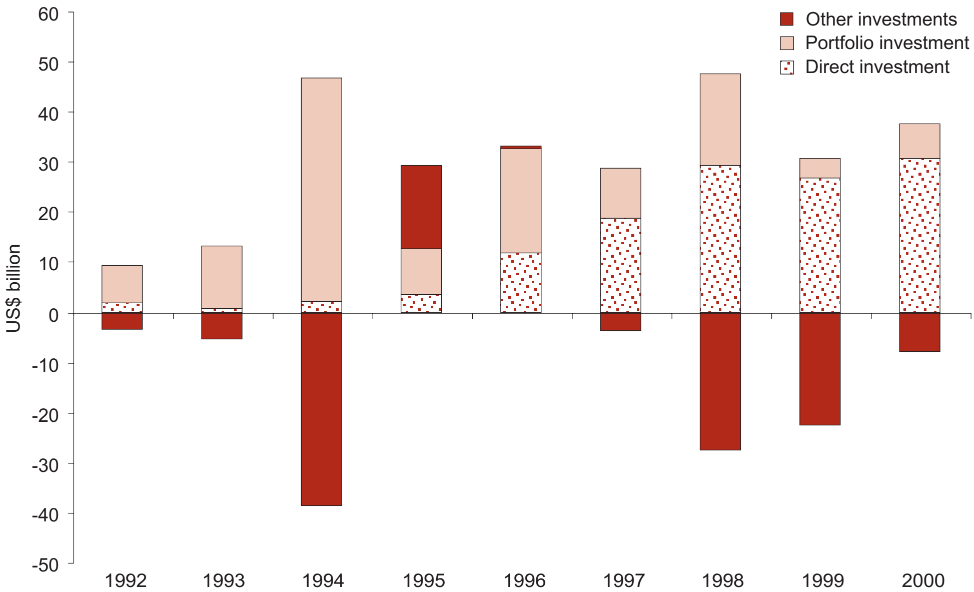
Note: A negative current account deficit figure indicates a surplus.

Source: International Monetary Fund, 2001b; and Inter-American Development Bank, 2001a.

Figure 3.10

FDI Dominates Foreign Capital Inflows in late 1990s

Net Financial Flows, 1992-99, US$ billion



Note: This chart excludes derivatives, which only have been reported since 1999.

Source: International Monetary Fund, 2001b.

Between 1996 and 1999, privatisation receipts accounted for 20 to 30 per cent of FDI inflows (Banco Central do Brasil, 2001c). Hence to 2006, as the privatisation program winds down, FDI inflows could fall. However, Brazil's openness to FDI, large potential domestic market, depreciated currency and ongoing market deregulation are likely to sustain FDI at levels that substantially reduce reliance on portfolio and other capital flows. Also, the flexible exchange rate and ongoing fiscal reforms eventually should reduce the current account deficit.

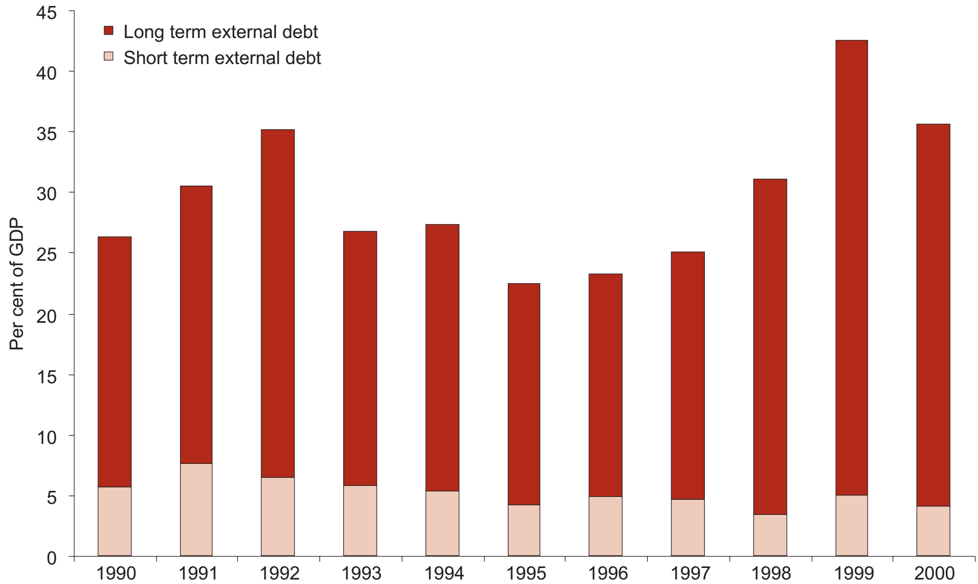
External Debt

Despite strong FDI, from 1995 to 1999, foreign borrowing to finance persistent current account deficits and private sector credit needs almost doubled Brazil's long term external debt as a share of GDP, although this dropped back somewhat in 2000. Short term debt remained low and stable, offering debt servicing a degree of certainty (Figure 3.11).

Figure 3.11

Long Term Debt Growing

Evolution of Brazilian External Debt by Maturity as a Ratio of GDP, End of Year



Source: Banco Central do Brasil, 2001a.

Nevertheless, by the late 1990s, the growing stock of external debt and rising interest payments were draining the economy. In 1999, Brazil's external debt servicing commitments exceeded export revenues by 40 per cent (Figure 3.12). In 2000, Brazil repaid most of the IMF's 1998 US$41.5 billion emergency financing package, so external debt fell considerably, reducing the ratio of external debt repayments to exports (Figure 3.12).

OTHER KEY IMPACTS ON FUTURE ECONOMIC PERFORMANCE

Other major long term issues critical to Brazil's future economic performance include reducing poverty, reforming the constitution, reducing the size of informal labour markets and boosting export revenues. A growing short term problem is the looming energy crisis.

Poverty

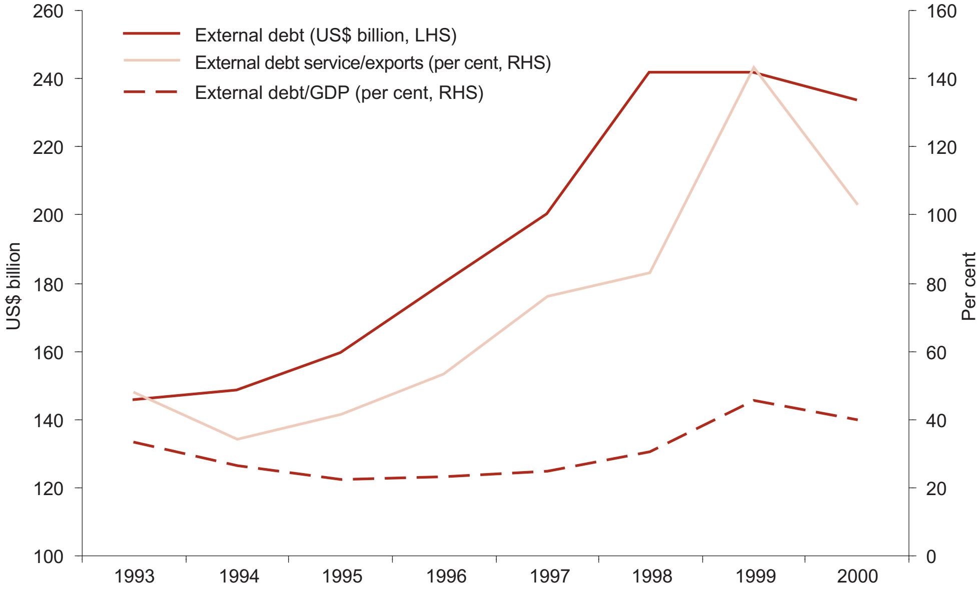
Brazil has major poverty and inequality problems. As inflation fell and growth improved, the percentage of the population below the official poverty line fell from 44 per cent (63 million people) in 1990 to 34 per cent (53 million people) in 1999.[15] However, the problem remains significant (Paes de Barros et al, 2000). Income distribution is highly unequal, with the top 10 per cent of the population receiving 48 per cent of income (World Bank, 2000).

15 The national statistical agency, IBGE, determines the official poverty line.

Figure 3.12

Growth of External Debt Turns Negative after Strong Surge

External Debt, US$ billion and Per cent of GDP, and Debt Service Ratio



Source: International Monetary Fund, 2001b; and Banco Central do Brasil, 2001a.

The scale and persistence of poverty are major economic problems. Around 25 per cent of the population (42 million people) are outside the formal sector and live in acute poverty. This causes widespread social suffering, wastes substantial human resources and reduces market opportunities (Paes de Barros et al, 2000). If large numbers of poor people do not continue to receive the benefit of recent growth, support for economic reform could dwindle.

The Need for Constitutional Reform

The Government recognises Brazil's constitution needs further reform. While the federal Government has tightened funding flows to the states, state and municipal spending and taxation powers remain poorly defined and inefficient. In addition, the constitution is in places excessively detailed, for example, specifying many elements of macroeconomic and pension policy, and requiring multiple votes to approve new laws.

The Size of the Informal Sector

Brazil's large informal labour market, the product of high taxes and rigid labour laws, deprives the Government of significant revenue. Furthermore, compared to formal sector workers who receive extensive benefits and protection, informal sector workers receive hardly any. Only 16 million of Brazil's 166 million people pay personal income tax, and many small and medium businesses in the informal sector do not pay company income or other taxes (Conolly, 2001).

Openness and External Risks

To achieve high growth rates and finance foreign debt payments, the Government recognises it needs to increase its share of exports to GDP. In 2000, Brazil's export share of GDP was around 9 per cent. This is low compared to 29 per cent for Mexico, 26 per cent for Chile, 39 per cent for the Republic of Korea, 23 per cent for China and 20 per cent for Australia.

Several short term risks threaten exports. A slowdown in the United States over 2001 will limit Brazil's growth, as the United States takes around 23 per cent of Brazil's exports and, between 1996 and 1999, provided almost 22 per cent of Brazil's FDI inflows. As primary commodities, principally coffee and sugar, comprise 41 per cent of Brazil's exports, trends in commodity prices, which could turn down with slower world growth, also will affect Brazil's external situation.

The competitiveness of the real, which depreciated by around 25 per cent between January and July 2001, is a key element in raising exports' share of GDP and in maintaining competitive prices for privatised assets. After the real's depreciation in early 1999, exports initially did not respond to depreciation, but now are growing strongly, rising 14.7 per cent in 2000 (in US dollar terms). This trend should continue, given the real's more competitive level.

Brazil could be affected by the current crisis in Argentina. Argentina is Brazil's second largest export market and Brazil's large external financing requirement makes it vulnerable to the economic crisis in Argentina. Already foreign creditor concerns have led to an increase in Brazil's risk premium through contagion, exerting pressure on Brazilian financial markets. Moreover, given Brazil's significant external debt servicing burden, the rising sovereign risk premium will put further pressure on Brazil's fiscal situation.

Energy Shortage

In 2001, a long drought reduced the level of lakes by 30 per cent, reducing Brazil's capacity to generate hydro electricity, which provides the great bulk of Brazil's power. Since 1 June 2001, firms and households have been forced to cut back their electricity consumption by 15 to 25 per cent.[16] Analysts expect these cuts will reduce growth by 0.5 to 2 percentage points and also will raise inflation, reduce export growth and erode tax collections (Economist Intelligence Unit, 2001). A new transmission line from southern to northern Brazil will not be in place quickly enough to carry power from surplus to deficit areas. The gas pipeline from Bolvia and associated thermal power plants are still under construction and also will assist only in the long term (Flôres, 2001).

[16] Under these measures, users must reduce consumption or face significantly higher tariffs, and industry cannot expand capacity if it requires new electricity connections.

ACHIEVEMENTS AND PROSPECTS

Brazil's economic policy makers achieved much in the 1990s, beating inflation and achieving average annual growth of 3 per cent. They significantly liberalised trade, and privatised and deregulated important sectors of the economy. In addition, FDI surged, helping make Brazil less vulnerable to volatile capital flows and increasing efficiency in recipient sectors. Nonetheless, both fiscal and external debt remain high and a potential source of vulnerability.

Over the next three years, analysts expect respectable although, given Brazil's relatively low GDP per capita, not spectacular GDP growth. Higher growth levels, like East Asia's before the crisis, are unlikely. Continuing rigidities in the labour market and relatively low public sector efficiency in taxation, income redistribution and public goods and services delivery, including in mass education and law and order, constrain growth. Brazil's relatively weak credit culture, largely due to the serious bias of its insolvency regime against creditors, and public secor 'crowding out', also constrain faster growth, as private sector lending growth is slow.

Risks

The main risks to projected growth levels are weaker world growth; problems funding external debt, potentially associated with a crisis in Argentina; backtracking on fiscal consolidation; and the energy crisis.

In the short term, slower world growth, Argentina's continuing difficulties, Brazil's high debt levels and the energy crisis will constrain growth. The central bank reduced its 2001 growth forecast from 4.5 per cent to 2.8 per cent due to the impacts of energy rationing and rising interest rates. The weak real also led the central bank to revise its inflation forecast from 3.9 to 5.8 per cent but has kept its targets of 3.5 per cent for 2002 and 3.25 per cent for 2003. In June 2001, the central bank also hiked interest rates by 1.5 percentage points to counter the falling real and increasing inflation.

A final, critical influence on Brazil's prospects will be the policies the new government, due to be elected in 2002, adopts. The election result will be crucial to determining ongoing commitment to fiscal consolidation and trade and other microeconomic reforms. Some elements in the Workers' Party, the government party's main contender at the forthcoming elections, are calling for a default on foreign debt repayments, although other factions within this party are more pro-business. Obviously any default on foreign debt would have a very serious adverse long term effect on Brazil's growth prospects. Putting aside this risk, Brazil's growth prospects look the best they have for three decades.

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TRADE AND INVESTMENT OPPORTUNITIES IN BRAZIL

KEY POINTS

- Brazil significantly liberalised trade in the early 1990s and foreign direct investment, FDI, in the second half of the 1990s. The Government reduced tariff and non-tariff barriers and opened petroleum, communications, mining, power generation and internal transport sectors to foreign investment, and accorded foreign companies national treatment.
- Australia has a relatively low level of trade engagement with Brazil and Brazil's resource abundance and distance is likely to prevent a major bilateral resource trade developing.
- Car exports underpin elaborately transformed manufactures, ETM, exports from Australia, although exports are diversifying steadily. Major areas of export opportunity include telecommunications equipment; agricultural and mining equipment, supplies and services; car parts; information technology services and pharmaceuticals.
- Australia's strong expertise in mining, agribusiness and related sectors, and service sector opportunities are generating significant direct investment opportunities.
- Rapidly deepening regional integration via free trade agreements and Brazil's dominant economic position in South America make Brazil an attractive location for investment to supply the South American market.

In the 1990s, the Brazilian economy underwent unprecedented change; the Government lowered high trade barriers, deregulated markets, privatised large state enterprises and utilities, and eliminated hyperinflation. The Brazilian market of 166 million people now offers major opportunities for foreign investors and exporters. Multinational corporations rapidly increased FDI in Brazil making it the largest emerging market FDI recipient after China. At the same time, trade liberalisation and growing consumer incomes create diverse and expanding export opportunities.

This chapter focuses on trade and investment opportunities for Australia. It analyses import and export growth patterns and import growth drivers, highlighting major merchandise and service imports, and Australian export trends. It analyses Australia's investment presence in the context of Brazil's wide ranging FDI liberalisation and massive FDI inflows. Finally, it identifies major Australian trade and investment opportunities in mining, agribusiness, processed food, elaborately transformed manufactures, ETMs, infrastructure and services, and anticipates future Brazilian market trends.

EXPORT AND IMPORT GROWTH PATTERNS

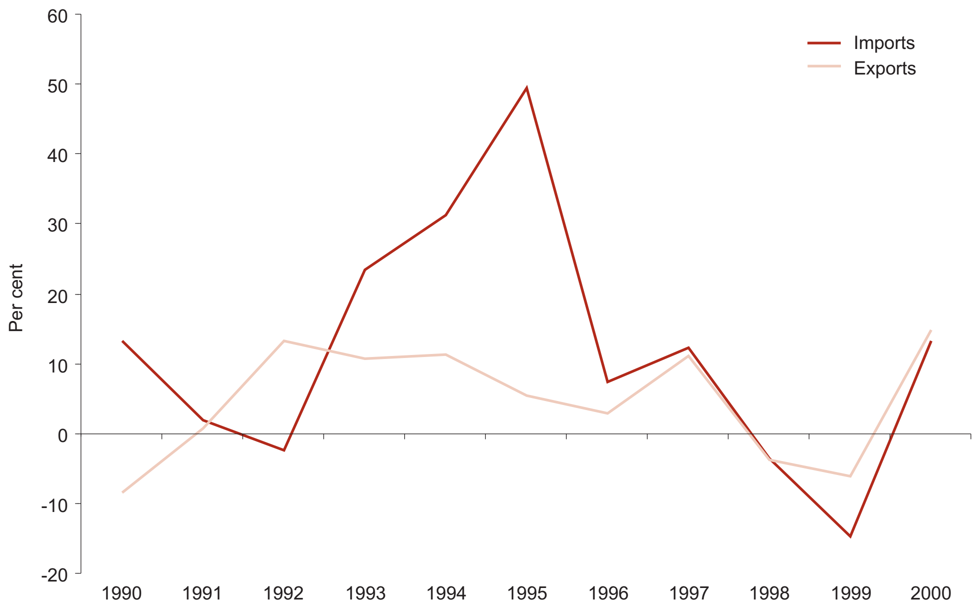
While Brazilian trade now is growing rapidly, its ratio of trade to GDP is still a relatively low 23 per cent, compared for example, to 40 per cent in China and 78 per cent in the Republic of Korea. Between 1990 and 2000, due to an uncompetitive pegged exchange rate prior to 1999, Brazilian imports grew at an average annual rate of 13 per cent, while exports grew an average annual rate of only 6 per cent. Imports grew rapidly in the mid 1990s, but with weakening growth in 1998 and 1999, almost all import categories except ETMs fell. A high exchange rate, scarce export credit and weak demand in key Latin American markets saw exports contract in 1998.[1] They contracted further in 1999, despite the real's 40 per cent depreciation in January 1999 (US Department of State, 2000a). However, exports and imports recovered strongly in 2000 (Figure 4.1).

[1] In 1999, Latin American markets took 21 per cent of Brazil's exports, with Argentina alone taking 11 per cent; this compares to the United States taking 23 per cent of exports.

Figure 4.1

Import Growth Exceeds Export Growth

Growth Trends in Brazil's Exports and Imports, 1990-2000, Per cent



Note: Original series expressed in US dollars.

Source: International Monetary Fund, 2001a.

KEY DRIVERS OF IMPORT TRENDS

Trade policy changes, macroeconomic developments, particularly exchange rate movements, and privatisation related investment drive Brazilian import trends.

Trade Policy Reform

Between 1992 and 1996, the government slashed average tariffs from 32 per cent to 14 per cent (Kume, 1996). However, in the second half of the decade, in response to surging imports resulting from the real's pegged exchange rate, the Government raised tariffs again on consumer goods but exempted most capital goods. Then in 1997, it temporarily raised all tariffs, including the common external tariff.[2] This temporary increase was planned for removal at the end of 2000; however, Brazil requested that it be reduced slowly (US State Department, 2000b; and World Trade Organization, 2000).

[2] The Government increased the common external tariff ceiling, the tariff on goods entering Mercosur from non-Mercosur countries, from 20 per cent to 23 per cent. Generally, each country sets the same common external tariff rate on specific goods entering the free trade area.

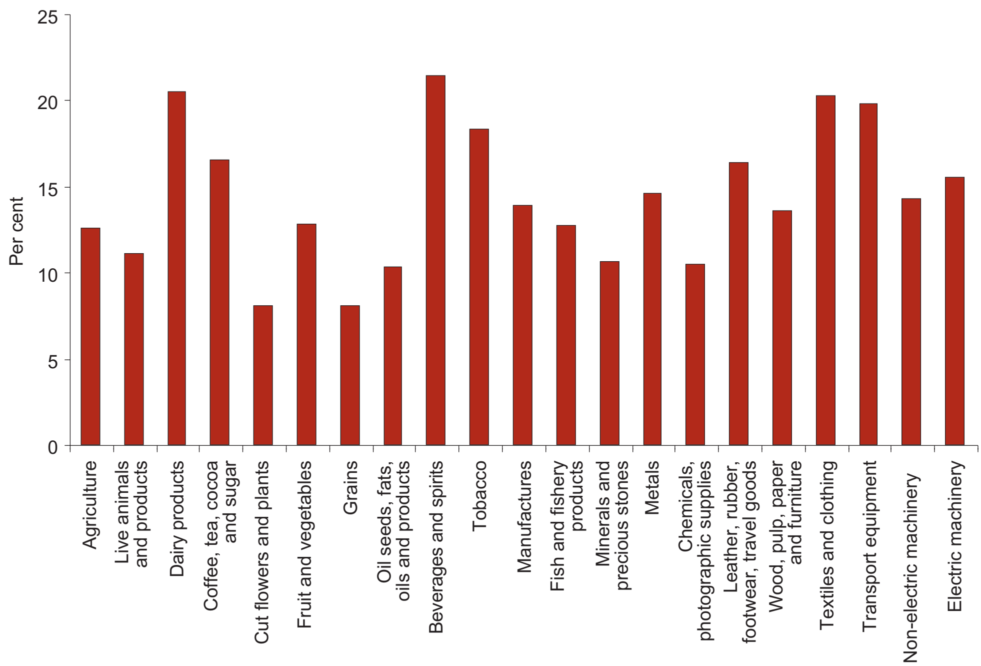
Brazil's average most favoured nation tariff rose 1.2 per cent to 13.7 per cent in 1996, largely due to these temporary increases and an increase from 0 per cent to 5 per cent for those capital goods not produced domestically (World Trade Organization, 2000). In 2000, average tariffs were highest on beverages and spirits, dairy products, and textiles and clothing; these rates exceeded 20 per cent (Figure 4.2).

In addition to tariff reform, the Government removed key non-tariff barriers in the 1990s.[3] In 1990, when it abolished the Law of Similars, which effectively prohibited imports of consumer durable and capital goods produced in Brazil, the Government enormously increased competitive pressure on Brazilian businesses. In 1997, after the Government introduced SISCOMEX, a computerised system for customs clearance and import licensing, import growth peaked because automatic licensing made identifying and processing imports easier.

Figure 4.2

Tariffs Highest on Alcohol, Dairy and Textiles

Brazilian Average Most Favoured Nation Tariffs, by Commodity, 2000



Source: World Trade Organization, 2000.

3 After 1990, the only major non-tariff barrier remaining was local content rules for government procurement.

However, responding to the flood of imports from these reforms, customs now makes limited use of this process, delaying import clearances effectively as a form of non-tariff barrier, even for automatically licensed products.[4] In 1997, other government measures to limit imports included restricting import finance and consumer credit. Brazil sets several other charges on imports, such as the airport warehouse tariff surcharge, which represent de facto non-tariff barriers.

Macroeconomic Trends

Greater trade credit availability, higher real incomes due to price stabilisation, a strong currency, falling trade barriers and a jump in the minimum wage freed pent-up consumer demand, driving an import boom in 1994 and 1995. In contrast, the 3 percentage point tariff increase in 1997, weak economic growth in 1998 and 1999, and the real's 48 per cent depreciation against the US dollar in 1999 saw imports contract 3.5 per cent in 1998, and 14.7 per cent in 1999. However, by 2000, economic growth and imports were recovering strongly.

Privatisation

Since 1995, infrastructure privatisation has stimulated import demand for infrastructure-related intermediate goods.[5] For example, between 1995 and 1999, imports of electric power machinery grew by 80 per cent to US$478 million, and imports of crude and refined petroleum grew after up and downstream petroleum industries were deregulated in 1997. Telecommunications privatisation and deregulation now is driving massive investment in telecommunications network expansion and related goods and services.

MAJOR MERCHANDISE IMPORT TRENDS

In 2000, Brazil's imports rebounded 13 per cent to US$55.8 billion, recovering most of the ground lost in their 15 per cent fall in 1999, caused by the Brazilian crisis induced slowdown (Table 4.1). In the first four months of 2001, imports were 19 per cent higher than for the same period a year earlier.

ETM Imports

Using Australian trade classifications, elaborately transformed manufactures, ETMs, dominate Brazil's imports, accounting for 62 per cent of total imports in 1999. ETMs also are the fastest growing import class, averaging annual growth of 27 per cent between 1990 and 1997, and 10 per cent between 1997 and 1999. Simply transformed manufactures, STM, imports held their import share in the 1990s, while primary product imports fell in relative terms.

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[4] Customs clears imports subject to non-automatic licensing, such as products subject to tariff quotas or zero tariffs, only after examining import declarations, physically verifying imports and analysing customs values. Also importers must complete perfectly extensive forms or risk customs rejecting their documentation.

[5] The industry privatisation program started in 1988; the Government privatised the steel and petrochemical industries by 1992 and the main state owned mining company in 1997. (See Chapter 3 - *Brazil's Economy*.)

Table 4.1

Intermediate Products the Major Share of Imports

Brazilian Merchandise Imports by Broad Category, US$ million and Percentage share

Import category	1996	1997	1998	1999	2000	Growth, 1999-2000 per cent
Total	**53 346**	**59 744**	**57 744**	**49 276**	**55 801**	**13**
Capital goods	**12 918**	**16 107**	**16 102**	**13 570**	**13 593**	**0**
(percentage share)	**(24)**	**(27)**	**(28)**	**(28)**	**(24)**	
Industrial machinery	4 871	6 042	5 585	4 825	3 923	-19
Other fixed equipment	1 845	2 621	2 657	2 506	2 870	14
Office and scientific machines and apparatus	2 637	2 745	2 697	2 207	2 547	15
Parts for industrial capital goods	1 169	1 443	1 617	1 462	1 626	11
Heavy plant and equipment	929	1 727	1 911	1 322	1 261	-5
Industrial machinery parts	1 028	1 014	1 004	843	947	12
Tools	279	287	278	185	205	11
Fixed equipment for transportation	59	75	135	72	131	82
Machines and tools	62	104	153	90	39	-57
Capital goods–sundry	37	51	66	59	45	-24
Consumer goods	**9 757**	**11 134**	**10 723**	**7 345**	**7 309**	**0**
(percentage share)	**(18)**	**(19)**	**(19)**	**(15)**	**(13)**	
Non-durable consumer goods	5 172	5 486	5 470	4 174	3 932	-6
Foodstuffs	2 485	2 463	2 514	1 655	1 507	-9
Pharmaceutical products	663	816	997	1 190	1 124	-5
Beauty products	180	233	260	228	239	5
Clothing	367	441	353	196	167	-15
Beverage and tobacco	281	318	289	173	161	-7
Non-durables–sundry	1 197	1 215	1 057	732	735	0
Durable consumer goods	4 586	5 648	5 253	3 171	3 376	6
Passenger vehicles	1 589	2 444	2 677	1 214	1 211	0
Articles of adornment	825	847	783	655	696	6
Domestic machines and apparatus	560	925	681	424	551	30
Parts and spares	1 053	820	573	506	503	0
Furniture and household equipment	215	244	252	162	182	13
Household appliances	143	114	96	71	79	12
Durables–sundry	202	254	193	141	154	9

Table 4.1 (continued)

Import category	1996	1997	1998	1999	2000	Growth, 1999-2000 per cent
Fuels and lubricants	**5 929**	**5 597**	**4 106**	**4 258**	**6 362**	**49**
(percentage share)	**(11)**	**(9)**	**(7)**	**(9)**	**(11)**	
Intermediate products and raw materials	**24 742**	**26 907**	**26 813**	**24 102**	**28 537**	**18**
(percentage share)	**(46)**	**(45)**	**(46)**	**(49)**	**(51)**	
Chemical and pharmaceutical products	7 414	7 733	7 678	7 250	7 850	8
Intermediate products–parts and spares	3 182	3 675	3 563	3 410	4 883	43
Mineral products	3 606	4 399	3 945	3 739	4 942	32
Transportation equipment parts	2 995	3 648	3 872	3 659	4 031	10
Inedible farm products	3 087	3 109	2 800	2 174	2 467	13
Foodstuffs	2 622	2 000	2 287	1 735	1 639	-5
Other raw materials for farming	1 042	1 223	1 323	1 231	1 617	31
Building materials	431	654	756	431	390	-9
Transportation equipment–parts and spares	144	178	252	263	310	18
Animal feed	160	231	288	155	283	83
Intermediate products and raw materials–sundry	57	56	49	55	125	126

Source: Banco Central do Brasil, 2001.

Brazil's ETM imports are broadly based; the top ten imports, by value, using Australian trade classifications, include telecommunications equipment and integrated circuits (Table 4.2). Between 1997 and 1999, most of the top ten imports contracted, after growing strongly in the early 1990s. However, by 2000, many ETMs recovered (Table 4.1).

STM Imports

STM imports averaged annual growth of 17 per cent between 1990 and 1997, but in 1998 and 1999, were hit hard by weak economic growth, the 3 per cent tariff increase and the real's depreciation. However, in 2000, items like chemicals, farm materials, including insecticides, and processed minerals rebounded strongly (Table 4.1).

Primary Imports

Primary imports were flat between 1997 and 1999, but also recovered strongly in 2000 (Table 4.1).

Table 4.2

Top Ten's Shifts in Import Shares

Brazil's Top Ten ETM Imports, 1999

Commodity	US$ million	Per cent share in total exports	Average annual growth (per cent)		
			1990-97	1997-99	1990-99
Telecommunications equipment	2 531	4.9	38.2	-8.5	29.4
Integrated circuits	1 635	3.2	25.7	-2.6	20.3
Motor vehicle parts	1 582	3.1	28.8	-5.1	20.6
Passenger motor vehicles	1 248	2.4	99.6	-29.8	59.8
Specialised machinery	1 183	2.3	33.8	-17.4	25.1
Medicaments including veterinary	1 129	2.2	43.4	19.7	39.4
Internal combustion piston engines	954	1.8	26.7	-10.5	21.6
Other electrical machinery	941	1.8	24.2	-12.1	18.7
Aircraft and parts	933	1.8	18.0	-0.1	17.6
Electrical equipment for circuits	908	1.7	18.1	2.0	16.7

Note: ETMs are manufactured, finished goods and comprise the bulk of world trade in manufactures.

Source: Department of Foreign Affairs and Trade, 2001a.

Major Import Sources

The United States and Argentina are Brazil's key import sources; the United States supplied 11 per cent and Argentina supplied 8 per cent of Brazil's imports in 1999. Major EU nations, Japan and the Republic of Korea are among the top ten import sources, but over half of Brazil's imports come from other suppliers. Argentina's import share rose from 5.3 per cent in 1990 to 8 per cent in 1999.

TRENDS IN AUSTRALIAN EXPORTS TO BRAZIL

Due to strong reform induced growth and trade opening, Brazil is an increasingly important and dynamic market for Australia. (See Chapter 3 - *Brazil's Economy* for discussion of the impact of economic reforms on growth.) Brazil is Australia's largest Latin American trading partner, importing merchandise exports worth A$571 million in 2000, up from A$100 million in 1990. Over the decade, this represents an annual growth rate of over 19 per cent, more than double the annual growth rate of 8 per cent for total Australian exports. In 2000, Australia's two largest exports to Brazil were coal (worth A$296.7 million) and cars (A$56.4 million). Over the last decade, Australian ETM exports' growth outstripped primary exports' growth, reducing primary products' share from over 80 per cent to about 60 per cent (Figure 4.3).

Trends in Primary Products

Over the decade, Australia's primary exports grew at over 8 per cent per year, from A$83.2 million in 1990 to A$346.5 million in 2000; however, this was less than half the growth rate of total Australian exports to Brazil. In 2000, coal accounted for 86 per cent of total primary exports, with BHP dominating this trade, supplying coking coal to Brazil's steel making industry.[6]

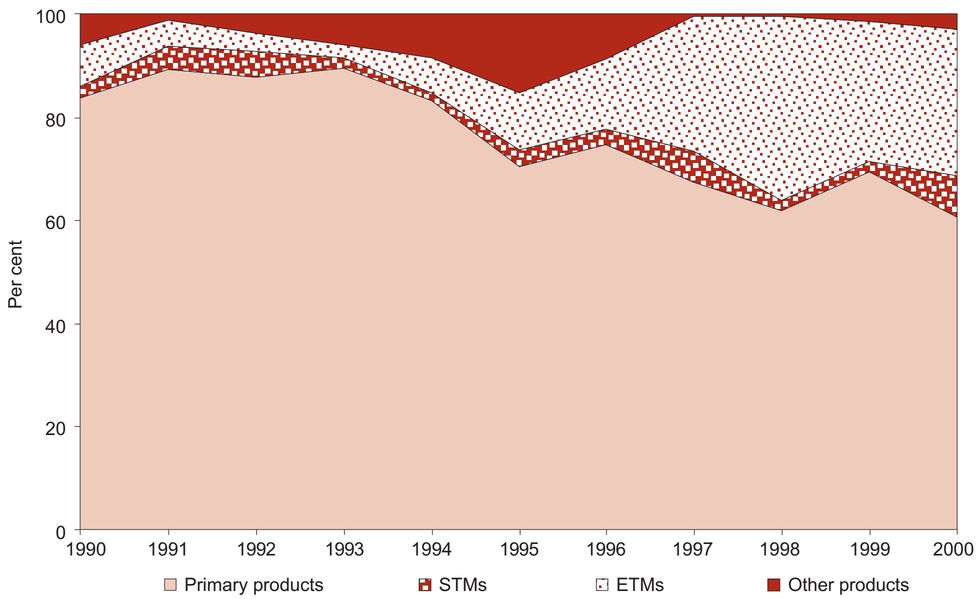
Other significant Australian primary exports include:

- crude petroleum (A$31.3 million)
- cereal preparations (A$6.2 million)
- crude animal materials (A$2.6 million)
- cotton (A$2.4 million)
- raw hides and skins (A$1.9 million).

Figure 4.3

ETM Export Share Growing

Composition of Australian Exports to Brazil, 1990-2000



Source: Department of Foreign Affairs and Trade, 2001a.

[6] In 1999, BHP supplied 2.7 million tonnes to Brazil. Construction of a deepwater port allowed BHP to use larger vessels, thus reducing the transport cost disadvantage BHP faced compared to closer competitors (Bahia Guimarães, 2000).

Trends in Manufactures Exports

Both ETM and STM exports grew strongly over the 1990s.

ETMs

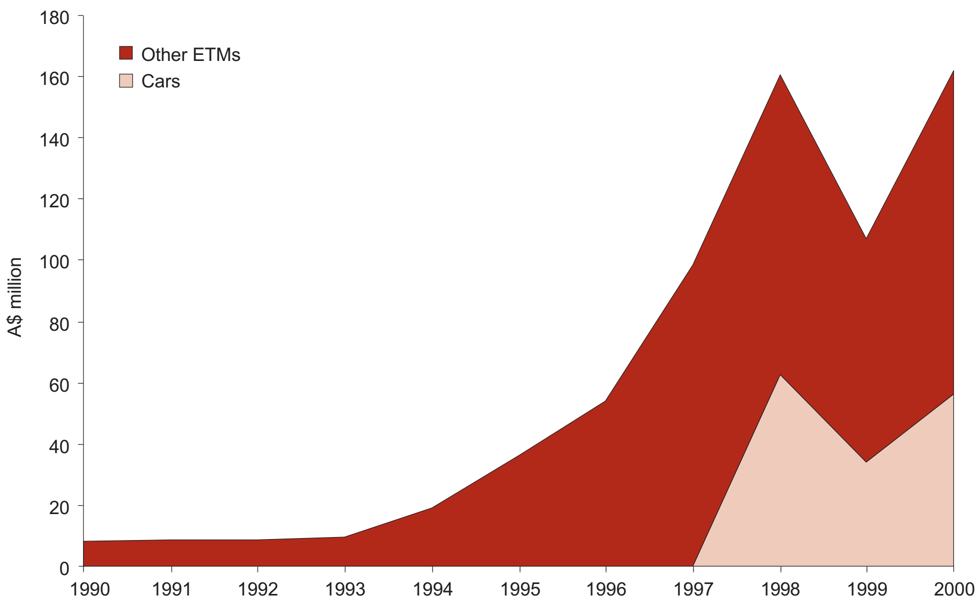
In the 1990s, Australian ETM exports to Brazil grew exponentially, from A$7.9 million to A$161.9 million, mainly due to car exports. Australian car exports grew from only A$0.2 million in 1997 to A$62.7 million in 1998 before settling back to around A$34.2 million in 1999, then growing to A$56.4 million in 2000 as economic growth and consumer confidence strengthened, outweighing the effects of the real's depreciation (Figure 4.4). General Motors Holden is the only supplier, rebadging Commodore VTs as Chevrolet Omegas.

From the mid 1990s, Brazil's imports of other Australian manufactures also increased, particularly measuring instruments, medicaments, telecommunications equipment and coated flat rolled steel (Figure 4.5). Measuring instruments and medicaments sustained ETM growth into 2000, despite the depreciation of the real pushing up import prices.

Figure 4.4

Cars Drive ETM Exports

ETM Exports, 1990-2000, A$ million

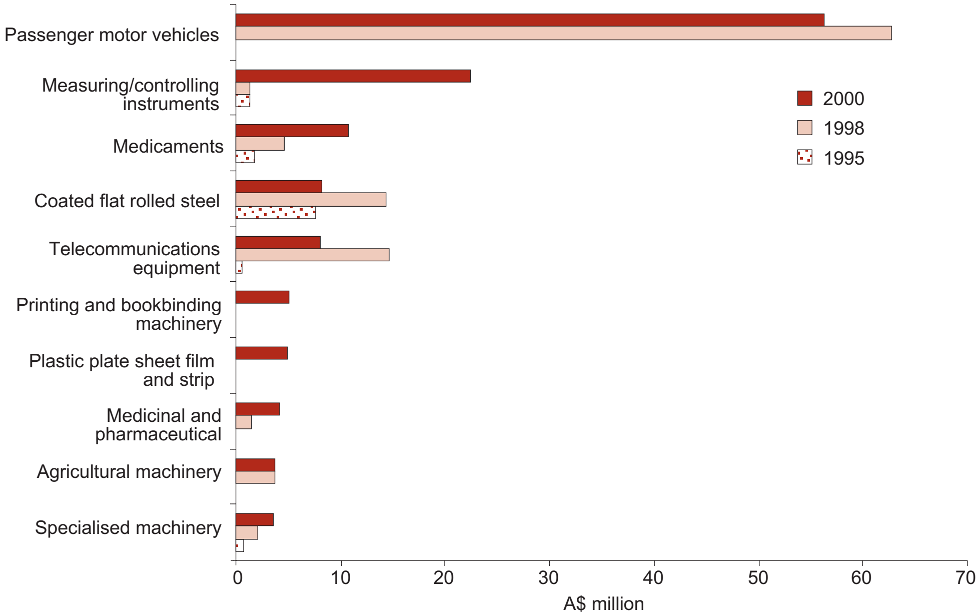


Source: Department of Foreign Affairs and Trade, 2001a.

Figure 4.5

Measuring Instruments and Medicines Grow Rapidly

Major Australian ETM Exports to Brazil, 1990-2000



Source: Department of Foreign Affairs and Trade, 2001a.

STMs

STM exports worth A$45.9 million in 2000, were higher than their previous record of A$22.6 million in 1997 and significantly higher than the A$7.4 million achieved in 1999. However, export items did not grow steadily or consistently. The most consistent export was leather for Brazil's shoe industry, with exports as high as A$10 million in 1996 and 1997, but only A$5.5 million in 2000. Nickel performed strongly in 2000, with exports worth A$27.8 million, up from a zero base.

FDI REFORMS, DIRECTION AND TRENDS

Brazil's extensive reform program and FDI liberalisation have encouraged major FDI inflows, particularly in infrastructure, financial services and manufacturing.

FDI Liberalisation

After decades of hyperinflation and slow growth, Brazil's industries urgently needed to attract new investment; this spurred FDI liberalisation. In particular, telecommunications and electricity, previously off limits to domestic and foreign investors but privatised after 1995, required massive new investment.

Brazil began major FDI liberalisation in 1988, but FDI inflows accelerated after 1995 when it eliminated the distinction between foreign and national capital. Other constitutional amendments opened formerly closed sectors, such as petroleum exploration and extraction, mining and banking, to foreign investors.

However, airports and air services, broadcasting, shipping and fisheries remain closed to foreign capital, while the Government continues to restrict foreign involvement in air and road transport, financial services and health care sectors. In January 1996, the government freed remittances for foreign investments registered with the central bank; abolished withholding taxes; and opened the insurance sector to authorised foreign investors.[7] New or expanded foreign investment in the banking sector remains technically forbidden. However, since 1995, the government has approved foreign bank entry or expansion, case by case, according to the national interest, obligations under international agreements or reciprocity.

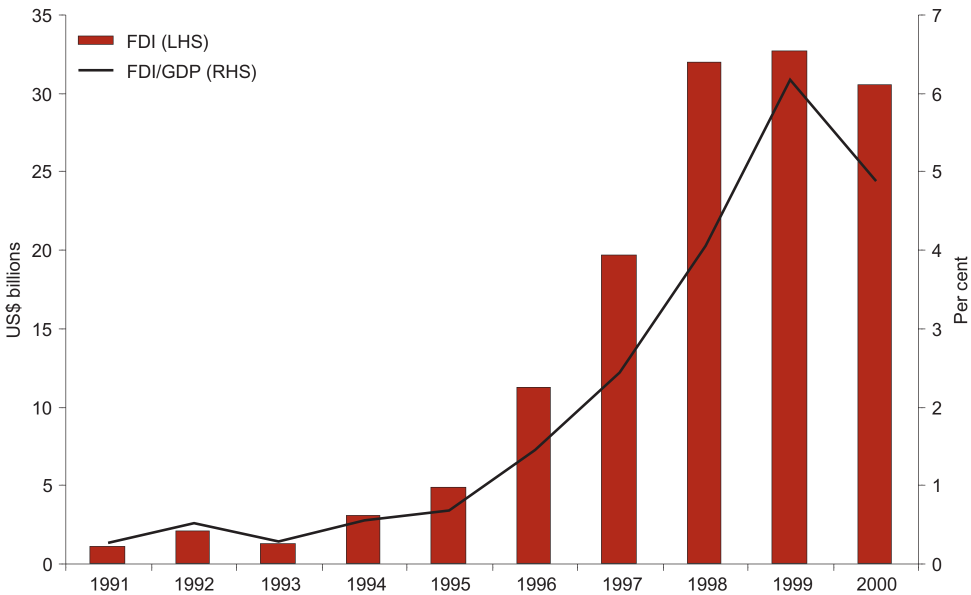
FDI Flows

Before full liberalisation, between 1990 and 1995, Brazil's annual FDI inflows averaged only US$1.6 billion or 0.2 per cent of GDP. After liberalisation, FDI inflows increased substantially, reaching over US$30 billion or 4.9 per cent of GDP in 2000 (Figure 4.6).

Figure 4.6

Brazilian FDI Inflows Surge during the late 1990s

FDI and FDI as a Share of GDP, 1990-2000, US$ billions and Per cent



Note: Figures are as at June; 2000 is an estimate.

Source: International Monetary Fund, 2001a.

[7] Foreign investors must register with the Central Bank Foreign Capital Registration and Supervision Office, FIRCE, within 30 days of bringing funds into Brazil.

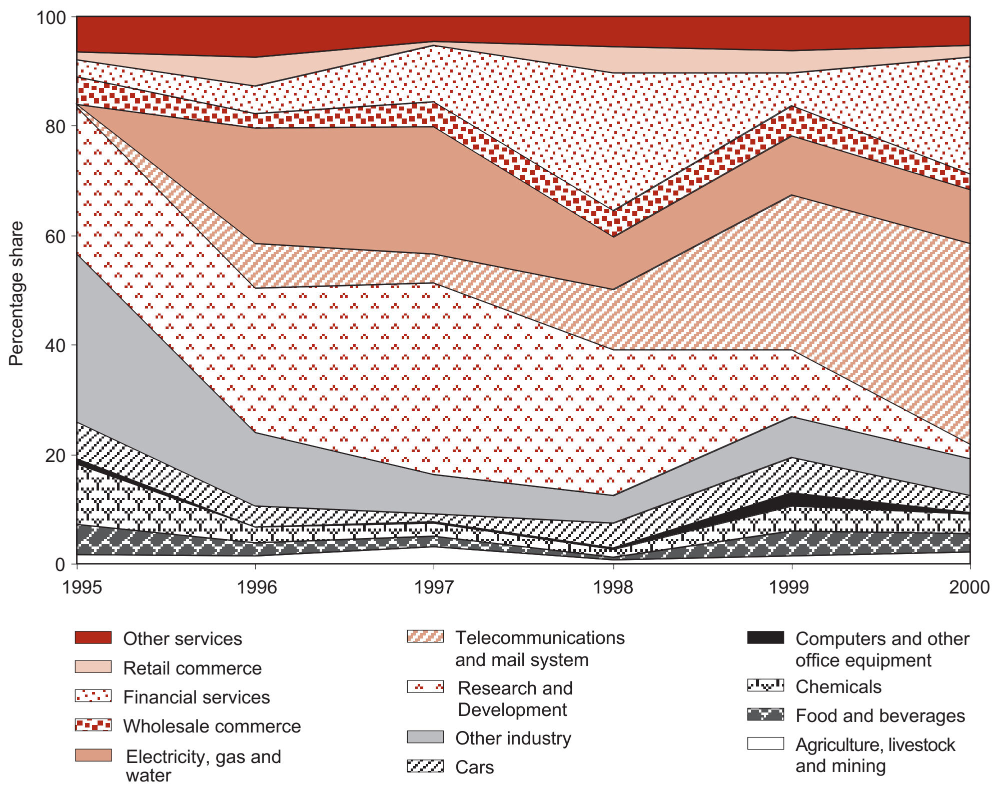
Overall, since 1996, services' share of FDI has increased from 43 per cent to 73 per cent as deregulation and big ticket telecommunications, electricity and financial privatisations occurred. Industry's share has fallen from 55 per cent to 25 per cent. Agriculture's share has remained low and static, since foreigners cannot own land in rural areas or adjacent to national borders (US Department of State, 2000a).

Telecommunications, electricity, gas and water, and financial services attract most service sector FDI, mainly due to privatisation. However, even in electricity, gas and water, and telecommunications, where privatisation has driven FDI most, between 1995 and 2000, total FDI flows exceeded privatisation flows by US$45.6 billion (or 157 per cent) and US$59.2 billion (or 194 per cent) respectively.[8] The main manufacturing sectors attracting FDI are cars, chemicals, and food and beverages (Figure 4.7).

Figure 4.7

Services Attract Most Foreign Investors

FDI by Sector, 1995-2000, Percentage Share



Note: Data for 1995 are FDI stock, not flows.

Source: Banco Central do Brasil, 2000; and 2001.

8 Between 1996 and 1999, privatisation inflows averaged 26 per cent of FDI inflows; electricity mainly attracted privatisation FDI in 1996 and 1997, and telecommunications mainly attracted it in 1998 and 1999.

Source Countries for FDI

The United States provides most of Brazil's FDI, 22 per cent between 1996 and 1999. Spain, Portugal, Netherlands and France were the other leading investors during this period (Table 4.3).[9]

Just under two thirds of US FDI is in manufacturing, mainly chemicals and cars, with banking and finance growing to 16 per cent in the late 1990s (US Department of State, 2000b; and Brazilian Development Bank, 2000). Since liberalisation, European investment has concentrated on services, particularly in telecommunications and banking. For example, Telefónica de España has major shares in five Brazilian telecommunication companies, while Banco Santander has majority shares in two Brazilian banks (Economic Commission for Latin America and the Caribbean, 2000).

Table 4.3

US and Spanish Investors the Biggest

FDI Flows, by Country of Origin 1995-99[a] (US$ million)

Country	1995[b]	1996	1997	1998	1999
United States	10 852	1 975	4 382	4 692	8 088
Spain	251	587	546	5 120	5 702
Portugal	107	203	681	1 755	2 409
Cayman Islands	892	656	3 383	1 807	2 115
Netherlands	1 535	527	1 488	3 365	2 042
France	2 032	970	1 235	1 805	1 982
United Kingdom	1 793	92	183	128	1 269
Germany	5 828	212	196	413	481
Canada	1 819	119	66	279	445
Italy	1 259	12	57	647	409
Switzerland	2 815	109	81	217	405
Japan	2 659	192	342	278	274
Australia	248	na	na	na	271
Others	10 440	4 842	6 103	7 974	5 470
Total	42 530	10 496	18 743	28 480	31 362

Note: a 1996-99 figures refer to inflows above US$10 million by company per year.
b FDI stock as at 31 December, 1995.
na means not available.

Source: Banco Central do Brasil, 2000; and 2001; Austrade, 2000c; and Department of Foreign Affairs and Trade, 2000.

9 Investment from the Cayman Islands began growing rapidly in 1995, possibly representing reverse capital flight of Brazilian capital entering as foreign investment, and to a lesser extent, investment activity by other national groups (International Monetary Fund, 2001c).

AUSTRALIA'S INVESTMENT IN BRAZIL

Australia's direct investment in Brazil is modest, although Austrade estimates indicate it more than doubled from A$200 million in 1995 to A$420 million in 1999. The number of Australian companies investing in Brazil grew from only five in 1995 to 25 in 2000, with Australian exports associated with these investments rising from A$80 million to A$180 million (Austrade, 2000c).

While Australian investment presence is strongest in mining and resources, Australian businesses also have developed a presence in processed foods, financial services, infrastructure, construction, entertainment, education and training, and telecommunications technology and services.

BURNS PHILP: A RISING SUCCESS IN BRAZIL'S YEAST MARKET

Burns Philp has 59 plants in 20 countries, including Brazil, mostly producing yeast. Trading as Mauri Foods, each year Burns Philp produces 30 000 tonnes of high quality, low cost bakers' yeast for a total Brazilian market of 100 000 tonnes.

Mauri sells about 85 per cent of its products to 45 000 small bakeries via 80 distributors. It also sells to 20 large and 300 medium sized bakeries. By using distributors to supply small bakeries, Mauri complies fully with Brazilian tax requirements. Distributors have strong credit records and expertise in dealing with small business credit issues.

Burns Philp undertook considerable pre-marketing preparation and investment, and identified a team of talented local staff and advisers to ensure successful market entry. This ensured it did not encounter any insurmountable regulatory or cultural barriers to entry.

Mauri believes the major reasons for its success include:

- Brazilian openness to new products and ideas
- strong municipal government and local community support for its factory, which employs 128 people in western São Paulo state
- a strong local management team with full management responsibility and ability to hire the required expertise
- use of multinational accounting and human resources consulting firms and reasonably priced local lawyers to navigate the Brazilian taxation and government system
- the basic needs sector in which Mauri operates.

Mauri believes Brazil's size, geography, culture and large lower income population mean economic cycles do not disrupt basic 'bread and butter' sectors of the economy. Although they may grow more slowly, they are relatively safe and constantly developing. At the opposite end of the spectrum are sectors more easily influenced by government policies, including privatisation and exchange rate fluctuations.

Source: Stoffel, 2001; and Quirk, 2001.

TRADE AND INVESTMENT OPPORTUNITIES IN BRAZIL

Increasingly, reform driven income and trade growth is making Brazil an important market for Australian merchandise exports and FDI. The size, diversity and rapid opening of Brazil's economy, and Australia's relatively small presence in this market should create considerable opportunities to expand both trade and investment. Four key factors are likely to drive medium term investment:

- Brazil's competitiveness in primary export markets, which limits Australia's primary export opportunities (see Chapter 2 - *Asia Pacific Comparisons*)
- Brazil's proximity and linkages to other major markets, such as the United States and Europe
- the scope for world competitive, Australian resource and agricultural companies to leverage their expertise in these sectors in Brazil, via direct investment
- deepening Latin American integration, which creates an incentive to invest in Brazil, the main regional market, and access other markets using preferential trading arrangements
- the requirements for a local presence to access successfully the Brazilian market.

Mining

Brazil's mineral abundance limits Australia's mining exports to A$297 million of metallurgical coal annually. However, mining is the major area of Australian investment, with BHP Billiton, WMC, Hammersley Iron and Mariana Goldfields all exploring or producing in Brazil.

Important opportunities are emerging in oil and gas. The Government abolished Petrobras' monopoly on exploration, production, transport and refining of oil and gas in 1997.[10] Currently, foreign investors must form joint ventures or partnerships with Petrobras, but ultimately wholly foreign owned projects will be allowed. Major international oil companies dominated the first auction of exploration and production licences. However, in the second round in 2000, Petrobras joint ventures with small, independent Canadian, European and Brazilian companies won many bids. Two Australian companies submitted unsuccessful bids. A third round of auctions was completed in mid 2001 and a fourth round will be decided by 2002.

Agriculture

Brazil's abundant agricultural land, climatic diversity and distance from Australia limit Australia's opportunities to export bulk agricultural produce. Brazil's main agricultural imports include wheat, corn, fruit and vegetables, and fish while Australia's agricultural exports to Brazil largely are confined to niche products. In 1999, Australia exported crude animal materials (A$2.6 million), cotton (A$2.4 million) and hides (A$1.9 million). Prohibition on foreigners holding rural land limits investment opportunities in agriculture.

[10] Petrobras had a monopoly on Brazil's exploration, production, transportation and refining of oil and gas for 45 years. A new law in 1997 allowed for competition from major international petroleum companies and a regulatory body, Agencia Nacional de Petroleo, deregulated up and downstream petroleum sector activities.

BHP BILLITON IN BRAZIL

The recent merger between BHP Ltd and Billiton PLC has resulted in BHP Billiton having a substantial range of operations in Brazil, comprising iron ore mining and pellet production, bauxite, alumina and aluminium production, oil and gas exploration, and development and marketing of copper, coal and coke products. Until recently, BHP was involved in the power sector and was a foundation partner in the Bolivia to Brazil gas pipeline.

Through its Brazilian subsidiary, BHP Brasil Ltda, BHP Billiton is a 50:50 partner with the largest Brazilian company, CVRD, in the iron ore pellet and concentrate producer Samarco, which operates an open pit mine in the state of Minas Gerais. The iron ore is processed and fed into a 396 kilometre slurry pipeline to the coast where it is formed into pellets and shipped to steel companies in North Atlantic markets. In 1999-2000, Samarco produced 13.5 million tonnes of pellets and pellet feed.

BHP Billiton's other main activity in Brazil covers bauxite, alumina and aluminium where it is a joint venture partner in several operations. Through its Brazilian subsidiary, Billiton Metals SA, it participates in the MRN consortium, in northern Brazil, which operates one of the largest bauxite mines in the world, the Alumar alumina plant and the Valesul aluminium smelter in Rio de Janeiro. Annual average aluminium production is 215 000 tons.

Brazil is an attractive location for mining and minerals processing companies; this is due to resource quality and availability, a competitive tax regime, proximity to major markets and recent reforms that have increased economic stability and transparency. In addition, Brazil has a skilled labour force, stable foreign investment rules, well developed infrastructure and equipment industries, and a 300 year mining tradition. Brazil has the added attraction of being the ninth largest aluminium market in the world, with good growth potential.

BHP Billiton therefore continues to pursue opportunities in Brazil. Recently, it bid unsuccessfully for the Brazilian iron ore producer Caemi. It also is exploring for minerals, oil and gas; gas sector activity increased after 1995 laws abolished Petrobras' monopoly and facilitated private sector participation.

BHP Billiton has an active community and environmental program in areas neighbouring the Samarco Mine, promoting health, education and culture, as well as employee participation in community based activities. The Alumar joint venture targets the poor and disadvantaged through diverse social projects in the state of Maranhão.

BHP Billiton's environmental programs protect native flora and fauna. Samarco sponsors environmental education and works closely with local non-government organisations. Aluminium sector activities focus on strict pollution control, restoration, re-forestation and preservation of natural forests around the operations and re-processing of spent pot linings. Alumar's nature park adjacent to the plant preserves native flora and fauna, and provides environmental education for children. All operations have, or are undergoing ISO14001 environmental management certification. As MRN is an isolated mine in the Amazon forest, the company maintains a full town providing health, education, cultural and leisure activities, and financial support to several riparian communities and social organisations.

Brazil is an attractive investment location supported by an internationally competitive fiscal regime, strong resource endowment and a skilled workforce. A vital ingredient in doing business in Brazil is having an effective on-the-ground presence and demonstrating a visible long term commitment by having qualified Brazilians in key management positions.

Source: BHP Billiton, 2001.

Processed Food

However, Australia has a strong niche investment presence in agribusiness and processed food. For example, Product Makers Australia Pty Ltd opened a São Paulo subsidiary to develop flavours for the beverage industry. In addition, Leiner Davis Gelatin, a wholly owned subsidiary of Goodman Fielder Ltd, the largest food company in Australasia, manufactures and markets gelatine for Brazil's food and pharmaceutical industries. Unifoods exports several processed food products to Brazil.

Brazil's pre-prepared food market is growing well, making the export of inputs for it particularly attractive. From 1994 to 1999, demand expanded rapidly for dairy products (91 per cent), aerated soft drink (88 per cent), wine and beer (65 per cent), cheese (54 per cent), biscuits (50 per cent), pork (33 per cent), poultry (43 per cent) and meat products (29 per cent) (da Fonesca, 2000b).

Australian processed food exports to Brazil are underdeveloped and volatile, and largely concentrated in cereal preparations, alcoholic beverages and milk and cream.[11] One specific area of opportunity is whey. Australia was the world's sixth largest exporter of preserved and concentrated whey in 1999; Brazilian demand is booming as increasingly whey is needed in dairy based drinks and animal feed. Total Brazilian imports of whey were around 14 000 metric tons in 2000 (Food and Agriculture Organisation, 2001; and US State Department, 2001).

Another area of opportunity is supplying food inputs for the hospitality industry. With Brazil's economy recovering and tourism expanding, growth in bars, restaurants, fast food, snack shops, bakeries, pastry shops and industrial catering operations is significant; the sector is expected to grow from 6 to 8 per cent per year from 2000 to 2005 (da Fonseca, 2000a; and 2000b). Australian exporters also should look to enter niche markets for new, sophisticated food products that Brazilian importers target. A major area of opportunity is in wine; companies exporting to Brazil include Redbank Winery in Victoria, Lindemans, Penfolds, McWilliams, Oxford Landing and Miranda.

ETMs

Given the growing diversity and value of Brazil's ETM imports, opportunities exist to expand Australian exports. Over time, some exporters will set up operations in Latin America, and Brazil's position as the dominant market in Mercosur and its good economic prospects, make it a logical investment location.

Telecommunications

In 2000, Australia's total telecommunication exports to Brazil were only A$8 million in an import market worth US$2.5 billion. Most Australian companies worked through local representatives. The sector has strong growth potential with a pro-competitive regulatory framework and aspirations to dramatically bolster teledensity. Between 2000 and 2005, the requirements of concessions already granted may drive investment of US$64 billion in the Brazilian telecommunication sector (US Department of State, 2001).[12] More conservative analysts estimate investment of US$10 billion to 2003, with US$90 billion already invested between 1997 and 2001 (Barker, 2001).

[11] Australia's processed food exports to Brazil peaked at A$56.6 million in 1996 before falling to A$3.3 million in 1999.

[12] The 12 concessionaires that bought Telebras holdings must install 14 million communication networks (such as telephone networks, cable television and data communications networks) within the next three years (Austrade, 2000a).

Several regional fixed line and mobile phone carriers already employ Australian data communications technology, including frame relay, UNIs, fast modems, and access and power equipment (Austrade, 2000a). Opportunities exist to expand existing copper line capacity through digital pair gain and digital local loops. Furthermore, with wireless local loop technology to be used in 8 million lines, consulting opportunities for Australian expertise and technology in this area should grow. Telecommunications network management, provisioning, customer care and billing software also offer high growth opportunities (Austrade, 2000a; and US Department of State, 2000b).

Car parts

Brazil has an enormous but complicated market for car parts, with complexity mainly due to the impact of Mercosur. (See Chapter 13 - *Regional Economic Integration*.) Eighteen US, EU and Japanese companies manufacture cars in Brazil. Audi, Mercedes Benz, Toyota and Renault started producing in Brazil in 1999 joining Volkswagen, General Motors and Fiat which are established market leaders.[13] While imports fell from their 1996 peak of US$1.8 billion to US$1.6 billion in 1999, the market is set for renewed growth with lower interest rates and stronger economic growth.

ACL: CREATIVELY OVERCOMING TRANSPORT BARRIERS

ACL is a Melbourne based automotive components manufacturer. It mainly exports piston rings and engine bearings for Latin America's replacement market. This market is ideal for its products, as the vehicle population is old and mainly of Japanese and American origin; the terrain is mountainous; and the roads are poor. These factors ensure a healthy demand for replacement products.

ACL's main Latin American market is Brazil, followed by Venezuela, Peru, Ecuador and Chile. Sales peaked in 1997 and are recovering from weak demand and regional growth in 1998 and 1999. ACL supplies Latin America through a regional manager in Miami, with agents in each country. Agents overcome language barriers and satisfy customer expectations. ACL thoroughly checks agents before engaging them, and often finds smaller agents which are not dependent on one line can give better representation.

Getting transport and logistics right is a key part of ACL's success, as the company only ships part container loads from Australia. It takes advantage of competitive air freight rates to send its products to Auckland. From there, a freight forwarder consolidates the cargo and ships it to Latin America. Using this system, products arrive in Chile and Peru in 20 to 25 days, faster than Japanese and European competitors manage.

ACL finds Latin American markets are price conscious, and 90 day credit terms are common. ACL uses US dollar invoicing because they believe US$10 sounds cheaper than A$20 to customers. Mercosur also can affect prices. For example, ACL must compete against bearings made in Brazil that are exempt from the 20 per cent tariff applying to non-Mercosur producers.

Source: Pearse, 2001.

[13] Between 1990 and 1997, car production expanded by 153 per cent to 1.7 million units. Production fell by 27 per cent in 1998 due to rising interest rates which dramatically increased the cost of motor vehicle finance (Economic Commission for Latin America and the Caribbean, 2000).

In 2000, Australian car part exports to Brazil were only A$3.4 million, below their 1998 peak of A$4.1 million. Australian players in this market include EGR South America, the Brazilian subsidiary of an Australian company selling plastic accessories, and ACL. Other good export prospects include: sub-assemblies and accessories for tractors and cars; spark ignition and internal combustion engines; gearboxes; cylinder blocks, valve heads and crankcases; soft vulcanised rubber joints and gaskets; and vehicle ignition keys (Department of Foreign Affairs and Trade, 1998; and US Department of State, 2000b). Given the importance of major car manufacturers, successful firms are likely to have strong links with these companies. One Australian company using these links is Bishop Steering Technology Ltd which makes power steering units for Mercedes Benz in Brazil (*The Australian*, 17 May 2001, p. 23).

Agricultural equipment

Agricultural equipment is another area of potential export and investment growth. In the enormous agricultural sector, Brazilian farmers seek productivity improving technologies to boost their profitability and competitiveness.[14] In addition, rising consumer and retail expectations increase pressure on Brazilian farmers to invest in new equipment and skills to raise product quality. For example, pending legislation requires the dairy industry to invest in farm level refrigeration, refrigerated transport systems and new quality assurance tests.

Already, Australia exports mechanical weeders, bulk handing equipment, cattle handling equipment and milking machinery to Brazil. For example, Trethewey Industries exports cattle crushes and head bails; and Queensland based Agrichem Manufacturing Industries Pty Ltd has a Brazilian joint venture subsidiary manufacturing fungicides, liquid fertilisers and other yield improving chemicals (Department of Foreign Affairs and Trade, 2001b). Further growth potential in this sector is enormous.

Mining equipment

Australia's strong reputation for, and competitiveness in, mining equipment and services creates many opportunities. Privatised Brazilian mining giant, CVRD alone spends A$900 million annually on goods and services (Seeber, 2001). Large, domestic mining companies are keen to deal with Australian mining equipment suppliers, who are very competitive at current exchange rates.

In addition, after prolonged stagnation, mining law reforms are stimulating foreign investment interest. (See Chapter 3 - *Brazil's Economy*.) Development and exploration of new mines generates demand for new equipment, including sample analysis equipment, trucks, shovels, drilling equipment, front loaders, wheel dozers and environmental control equipment.

With trade and investment barriers in the Brazilian oil and gas sector removed, exploration is expanding rapidly and production is likely to grow. In 1998, imports met 28 per cent of Brazil's market for oil and gas machinery and equipment; opportunities exist for Australian companies to export equipment, supplies and services for drilling, exploration, engineering, refining, pumping and pipelines (Austrade, 1999).

[14] According to one estimate, only 17 per cent of Brazil's cultivable land use is profitable (US State Department, 2001).

Environmental and other specialised equipment

Driven partly by the introduction of water consumption and pollution charges in 2000, excellent prospects exist for water, wastewater and solid waste treatment equipment and technology (US Department of State, 2001). A growing market also services public water companies and large, export-oriented manufacturers implementing ISO 14000 environmental quality standards.[15]

Good opportunities also exist to supply technology and products for the US$200 million security market; imported products supply about 80 per cent of the market (US Department of State, 2000b).

CATERPILLAR ELPHINSTONE: UNEARTHING OPPORTUNITIES IN LATIN AMERICA

Caterpillar Elphinstone, based in Burnie, Tasmania, manufactures underground mining machinery. In 1995, it entered a 50:50 joint venture with Caterpillar Inc, which bought out the local company's remaining 50 per cent share in 2000. It uses Caterpillar's worldwide distribution network while maintaining separate branding.

Before entering Latin America, Elphinstone closely studied the market. Then in early 1999, it became active, initially undertaking training to increase dealers' knowledge of underground mining equipment and the market's potential.

Elphinstone believes a major challenge in Latin America is getting to see the right people; convincing both users and senior managers of a product's merits is important. Transport is another challenge, particularly for such a bulky, high value product. Due to problems with Australian freight services direct to South America, most products go via sea from Melbourne to the United States, then are transshipped to Latin American ports.

Elphinstone's sales to Latin America have exceeded their expectations so far. Brazil is a particularly good market as customers like Elphinstone's high quality and differentiated products, and fully use their features. Elphinstone also supplies CVRD.

Elphinstone is taking longer to establish a presence in Chile's mature mining industry but is targetting some of the world's largest underground copper mines.

Source: Palmer, 2001.

15 ISO 14000 covers international standards on environmental management, setting standards for monitoring air, water and soil quality.

Pharmaceuticals and medical equipment

Export opportunities for Australia are growing in pharmaceuticals and medical equipment as import penetration increases, patent protection improves and the Brazilian Government encourages generic brands. Between 1997 and 1999, Brazilian pharmaceutical imports grew almost 20 per cent annually to US$1.2 billion, representing 12 per cent of total sales compared to 8.5 per cent in 1997. However, in 2000, they dropped back 5.5 per cent to US$1.1 billion. In 1996, the government introduced 20 year patents for pharmaceuticals, and protection for drugs not yet on the market (Mossinghoff, 1996; and Mendonca, 1999). On the other hand, where lower prices are legal, the Government encourages companies to lower generic drug prices.[16]

The Brazilian market for medical devices and equipment was worth US$3.4 billion in 1998, with the public health sector buying around 60 per cent and the private sector buying 40 per cent (US Department of State, 2000b). Demand grew at an average annual rate of 12 per cent between 1997 and 2000, as hospital and medical services expanded and equipment import duties declined (US Department of State, 2000b). Key opportunities lie in providing training/management services and technologically advanced medical equipment to the rapidly growing private health sector as it seeks to offer new services and control costs. The market for disposable medical products represents another important opportunity (Neto and Lemes, 1998).

Infrastructure

The size of the economy, scale of infrastructure needs, deregulation and privatisation drive opportunities in Brazil's infrastructure sector. Opportunities are identified by the Secretariat for Planning and Strategic Investments, which forecasts demand and infrastructure needs on a long term basis.[17]

Privatisation

While telecommunication and railroad privatisation is complete, electricity, gas, port, highway, sanitation and bank privatisation still is underway (Brazilian Development Bank, 2000). Although these large scale privatisations require huge financial resources, associated investments in newly privatised infrastructure will create many goods and services trade opportunities.

Planned water and sanitation privatisations and investments should generate opportunities for Australian suppliers. At present, state companies provide sanitation services under concessions for the municipalities; many are to end by 2005. By 2005, about 3 700 municipalities will implement bidding processes to renovate or establish new concession contracts (US Department of State, 2001). In addition, concessions for new facilities will be via build, operate and transfer arrangements and joint ownership of new facilities.

16 The Senate approved legislation to allow a 40 to 45 per cent price cut in generic pharmaceuticals, exempting them from federal industrialised product tax, to encourage this market to grow.

17 Details of Brazil's four year plan can be found at the Avança Brasil site, www.abrasil.gov.br; other investment opportunities are outlined at www.infrastructurebrazil.gov.br.

Infraero, the agency responsible for major airports, recently announced tenders for major airport projects, including a new third terminal at São Paulo's international airport for US$265 million, a new cargo and passenger terminal in Campinas for US$16 million and a major upgrade of São Paulo's domestic airport for US$20 million.

Deregulation

Deregulation also creates opportunities. The real's depreciation in 1999 cut investment in electrical infrastructure, but to gain and retain electricity customers in gradually opening power markets, utilities must resume investment.[18] Transmission line expansion is underway, with three major transmission lines, covering 11 500 kilometres, estimated to cost over US$1 billion, open for tender.

Substation automation, power measurement systems and load transfer devices also are growth areas. The Brazilian Association of Infrastructure and Basic Industries inventoried 826 planned electricity sector projects worth US$95.1 billion to 2003 (International Monetary Fund, 2000).

Services

Since 1992, Brazil's total service imports have grown annually at around 10 per cent, with royalties and licence fees (US$1.2 billion in 1999) and computer and information services (US$1.0 billion) growing strongly from negligible levels (International Monetary Fund, 2001b). Potential Australian opportunities centre on information technology, financial services, construction services and education. Often, an on-the-ground service delivery presence means service exports quickly can translate into an investment presence.

Information technology and associated products

Brazil is Latin America's largest, most developed information technology market estimated at around US$18 billion in 1999. For example, Internet use is projected to grow 139 per cent between 1999 and 2004, when 34.5 million people should be users. This size means large companies often can finance world best practice technology across the full spectrum of activity.

Already, Australian company involvement includes:

- VFJ which sells smart cards to Natal, Fortalza and Brasília
- Open Telecommunications which supplies Telefonica with information technology equipment and support assistance to upgrade switching capacity and Embratel with provisioning software
- Trak Systems which installed its patient management database system in a São Paulo hospital
- Mincom and Maptek which sell software packages to the Brazilian mining industry (Department of Foreign Affairs and Trade, 2000)
- Keycorp which provides PIN pads and key stations for Banco Bradesco, one of Brazil's largest commercial banks (Austrade, 2000b).

18 Since July 2000, all electricity consumers with power loads above 3MW are free to select suppliers, with further liberalisation set down for 2003 (US State Department, 2001).

OPEN TELECOMMUNICATIONS: GAINING FROM PRIVATISATION AND DEREGULATION

Founded in 1992 as Open Technology, Australian telecommunications supplier, Open Telecommunications, OT develops and integrates software solutions for the telecommunications industry. Its advanced software enhances established and fixed line networks and new world Internet Protocol networks. OT services its international customer base from offices in Australia, New Zealand, Europe, Asia, North America and Brazil.

OT entered the Brazilian market after collaborative efforts with Austrade identified commercial opportunities in South America. In January 2000, OT signed the first of three large contracts with Embratel, Brazil's long distance carrier to provide support and development services. Subsequently, OT signed a contract for a software licence and then a further contract for solution and product support.

Brazil's ongoing privatisation and deregulation of telecommunications has made it an integral element in OT's global strategy. The dynamics of operating in many South American countries, including Brazil, are similar to Australia's deregulated telecommunications market. Brazilian investment in information technology equipment and telecommunications software should reach US$500 million to US$700 million per year over the next few years, as liberalisation gains momentum. Brazil's telecommunications software market is at the start of the growth curve, and telecommunications providers seek companies like OT for new value added services, so they can win new customers and expand their market share.

OT believes it is critical to commit to and understand the Brazilian market to be successful, particularly with big telecommunications investments. Consequently, OT established an early presence in Brazil so it could make the right contacts and establish trust with potential clients, an essential element to conducting business in Brazil.

Potential Australian investors need to be aware of high salary costs in Brazil. Professional salaries, particularly in the information technology and telecommunications sector, are at the upper end of the scale, and add on costs, including tax, can often double this amount. Salaries may decline somewhat as Brazil's training sector adapts to the requirements of the new economy.

Being an innovative Australian company has several advantages. OT's Brazilian employees have embraced the company's way of doing business, because it offers them greater opportunities than many competitors. Brazilians appreciate Australian companies valuing local knowledge and personnel; OT builds a partnership with local customers and does not merely export solutions. Flexibility also is important as Brazil can be a frustrating market. A flexible approach, long term commitment, forging of local partnerships and not pre-judging are integral to success in Brazil.

Source: Barker, 2001

Financial services

The availability of electronic banking equipment and willingness to adopt new financial products or services drives opportunities in Brazil's financial services sector. Financial institutions are keen to improve risk management, expand bank lending, reduce the adverse effects of commodity price swings and allow greater access to capital market finance. For example, Macquarie Bank's Brazil branch offers a range of services, including equity marketing and commodity price hedging, and seeks to offer warrants and options. Aykman Financial Services opened an operation in São Paulo.

MACQUARIE BRAZIL: PROVIDING RISK MANAGEMENT AND FINANCING SOLUTIONS

Macquarie Bank, a leading Australian investment bank, offers the full range of investment banking, commercial banking and retail financial services. Since 1969, Macquarie's major financial innovations have underpinned its reputation as a market leader. Internationally, Macquarie pursues specialist investment banking activities in a range of markets.

From its regional headquarters in São Paulo, Brazil's financial centre, Macquarie operates in the areas of equity derivatives, agricultural commodity price hedging and investment banking. With the world's fifth largest population and an economy ranking within the world's top ten, Macquarie views Brazil as an important market in the Americas, both on a stand-alone basis and for servicing clients doing business in the country.

Macquarie began its venture in Brazil in August 1999 when it acquired the investment banking business of Bankers Trust Australia. Working closely with other offices in Macquarie's worldwide network, the São Paulo office is staffed with highly experienced local executives.

Equity Derivatives

Macquarie's Equity Markets Division provides derivative and structured products linked to Brazil's equity market, both for institutional and retail clients. Macquarie believes deregulation in the Brazilian equity market favours players dedicated to developing new business opportunities; consequently, Macquarie is negotiating with local regulators and exchanges to introduce new products to Brazil.

Agricultural Commodities

Macquarie provides the Latin American agricultural sector with unique price risk management solutions and innovative financing alternatives. By partnering Brazil's largest commercial bank, Banco do Brasil, it offers Brazilian primary producers price risk protection historically only available to large corporations. Primary producers can access Macquarie's risk management products online or through one of Banco do Brasil´s 7 000 branches, and includes coffee and soy options which enable primary producers to manage market risk and secure future prices through the use of derivatives. Macquarie also provides over-the-counter risk management products to the sugar, cotton, coffee, soy, wheat, corn and orange juice sectors.

Investment Banking

Macquarie also conducts investment banking activities in Brazil, focusing on infrastructure finance and managing specialist infrastructure funds, both areas in which Macquarie is a recognised world leader. Working with Brazilian pension funds, Macquarie currently is seeking to establish an infrastructure fund in Brazil targetting the country's transport infrastructure. Once it is established, the fund will be one of the first investment funds of its kind in Brazil.

Source: Pye, 2001.

Construction services

Like Australia, Brazil is highly urbanised with widespread construction activity in shopping malls, residential complexes, resorts, hospitals and office buildings, ports and roads, and other infrastructure facilities. These projects offer opportunities in construction project development, and associated services such as architecture (American Chamber of Commerce, 2000). Australian company, Bovis Lend Lease, is operating in this sector.

Education

Australian education exports to Brazil are growing rapidly from a low base. In 2000, 1 500 Brazilian students studied in Australia, significantly up from 405 in 1995. Around 60 per cent do short term English courses; 35 per cent were undergraduates and postgraduates; 3 per cent were high school students; and 2 per cent were TAFE students (IDP Education Australia, 2001). The potential to attract further students from Brazil is significant. Already Australia is Brazil's fourth most important destination, after the United States, the UK and Canada. With 80 000 to 90 000 Brazilian students studying offshore, relatively small changes in Australia's market share would translate into thousands of students. Australia's key competitive advantages include:

- lower course and living costs than the United States or UK, due to the Australian dollar exchange rate
- the opportunity to work up to 20 hours per week when undertaking long term courses
- coinciding summer holidays, the peak time for short courses
- a strong view that Australia is safe, friendly and attractive country.

LEARNING ENGLISH AT THE SYDNEY ENGLISH LANGUAGE CENTRE

Sydney English Language Centre, SELC, established in 1985, is an international language school with students from over 30 countries in Europe, South America and Asia. Known for its quality education and great atmosphere, it is 10 minutes from Bondi Beach and the city. Over the last two years, Brazilian student numbers have grown rapidly, and Australia's booming post-Olympic profile and popularity has spurred interest. SELC attracts over 200 Brazilian students per year (around 15 per cent of the total yearly intake), studying for 12 weeks on average. SELC's commitment to optimising student numbers and maintaining a good mix of nationalities constrains future growth in Brazilian student numbers.

Specialised education agents working on commission source SELC's Brazilian students. SELC's position was strengthened by its early market entrance and loyal agency networks. While airfares to Australia exceed those to the United States or UK, cost savings over a 12 week course more than compensate for this, especially with the real depreciating against the US dollar. Canada is the main competition, with similar living costs and cheaper airfares. Brazilians sometimes are surprised by the time it takes to get a short term visa for Australia, with some opting for New Zealand which does not require a visa for stays of three months or less.

Source: Sydney English Language Centre, 2001.

For universities, Australia's main opportunities are in courses such as agriculture, mining, urban planning, environmental studies, tourism and marine biology. Australia also may have a niche in Asian studies. However, not all high school graduates may need to take the current pre-requisite, 12 month preparatory course, before entering university; this requirement could discourage more able students (IDP Education Australia, 2001). Improved institutional links and marketing of Australian institutions would develop this market.

LOOKING FORWARD

Brazil is Latin America's largest market, with roughly half its population and land area. Ongoing regional integration will only increase its investment appeal. With trade a relatively low ratio to GDP, imports and exports have enormous potential to grow. Assuming, as is likely, that future governments maintain trade and economic reform momentum, incomes will continue rising, ensuring Brazil will become a more important importer and exporter. This will make it a dynamic and attractive market, particularly for Australian manufactures and service exporters. Investment in mining, manufacturing, agribusiness and related sectors, and financial and information technology services also should be increasingly attractive.

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MEXICO'S ECONOMIC PERFORMANCE AND PROSPECTS

KEY POINTS

- **Since 1982, and particularly 1994, Mexico has opened its trade and investment regime, mostly by integrating with the US economy; the desire for further integration disciplines much of Mexico's economic policy decision making and institutional development.**

- **Privatisation and deregulation support market opening policies and increase productivity.**

- **Since Mexico's 1994-95 crisis, the North American Free Trade Agreement, NAFTA, membership has strengthened Mexico's economic performance.**

- **Since this crisis, Mexico's external vulnerability has declined; the current account deficit remains well below pre-crisis levels; external debt is low and foreign direct investment, FDI, is a major source of capital inflow.**

- **Despite extensive financial sector opening, including a strong foreign bank presence, and recent insolvency reforms, Mexico's weak credit culture undermines local lending, and a credit crunch restrains the economy.**

- **Foreign investors also should watch for activity to broaden the tax base and reform the energy sector.**

Since the 1994-95 crisis, Mexico has become a dynamic emerging market, due mainly to rapidly deepening integration with the United States. Since joining the North American Free Trade Agreement, NAFTA, in 1994, Mexico's international trade and investment has surged. Mexico's 1999 free trade agreement with the EU further enhances Mexico's attractiveness as an investment destination; Mexico is the only emerging market with free trade agreements with both the United States and the EU.

Significant improvements in macroeconomic management and structural reforms since the late 1980s, and particularly after 1995, also contribute to Mexico's stronger performance. The 1994-95 peso crisis revealed serious economic weaknesses, particularly in the banking sector and its prudential regulation. While the Government has strengthened many policies since 1995, President Fox's new administration recognises trade, foreign investment, privatisation, labour, fiscal and regulatory reforms still are incomplete, and has pledged to pursue these vigorously. If he succeeds, these reforms will help sustain Mexico's recent strong growth.

This chapter focuses on Mexico's economic performance in the 1990s, analysing key issues affecting foreign investors and traders. It highlights economic reform and market opening, Mexico's vulnerability to external crises, weaknesses in public finances, banking and capital markets. Finally, it analyses future reform priorities and economic prospects.

MEXICO'S ECONOMY OPENS UP

Two decades ago, Mexico's economy was practically closed to foreign investment and most trade. Regulation was extensive; many sectors had barriers to local and foreign competition; and government production was widespread. A crisis precipitating a massive external debt default in 1982 and the 1984 oil price collapse drove the government to initiate wide ranging reforms, including trade and investment liberalisation, privatisation, deregulation and fiscal consolidation.

Trade and Investment Liberalisation

Trade and investment liberalisation has been central to improving Mexico's economic performance. After entering the General Agreement on Tariffs and Trade in 1986, Mexico unilaterally liberalised its trade regime on a most favoured nation basis; it reduced the trade weighted average tariff to 11 per cent by 1994 from 16.4 per cent in 1983. In 1994, NAFTA promoted free trade with the United States and Canada and stimulated a trade boom in the region. However, in response to the Mexican crisis, the Government increased tariffs; the simple average most favoured nation tariff rose to 17.6 per cent by 2000 (Department of Foreign Affairs and Trade, 2001).[1] Between 1993 and 1998, the Government also opened most sectors to full foreign investment. For details on trade and investment liberalisation, see Chapter 6 - *Mexican Business Opportunities*.

1 However, including NAFTA trade, the average trade weighted tariff declined to 2.9 per cent by 1998 (Asia-Pacific Economic Cooperation, 2000).

Privatisation

After 1985, the government privatised many state owned enterprises and opened infrastructure to private investment. In 2001, fewer than 100 firms remain publicly owned, down from 213 in 1993 and over 1 100 in 1980 (OECD 1999a; and 2000). Privatisations included airlines in 1989, Teléfonos de Mexico, TELMEX (partially) in 1990, the banking sector in 1991-92, railways in 1997-99, and many others including mining companies, television channels, theatres, sugar mills, the fishing industry and automotive and steel companies. Due to the 1995 crisis, the Government now owns some previously privatised banks, toll roads and airlines, although it is not involved in daily operations and plans to reprivatise them in the near future (OECD, 1999a).[2]

In addition, the Government offered the private sector long term private concessions to operate infrastructure previously reserved for the state, including natural gas storage, rail transport and airports (Table 5.1).[3]

In most sectors, privatisation and concessions boosted productivity, lowered costs and lifted service quality. For example, between 1987 and 1994, port service charges fell by up to 40 per cent and trucking rates fell 23 per cent (OECD, 1999a). However, in some sectors, such as telecommunications, problems arose from a lack of market opening and the dominant position of the previous state monopoly, TELMEX. This resulted in low competition, and limited network expansion and telecommunications penetration.

Also, despite efforts to split and corporatise the state owned electricity supplier, the energy sector remains largely publicly owned. Political difficulties hamper the privatisation of the two vertically integrated regional electricity monopolies and the monopoly petroleum company Petroleos Mexicanos, PEMEX.[4] Even in petrochemicals, the private sector is limited to 49 per cent equity in existing plants, with PEMEX keeping the remaining, majority share; only new plants offer full private and foreign ownership. Consequently, private sector investment in energy and related sectors is negligible.

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2 In the case of the airlines, debate centres on how to structure the sales (OECD, 2000).

3 Under concession contracts, private operators have contractual rights to use infrastructure assets to supply customers and obtain sales revenue. They usually are responsible for capital extensions and maintenance (East Asia Analytical Unit, 1998). In the rail sector; the Government offered concessions to the four regional route based companies created in the 1997-99 railway privatisations (OECD, 1999a; and 1999b).

4 Comisión Federal de Electricidad, CFE, and Luz y Fuerza del Centro, LFC, are the vertically integrated state owned electricity enterprises; both can generate electricity, and they share the transmission and distribution market.

Table 5.1

Major Sectors Privatising

Main Steps in Liberalising Public Utilities, 1989-1999

Date	Petrochemicals and natural gas	Electricity	Seaports, toll roads and railways	Air transport	Telecommunications
1989-91			Toll roads built by private sector (1989-1995)	Privatisation of AeroMexico and Mexicana; deregulation	TELMEX partly privatised and mobile services liberalised
1992-94		Generation opened to the private sector	Seaports became autonomous (1993-94)	AeroMexico took over Mexicana; enforcement of financial criteria and safety regulations tightened	
1995		Regulatory agency, Comisión Reguladora de Energia, CRE, established	Toll road operators bailed out and toll roads re-nationalised	AeroMexico, Mexicana and two smaller airlines nationalised and consolidated under a single holding company, Controladora Internacional del Transporte Aéreo, CINTRA; fare setting liberalised	New regulatory regime established
1996			National railways restructured and split into five regional companies		
1997	Regulatory and legal framework for private distribution of natural gas established; concessions sold (1997-99)		Railways privatised on a concession basis (1997-99)		TELMEX fixed line monopoly expired; satellite fixed services privatised, resulting in competition on long distance calls
1998			Most ports privatised (1998-99)		Bands for local services auctioned
1999	No bidders for auction of petrochemical plants	Restructure of Comisión Federal de Electricidad, CFE started		Concessions for operation of airports sold (1998-2000)	New operators entered to provide local services

Source: OECD, 2000.

Deregulation

The Government began deregulation in the late 1980s to improve efficiency and increase service sector competition (OECD, 1999a; and 2000). The process included:

- implementing regulatory reforms in newly privatised sectors, including establishing independent sectoral regulatory agencies like the Federal Telecommunications Commission[5]
- enacting the Federal Law of Economic Competition in 1993 and creating the Federal Competition Commission to enforce it; this independent commission is increasingly vigorous, although legal challenges often delay its actions (OECD, 1999a)
- introducing a government wide deregulation program, from 1995, to reduce government intervention, promote better regulatory techniques and require agencies to review existing and new regulatory procedures.[6] Consequently, over the two years to July 1998, nine federal ministries agreed to remove or improve almost half the mandatory formalities for business and have implemented half of these changes (OECD, 1999b).

In addition, the Government reformed specific sectors including deregulating trucking and bus transport in 1989-1990, opening mining to increased national and foreign competition in 1992, increasing bank foreign ownership in 1994 then permitting full foreign ownership in 1998, and allowing the creation of a private market for generic drugs in 1997 (OECD, 1999b).

CRISIS VULNERABILITY AND THE EXTERNAL SECTOR

A pegged exchange rate, widening current account deficit, excessive domestic bank lending and massive public overseas borrowing triggered the 1994-95 Mexican crisis. Reforms introduced since then have made Mexico less vulnerable to crises; its current account deficit and external debt remain well below pre-crisis peaks; and strong FDI inflows reduce reliance on volatile portfolio flows or government borrowing to finance the current account deficit.

Current Exchange Rate Policy

The new Fox Government appears committed to maintaining a stable floating exchange rate regime. The February 1997 exchange rate stabilisation policy allows the central bank to auction up to US$200 million, at a price at least 2 per cent higher than the previous day's price, if, in a day, the peso drops more than 2 per cent against the US dollar (Caballero, 2000).[7] Since 1995, except during the Brazilian crisis, the peso's real effective exchange rate has appreciated steadily, despite a nominal depreciation against the US dollar (Figure 5.1).

5 The transparency and accountability of some regulatory decisions were a concern.

6 This program was called the Agreement for Deregulation in Entrepreneurial Activity.

7 The policy is designed to smooth out volatility in the market and provide increased liquidity in difficult times. Market players view it as an effective mechanism for lowering risk. The amount is not enough to sway the market significantly, especially in difficult times. Mexico currently has enough foreign reserves to apply the stabilisation mechanism for 150 days or 30 weeks (Financial Reporter, 2001).

THE MEXICAN CRISIS

By late 1994, portfolio investment and public borrowing mainly financed Mexico's large current account deficit, which reached 7.1 per cent of GDP. Short term, dollar denominated public debt was high; foreign reserves were dwindling; and the fixed exchange rate was overvalued. Capital flight occurred due to perceived political instability and expectations of devaluation, while the exchange rate defence rapidly depleted reserves.[8] On 20 December 1994, the Government widened the exchange rate band, allowing a 15 per cent devaluation, and two days later, after an adverse market reaction, floated the peso. Foreign investor concerns about poor communication prior to the band widening and delays in articulating a new post-float strategy eroded already low investor confidence, and between December 1994 and June 1995, the peso fell 56 per cent against the US dollar (Figure 5.1).[9]

This devaluation precipitated a banking crisis, as many borrowers were exposed to foreign currency loans. Many banks failed and had to be nationalised, as did several major companies. However, a major IMF led international support package enabled Mexico to meet its foreign exchange obligations, and subsequent macroeconomic and structural reforms produced a rapid recovery.[10]

Reduced Current and Capital Account Vulnerability

Since the crisis, the lower exchange rate and NAFTA have helped merchandise exports grow an average of 15 per cent per year, compared to 10 per cent per year between 1990 and 1994. While goods and service imports grew strongly, averaging 17 per cent per year from 1995 to 1999, the current account deficit, remains well below pre-crisis peaks and is now fully financed by FDI inflows (Figure 5.2).[11]

Strong FDI inflows reduced dependence on portfolio flows, but private foreign borrowing has increased since 1994, as domestic credit has contracted (Figure 5.3).

[8] By mid December 1994, reserves fell to US$11 billion compared to a US$30 billion peak in February 1994.

[9] Investor confidence already was low following two political assassinations in 1994. The 4 January stabilisation plan, including fiscal stringency, strict wage guidelines and a tight monetary policy framework, failed to reassure markets (OECD, 1995).

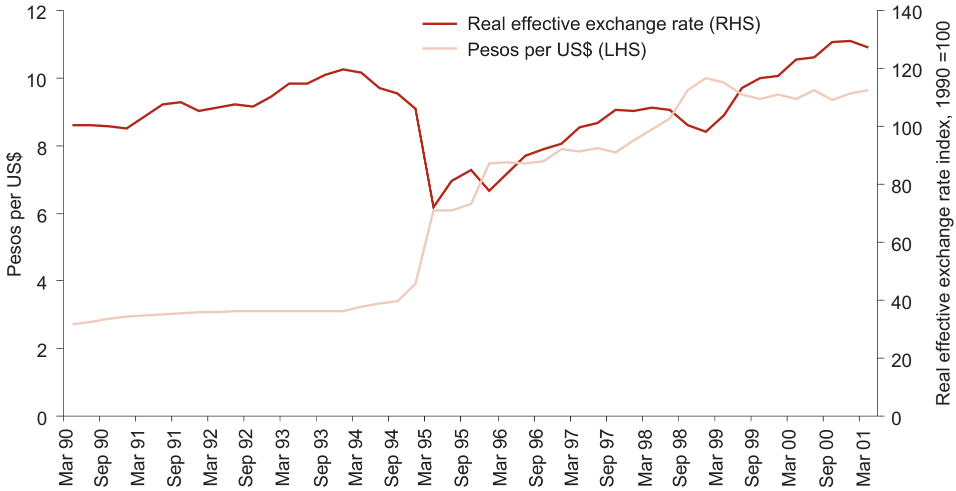
[10] Following the peso's float, foreign governments and international financial institutions developed a US$52 billion support package combining loan guarantees and credits. The Government used these funds to repurchase Mexico's substantial short term, dollar denominated debt, which had contributed to the liquidity crisis; reduce borrowing costs through early debt repayment; and extend debt maturities by issuing more two and five year bonds (Krueger and Tornell, 1999).

[11] Despite emerging market financial turbulence, between 1998 and 2000, on average, FDI financed 77 per cent of the current account deficit, compared to only 27 per cent between 1991 and 1994.

Figure 5.1

Real Exchange Rate Rising Strongly since 1995

Average Real and Nominal US dollar Exchange Rate, 1990-2000



Note: The JP Morgan 'Real Broad' Currency Index measures one country's currency strength relative to 22 OECD and 23 emerging markets' currencies included in the broad measure basket. The indices are weighted by each country's 1990 bilateral trade in manufactured goods, based to the 1990 average, equal to 100, and inflation adjusted.

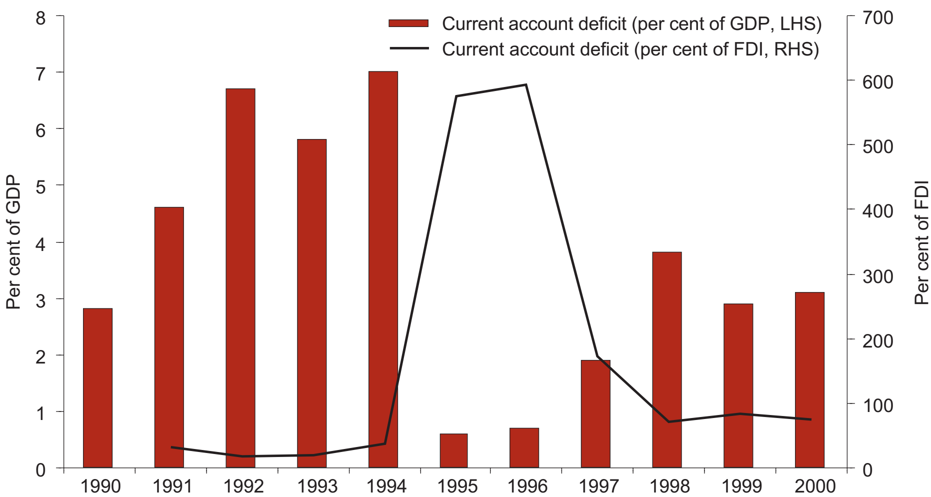
An increase in either of these two series represents an appreciation, real or nominal.

Source: OECD, 2001; and JP Morgan, 2001.

Figure 5.2

Current Account Deficit More Manageable

Current Account Deficit, 1990-2000, Per cent of GDP and FDI



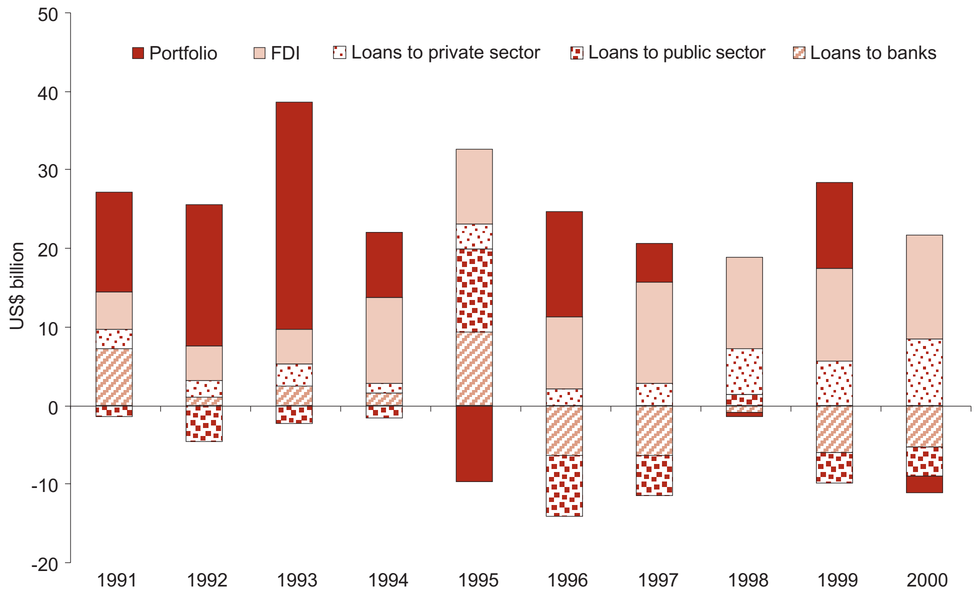
Note: Gross domestic product, GDP, shares in 2000 are preliminary estimates.

Source: Bank of Mexico, 2001.

Figure 5.3

Private Sector Accessing Offshore Markets

Composition of Capital Inflows, 1991-2000, US$ billion



Note: Loans to banks are to development banks, commercial banks and the Bank of México.

Source: Bank of Mexico, 2001.

External Debt Low Compared to Other Emerging Markets

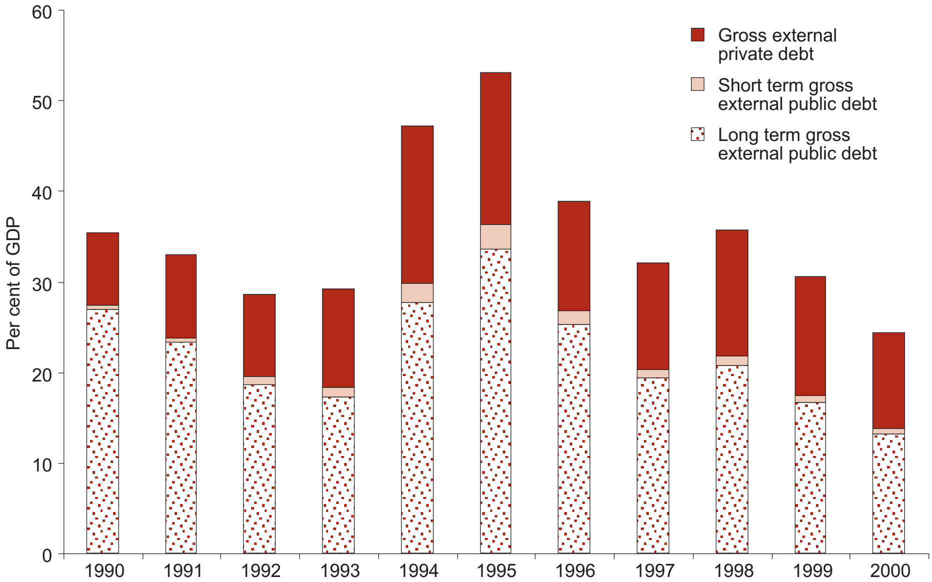
After peaking in 1995 at 53 per cent of GDP, Mexico's external liabilities plunged to 24 per cent of GDP by 2000 (Figure 5.4). This compares favourably to ratios of 100 per cent in Brazil, 54 per cent in Argentina and 56 per cent in Chile. Mexico reduced its long term public debt by making early debt payments after 1995.

Furthermore, the declining share, since 1996, of goods and service export revenues dedicated to interest payments on external debt illustrates Mexico can better sustain its debt burden (Figure 5.5). This compares favourably to Argentina, which currently devotes 100 per cent of its export income to servicing its debt, and Brazil which spent 143.5 per cent of export income on debt repayments in 1999.

Figure 5.4

External Debt Burden Lightens

Gross External Liabilities, 1990-2000, Per cent of GDP

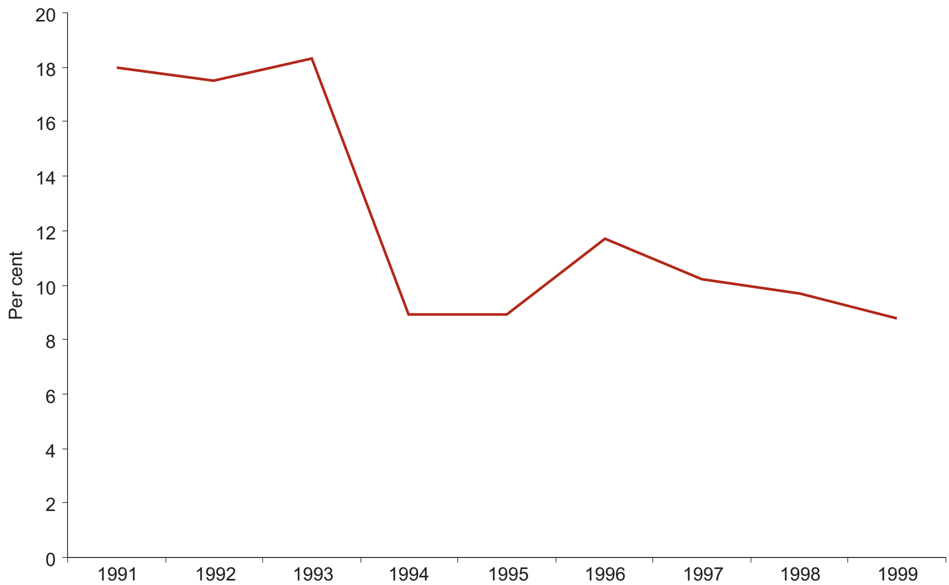


Source: Ministry of Finance, 2001b.

Figure 5.5

Debt Repayment Burden Declining

Interest Payments as Per cent of Goods and Service Exports, 1991-99



Source: Economic Commission for Latin America and the Caribbean, 2000.

ECONOMIC PERFORMANCE IN THE 1990s

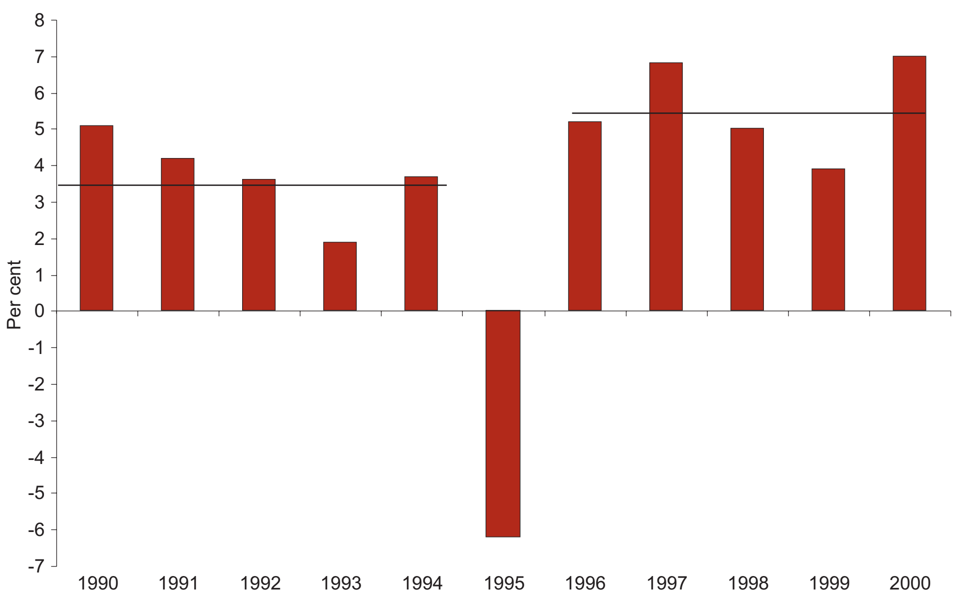
Despite carrying a stock of bad debts from the 1994-95 crisis, and higher interest rates during the Asian and Russian crises, real GDP growth accelerated in the late 1990s. Between 1996 and 2000, GDP growth averaged 5.3 per cent per year, well above 1990 to 1994 growth of 3.4 per cent (Figure 5.6). Since 1996, these industries have performed well:

- manufacturing, with average annual growth of 8 per cent, spurred by *maquiladora* exports to the United States and a depreciated exchange rate against the US dollar[12]
- transport and communications, with average annual growth of 8 per cent, driven by deregulation, privatisation and the worldwide communications boom in the late 1990s
- construction, with average annual growth of 7 per cent since the crisis induced recession in the mid 1990s.

Figure 5.6

A Decade of Highs and Lows

GDP Growth, 1990-2000, Per cent



Note: The horizontal lines delineate the average growth rate over the relevant period.

Source: International Monetary Fund, 2001.

[12] The *maquiladora* industry is made up of in-bond plants which can import inputs duty free, as long as they export their output. In 2001, changes to the sector were introduced. (See Chapter 6 - *Mexico's Business Opportunities*.)

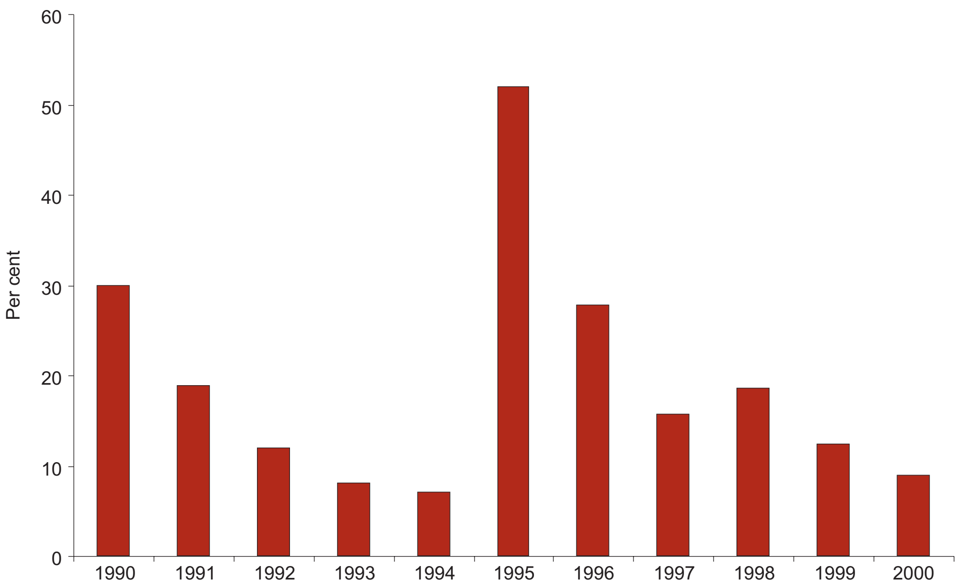
Inflation Outcomes

In the early 1990s, substantial capital inflows associated with NAFTA increased inflation. However, Mexico successfully neutralised the growing money supply by selling government securities, and inflation continued to decline to 1994 (Figure 5.7). After 1995, the peso's depreciation induced rapid price increases, with inflation spiking at 52 per cent. Between 1996 and 1999, the peso depreciated by 49 per cent against the US dollar, Mexico's dominant import currency, maintaining inflationary pressures. However, tighter fiscal and monetary discipline, including via central bank independence after 1994, and wage restraint agreements between government, labour and business, helped halve inflation by the end of 1996; inflation continues to fall. Mexico aims to facilitate closer integration with the United States by achieving US inflation rates; the inflation target for 2003 is 3.5 per cent (Baqueiro, 2000).

Figure 5.7

Inflation Falls but Remains Relatively High

Inflation Rate, 1990-2000, Per cent



Note: Inflation is measured as the December to December change in the consumer price index.

Source: National Institute of Statistics, Geography and Informatics, 2001; and Bank of Mexico, 2001.

PUBLIC FINANCES

In 1982, a public foreign debt repayment crisis forced Mexico to suspend international public debt payments; excessive government issues of short term, US dollar denominated bonds also contributed to the 1994-95 crisis. However, while challenges remain, Mexico's fiscal position now is much improved, with moderate deficits and debt (Figure 5.8).

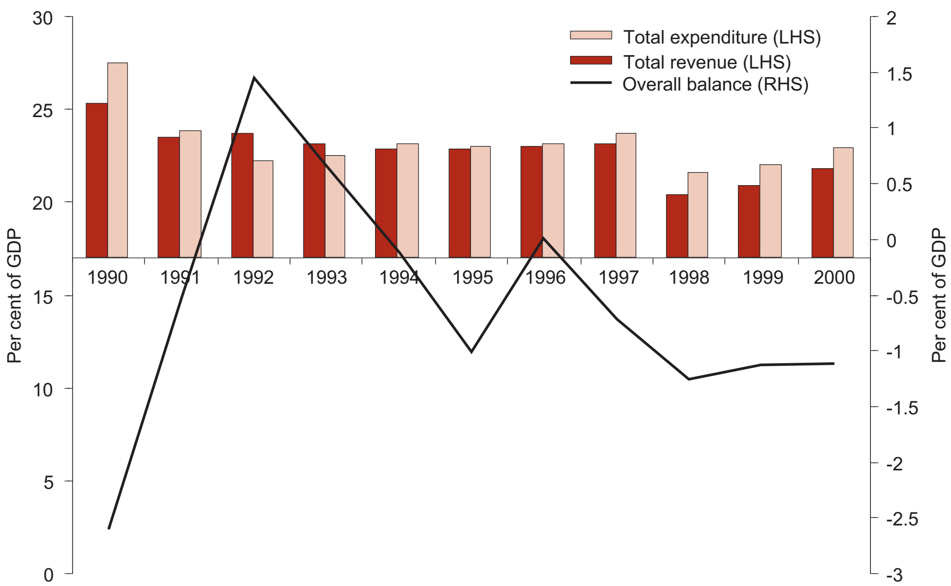
Fiscal Balance and Fiscal Debt

Moderate fiscal deficits and rapid repayment of long term, external public debt in the late 1990s caused gross public debt, as a ratio of GDP, to fall to 37 per cent in 2000. This compares to 60 per cent in the United States, 112 per cent in Italy and 20 per cent in Australia (Ministry of Finance, 2001a). Less public debt ultimately should boost private bank lending by reducing public sector crowding out. However, fiscal deficits increased in the second half of the 1990s. With private bank lending still contracting and domestic debt's share in total public debt rising from 30 per cent in 1990 to 44 per cent in 2000, public debt may need to fall further to stimulate bank lending to the private sector.

Figure 5.8

Deficits Increasing in Late 1990s

Government Revenue and Expenditure, Per cent of GDP



Source: Bank of Mexico, 2001; and Ministry of Finance, 2001b.

In the late 1990s and 2000, strong economic fundamentals and investor confidence allowed Mexico to refinance its public debt under improved terms. In 2000, Mexico lowered its overall debt burden, repurchasing US$7.8 billion of Brady Bonds by issuing new dollar denominated government securities.[13] In addition, the average maturity of domestic debt increased from 292 days in 1995 to 561 days in 1999 (Ministry of Finance, 2000a). Mexico continues to extend its debt maturity profile and reduce financing costs (Ministry of Finance, 2000b; and Ministry of Finance, 2000c).

Expenditure

Over the 1990s, Mexico avoided the expenditure blowouts Argentina and Brazil experienced. Government reduced expenditure in the early 1990s and in 1998. In the early 1990s, expenditure fell due to interest payments falling as a result of privatisation funded debt repayments. However, in 1998, reduced oil revenue drove cuts in government investment, which may restrain growth, given significant shortages of basic infrastructure (World Bank, 2000a).[14] Unlike in Brazil and Argentina, the Government contained public servants' wage and salary growth and transfers to state and municipal governments. However, as in Brazil and Argentina, social security transfers continue to expand as a share of government spending, and if not adequately addressed, could threaten fiscal balance (Figure 5.9).[15]

Revenue

The Government is highly dependent on profits from oil sales by the state owned oil company, which provide around 30 per cent of revenue. However, this narrow tax base caused public revenue as a share of GDP to shrink during the 1990s, particularly in 1998 when world oil prices weakened (Figure 5.10). The Government mitigates swings in revenue by raising petrol taxes when oil prices fall, but still to meet deficit commitments, when oil prices fall, expenditure also must fall. Hence in November 2000, with IMF backing, the government established the Oil Stabilisation Fund.[16]

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13 A Brady Bond is a consolidated, restructured debt obligation of a developing country, sponsored by the United States and at least partly collateralised by US Treasury obligations (IFCI Risk Institute, 1996).

14 Public investment fell from 2.6 per cent of GDP in 1997 to a low 1.9 per cent of GDP in 1998.

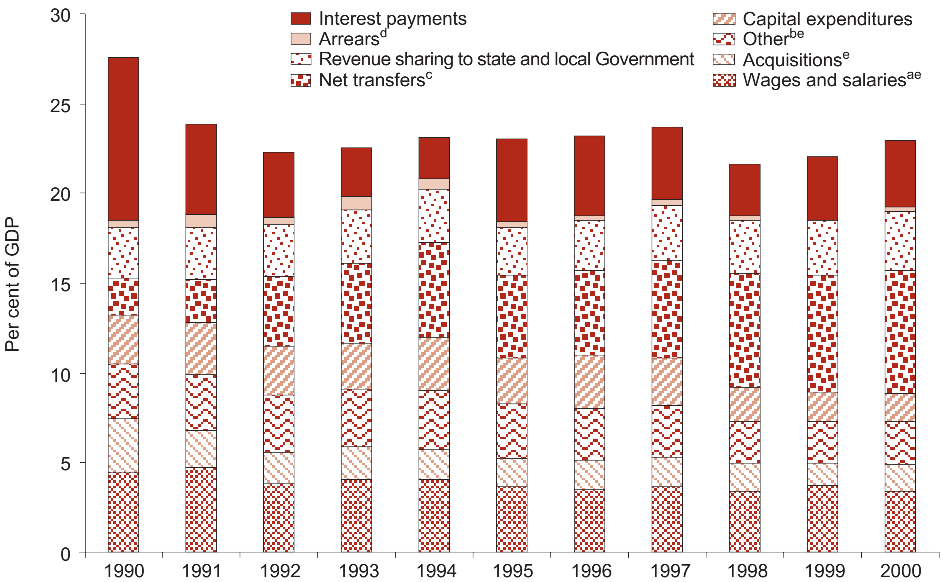
15 Over the 1990s, payments for wages and transfers to other levels of government contributed significantly to public expenditure. The government actually reduced wages and salaries from 4.7 per cent of GDP in 1991 to 3.4 per cent in 2000. Also, despite ongoing decentralisation and some state government bailouts, revenue sharing with the states and local government only increased from 2.8 per cent of GDP in 1990 to 3.3 per cent of GDP in 2000. Decentralisation in Mexico, unlike Brazil and Argentina, is not a major fiscal problem because the central Government controls budgeting, despite transferring responsibility for health, education and rural development to the states. In 2000, the central Government further avoided decentralisation driven expenditure blowouts by ceasing to collateralise state debt, imposing the same provisioning requirements on banks for lending to state and municipal governments as for private lending and establishing disclosure requirements for subnational borrowing (Giugale and Webb, 2000).

16 When oil prices are low, the fund will cover budget shortfalls; when oil prices are high, the fund will accumulate oil related budgetary revenues; resources above US$4 billion will be used for debt payments (Ministry of Finance, 2000c).

Figure 5.9

Interest Payments Lower, Pensions Growing

Main Components of Public Expenditure, 1990-2000, Per cent of GDP



Note: a Wages and salaries data exclude contributions to Social Security Institute for state employees.

b Other includes general services, extraordinary expenditures and direct taxes.

c Net transfers includes the Fund of Federal Contributions to states, municipalities and the federal district.

d Arrears includes the government's other net flows.

e Wages and salaries, acquisitions and other categories comprise current expenditures. Current expenditures along with capital expenditures and net transfers comprise programmable expenditures.

Source: Bank of Mexico, 2001; and Ministry of Finance, 2001b.

Necessary Fiscal Reform

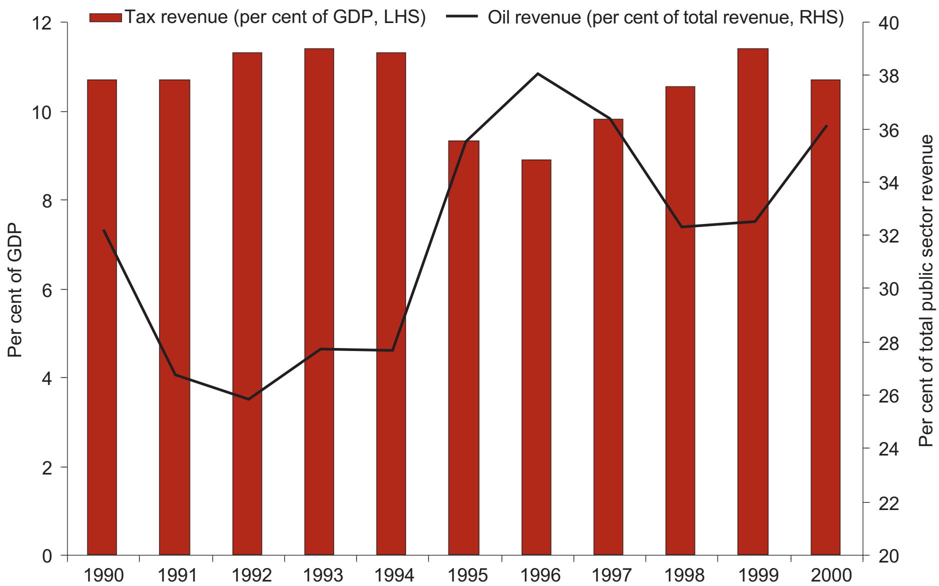
Mexico's fiscal position improved in the late 1990s; however, further desirable reforms include broadening the tax base, capturing the informal sector, reducing consumption subsidies and reorienting public investment to more efficient uses. Mexico's tax revenue share of 11.7 per cent of GDP, is well below average East Asian and Chilean levels of around 18 per cent; President Fox's pledge to raise the tax share of GDP to 17 per cent by 2004 addresses this weakness (Quintín, 2001).[17] Successfully passing these reforms would broaden the tax base and, by lowering some tax rates, may reduce incentives to evade taxes and work in the informal sector. However, congressional opposition is strong; further negotiations will occur in September 2001.

[17] In April 2001, the Government's tax reform bill proposed extending the 15 per cent value added tax, VAT, to medicines and food, (40 per cent of consumption) reducing maximum personal and corporate income tax rates to 32 per cent, increasing the tax free threshold from Pesos 44 000 to Pesos 50 000 (from US$4 585 to US$5 200) and simplifying procedures for calculating taxes. Other measures proposed include full, immediate tax deductions for the self employed's fixed capital investments, extending the private pension fund system to the self employed and creating a national mortgage facility for workers to construct and purchase homes.

Figure 5.10

Low Tax Revenue and Fluctuating Oil Revenue

Tax and Oil Revenues, 1990-2000, Per cent of GDP and Revenue



Source: Bank of Mexico, 2001; and Ministry of Finance, 2001b.

Mexico has reduced many subsidies, but electricity and water subsidies alone cost US$4.8 billion or around 1 per cent of GDP (OECD, 2000).[18] Residential and rural electricity tariffs cover only 39 per cent and 26 per cent of real supply costs; these subsidies also are regressive, as wealthier consumers capture most of the benefits.[19] Subsidies also encourage excessive consumption, in 1998-99, about half of all public sector investment was in state owned electricity and oil enterprises (OECD, 2000). With current constitutional constraints on private participation in these sectors, this generates major fiscal obligations. Huge oil and electricity sector investment demands crowd out essential spending on water supply, education and roads.[20]

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18 In the 1980s and 1990s, the Government gradually eliminated subsidised loans to industry, moved agricultural subsidies away from credit and marketing towards income transfers, and started to move from general consumer subsidies towards more targeted income transfers and food subsidies (OECD, 2000).

19 The wealthiest 30 per cent of Mexican families capture around 54 per cent of the benefits of the residential electricity subsidy, while the poorest 30 per cent receive only 8.7 per cent (Sarabia, 2001). For efficiency and welfare gains, targeted transfers should replace untargeted subsidies (OECD, 2000). Poorer farmers generally do not have access to reliable electricity supplies, while wealthier farmers are large consumers, capturing most of the benefits of the agricultural electricity subsidy.

20 Basic school building renovation and maintenance, and educational equipment requires around Pesos 20 billion, twice the 1998 education budget (OECD, 2000). Cuts in road and water reticulation spending left 14 per cent of the population in 1997 without access to safe drinking water and 27 per cent without a water treatment system.

BANKING SECTOR DEVELOPMENTS

Since the Mexican crisis, which revealed the insolvency regime offered creditors little protection, bank lending to the private sector has stalled, creating a serious credit crunch. However, new bankruptcy laws passed in mid 2000 should boost creditor protection. If courts effectively enforce the new law, the strong foreign presence in the banking system and other sectors provide the foundations for renewed lending growth.

Early Reforms

In the late 1980s, the government eased restrictions on bank operations in money and securities markets, deregulated deposit and lending rates, and eliminated mandatory credit allocations. In 1991 and 1992, large scale bank privatisations occurred and, following NAFTA accession in 1994, the Government raised the ceiling on foreign ownership from 30 to 49 per cent (OECD, 2000).

Mexican Crisis Banking Survival Measures

This liberalisation caused credit growth to boom in the early 1990s. However, as in Australia in the 1980s, authorities failed to recognise these credit controls performed a de facto prudential function; consequently, banks did not replace them with alternative risk management mechanisms. Ineffective prudential oversight, mismanagement and imprudent lending caused newly privatised banks' capitalisation to fall below safe levels and weakened the quality of their lending (OECD, 2000).

During the Mexican crisis, high interest rates and recession drove non-performing loans to 15 per cent of outstanding loans (Krueger and Tornell, 1999). With the peso's depreciation, Mexican banks also experienced problems meeting their short term, foreign debt obligations. Risk of a systemic collapse of the banking system forced the government to provide support to recapitalise banks and restructure loans costing over 14 per cent of GDP (Pesos 661.1 billion or US$69.6 billion) by the end of 1999.[21]

Recent Financial Sector Reforms

The Mexican crisis revealed serious weaknesses in prudential control and the Asian crisis demonstrated the potential for further financial crises; these drove further financial sector reforms in the late 1990s. In December 1998, Congress passed a reform package to stimulate banking sector recapitalisation and sound lending practices. It removed caps on foreign ownership; now Mexico's top three foreign banks are fully foreign owned, two by Spanish banks and one by Citigroup.[22] The package also

21 Support covered four main areas: banks converted loans to long term debt, at a fixed, indexed real interest rate, to support debtors; government took over the capital or management of deficient banks, closing them or reselling them after recapitalising them and cleaning up their bad loan portfolios; government subsidised the renegotiation of individual loans at lower rates and participating banks agreed to cease repossession and collection efforts; and remaining banks were recapitalised, including by transferring loans to the former deposit insurance fund in exchange for non-transferable ten year bonds.

22 As with the other Latin American economies, US and European firms are active in the banking sector. The recent US$12.5 billion acquisition of Mexico's number two bank, Grupo Financiero Banamex-Accival, Banacci, by Citigroup is the largest ever Latin American takeover by a US company and is worth almost as much as the total FDI Mexico attracted in 2000 (Business Monitor International, 2001).

created a new Institute for Bank Deposit Insurance, replacing the universal deposit insurance scheme with a limited guarantee scheme, and tasked it with selling non-performing assets accumulated from banks after the Mexican crisis. In September 1999, the Government also introduced new capitalisation and provisioning rules (OECD, 1999a).

After the crisis, the Government supported creating a futures market to hedge currency risk and promote financial market depth, liquidity and stability. In April 1995, the Chicago Mercantile Exchange began trading peso futures, and in November 1996, Mexico opened its first derivatives market, the Derivative Stock Exchange or MexDer (Meigs, n.d.).

Most importantly, in April and May 2000, Congress passed new bankruptcy and secured lending laws to eliminate pro-debtor bias. Becoming effective only in December 2000, the bankruptcy law has yet to be tested, but it is critical that its outcomes are quick and creditor friendly.

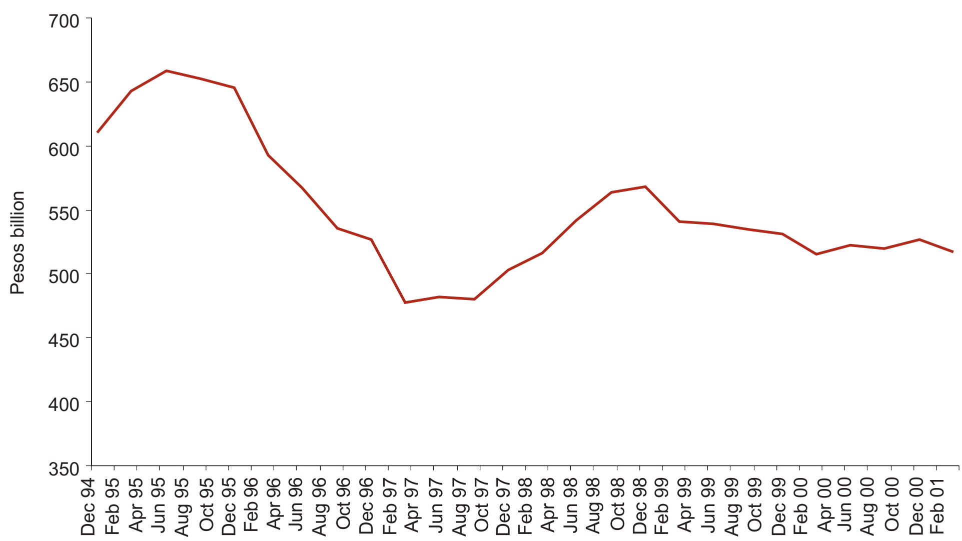
Bank Lending and Interest Rates

With private sector lending down by around 40 per cent in real terms since 1995, Mexico faces an ongoing credit crunch (World Bank, 2000a). Even in nominal terms, private sector bank credit is contracting (Figure 5.11).

Figure 5.11

Private Credit Still Falling

Private Sector Credit, Pesos billion, December 1994 to March 2001



Source: Bank of Mexico, 2001.

Nominal interest rates peaking at 50 per cent and still above 20 per cent, and real interest rates at just below 10 per cent and rising, restrain credit demand (Figure 5.12). Alternative credit sources, such as car manufacturers, department stores and non-bank financial institutions, and delayed bill payment also restrain demand. On the supply side, high levels of overdue loans due to inadequate creditor protection, risk aversion resulting from the Mexican crisis and high bank holdings of non-negotiable government bonds received in exchange for non-performing loans during the crisis, all limit bank willingness and ability to lend.

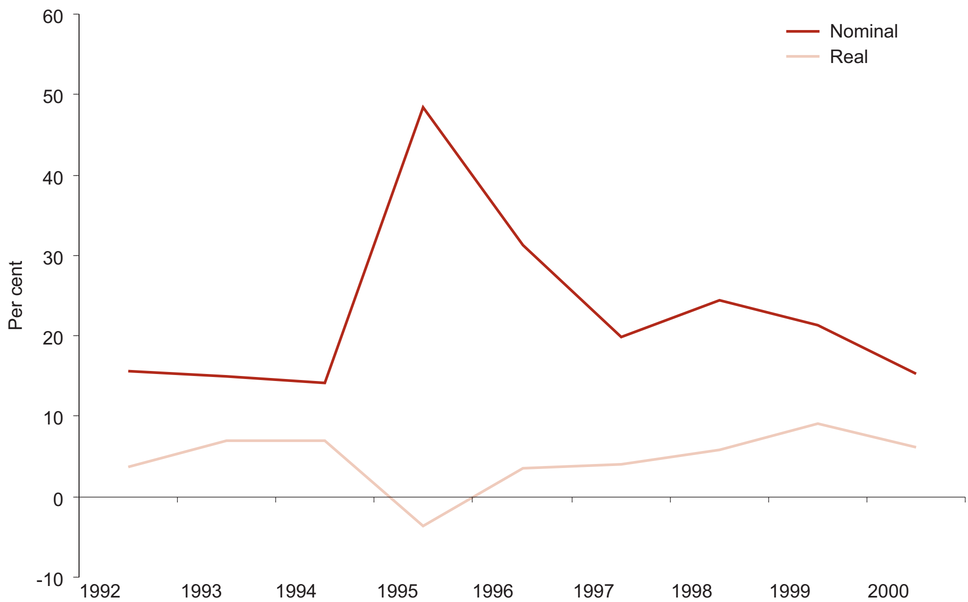
CAPITAL MARKETS

Mexican capital markets remain less developed than in other major Latin American economies. However, Mexico's recent promotion to investment grade credit ratings, and pension reforms, should stimulate these markets.

Figure 5.12

Real Interest Rates Rising, Nominal Rates Falling

Interest Rates, 1992-2000, Per cent



Note: Nominal interest rate is the rate on 28 day Cetes (government bonds).
Real interest rate is approximated by subtracting the inflation figure for a particular year from the interest rate figure.

Source: National Institute of Statistics, Geography and Informatics, 2001; Bank of México, 2001; and García and Martínez, 2001.

Equity Markets

Reflecting its relative shallowness, Mexico's stock market capitalisation as a ratio of GDP trails Brazil's and Chile's (Figure 5.13). Between 1999 and 2000, listings shrank 6.8 per cent, and a few large listings, such as TELMEX, dominate the market.[23] Nonetheless, if Standard and Poor's joins Moodys in giving Mexico an investment grade credit rating, this may boost the Mexican stock market as US pension funds could invest in Mexican securities.[24] Passage of initiatives to increase penalties for insider trading and protect minority shareholders also should increase equity market confidence and activity.

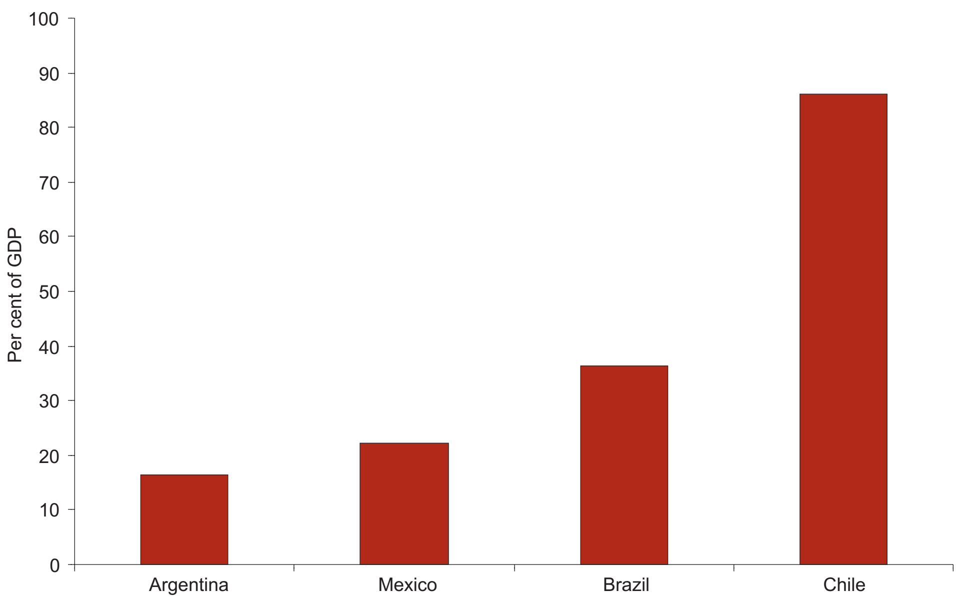
Bond Markets

Mexico's local bond market also is less developed than other major Latin American economies' markets but bond listings have grown from US$9 billion in 1995, to US$14.1 billion in 1999 (Iberoamerican Federation of Stock Exchanges, 2000). However, 83 corporate bonds are listed on Mexico's stock exchange, while in Argentina, an economy half Mexico's size, 116 corporate bonds are listed; Mexico lists 26 government bonds compared to 126 in Argentina (Iberoamerican Federation of Stock Exchanges, 2000). In 2000, the Government issued three and five year, peso denominated, fixed rate government bonds. Apart from lengthening the maturity of public debt, this established a benchmark yield curve, encouraging the corporate bond market.

Figure 5.13

Mexican and Argentinian Stock Market Capitalisation Low

Stock Market Capitalisation, 2000, Per cent of GDP



Source: Federation of International Stock Exchanges, 2001; and Economist Intelligence Unit, 2001.

23 In 2000, nine companies accounted for 61 per cent of market capitalisation and 66 per cent of market trading (Federation of International Stock Exchanges, 2001).

24 Moodys upgraded Mexico's foreign sovereign currency credit rating to investment grade in March, 2000. Congressional approval of fiscal reform should induce Standard and Poor's to award an upgrade.

Pension Reform

In mid 1997, the Government introduced a new, fully funded pension system including life insurance, retirement, housing and medical care. Individual, employer and government contributions are compulsory, and private fund managers manage individual pension accounts. Employees or employers also can make voluntary contributions. As the average annual real rate of return on pension funds was almost 10 per cent in the three years to 2000, this could increase savings in future (OECD, 2000). Gross domestic savings as a share of GDP was 20.3 per cent in 1999.

By December 1999, pension fund managers had 15.6 million workers registered and US$19.5 billion under management (OECD, 2000). Around half of these funds correspond to retirement funds, and specialised pension funds invest them in financial markets. About 38 per cent of retirement funds were in long term financial instruments, deepening capital markets.

Pension reform also encourages companies to get AAA credit ratings, a prerequisite to receive pension fund investment. In time, institutional investors managing pension funds should increase significantly the availability of long term domestic investment financing for infrastructure and other projects. However, to date, restrictions limiting fund managers to investments in low risk domestic bonds have tempered benefits to bond markets, as at least 65 per cent of funds are invested in government securities (Villaseñor, 2000).

ACHIEVEMENTS AND PROSPECTS

Bolstered by high oil prices and US growth, Mexico's economy performed strongly in 2000, with real GDP growth of 6.9 per cent and inflation at its lowest level since 1994. However, in 2001, the US slowdown and lower oil prices will decelerate growth, with the Government now targetting a rate of 2.0 to 2.5 per cent. Over the medium term, Mexico's deepening integration with the wealthy, dynamic US market should be a source of great strength. Continuing integration should discipline Mexico's inflation, fiscal and debt servicing performance, and encourage ongoing reform. However, government attempts to diversify export and import markets are wise, to prevent excessive links to the US economic cycle.

Further structural reforms, particularly in energy markets and taxation, are needed to maximise these opportunities. Reform prospects depend on President Fox's political resolve and ability to foster non-partisan coalitions, as he faces a divided, highly partisan, and at times, unpredictable Congress. The nearly unanimous approval of the federal budget in December 2000 bodes well; for the first time in three years, Mexico's three political parties agreed on a revenue bill. Opposition party support necessitated additional expenditures but similar negotiated outcomes on energy and taxation could deliver valuable reform.

For Australian exporters and investors, Mexico's robust growth and ongoing institutional reform should generate expanding opportunities in a range of sectors. These are discussed in the following chapter.

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TRADE AND INVESTMENT OPPORTUNITIES IN MEXICO

KEY POINTS

- **Mexico's participation in several free trade agreements, FTAs, particularly the North American Free Trade Agreement, NAFTA, and the booming bonded export, or *maquiladora*, sector drove Mexico's rapidly growing trade in the 1990s.**

- **However, Mexico's liberalisation on a most favoured nation basis has been disappointing, with simple average tariffs rising, although trade weighted average tariffs, including for NAFTA, fell over the last decade.**

- **While Australia's trade with Mexico is small, it is growing rapidly, averaging 29 per cent per year since 1996. With rapid, NAFTA-driven industrialisation and income growth, trade opportunities are expanding to supply a wide range of commodities, manufactures, mining and agribusiness supplies and services.**

- **Distance and Mexico's close ties to the United States limit Australia's market penetration to date; Mexico's numerous FTAs also penalise Australian exporters.**

- **Australian investment is likely to focus on manufacturing to access the local and NAFTA market. Mexico's open mining regime also provides opportunities, as do agriculture and services.**

- **Mexico's network of FTAs and ability to minimise costs by splitting production between Mexico and the United States, makes Mexico an attractive production site.**

Mexico's trade is booming due to NAFTA (the US-Canada-Mexico FTA), making Mexico the world's twelfth largest trading nation. To diversify trade beyond NAFTA and improve access to key markets, Mexico continues to enter FTAs with the EU and many Latin American countries. (See Chapter 12 - *Regional Integration*.) While Australia's export successes include starch and gluten, and a recent coal contract, Mexico's FTAs impose tariff discrimination against non-partners, increasing the challenge for Australia's exporters to Mexico. On the other hand, closer integration of the Mexican and US markets makes Mexico a prospective Australian manufacturing investment destination.

This chapter highlights trade and investment opportunities, and challenges for Australian business in Mexico. It briefly analyses Mexico's import and export growth patterns over the 1990s, including key Mexican merchandise imports, and drivers of import growth. It assesses bilateral trade flows between Australia and Mexico, and analyses Australian direct investment in the context of Mexico's wide ranging foreign direct investment, FDI, liberalisation and large FDI inflows. It then draws out major potential trade and investment opportunities in manufacturing, mining, agriculture, agribusiness, infrastructure and services.

EXPORT AND IMPORT GROWTH PATTERNS

Mexico's total trade in 2000 was US$340.8 billion or 59 per cent of GDP (Secretaría de Comercio y Fomento Industrial, 2001a).[1] Since 1990, Mexican export growth has averaged over 20 per cent per year, and import growth is only slightly less at 19 per cent (Figure 6.1). Exports have grown uninterrupted; imports weakened only during the 1994-95 Mexican crisis.

Exports and imports from Mexico's booming duty exempt manufacturing, *maquiladora*, sector drive trade growth; their share of exports continues to grow, but their share of imports is levelling off (Figure 6.2).

KEY DRIVERS OF IMPORT TRENDS

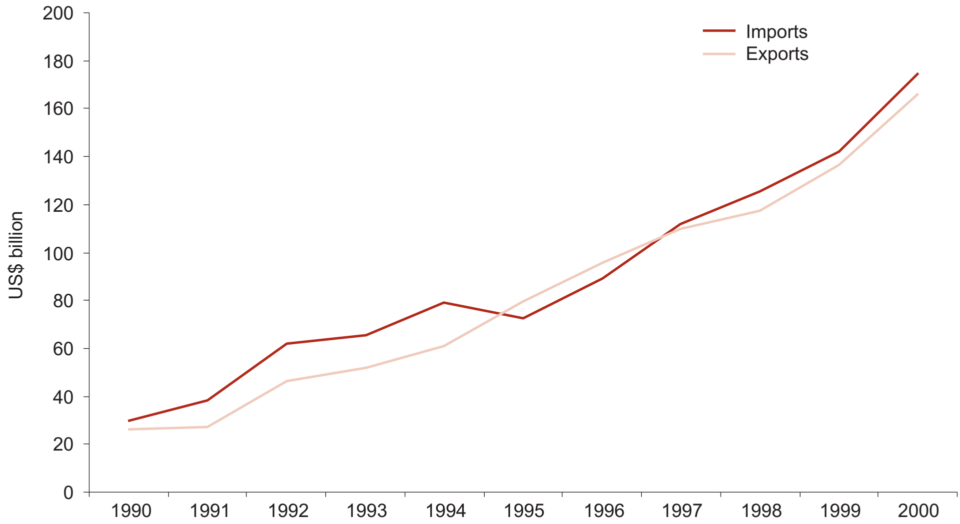
Bilateral trade agreements and the *maquiladora* sector drive Mexican import trends. Multilateral liberalisation has not produced change, with simple average most favoured nation, MFN, tariff rates rising.

[1] Trade figures include *maquiladora*, or in-bond, industry trade. In-bond plants could import inputs duty free so long as they exported their output. In 2001, this arrangement was changed.

Figure 6.1

Mexico's Trade Growing Strongly

Mexican Exports and Imports, 1990-2000, $US billion

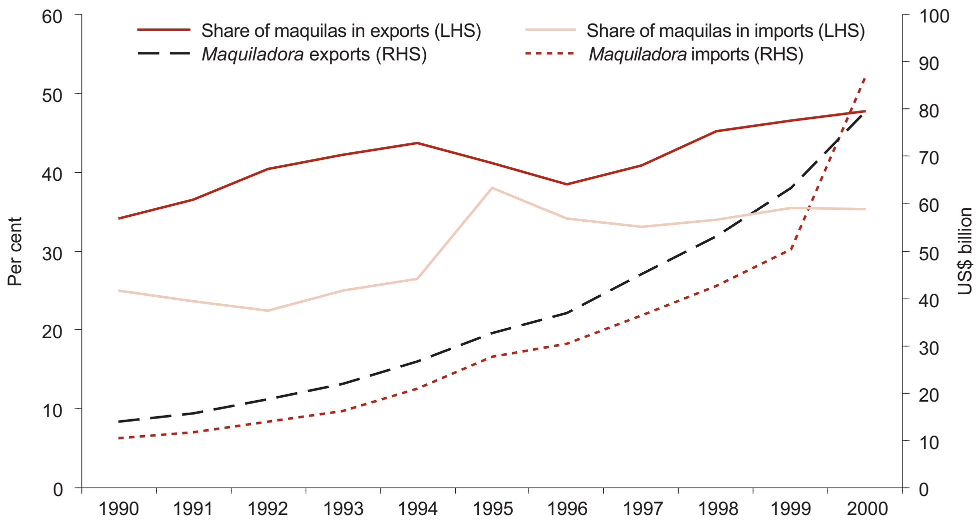


Source: International Monetary Fund, 2001a.

Figure 6.2

Maquiladora Trade Surging

***Maquiladora* Exports and Imports, and Share in Total Trade, US$ billion and Per cent**



Source: International Monetary Fund, 2001; and National Institute of Statistics, Geography and Informatics, 2001a.

Bilateral Trade Agreements

Mexico's 11 FTAs, covering 32 countries in three continents, stimulate trade growth, while its 17 bilateral investment treaties covering mainly European countries and the Republic of Korea are designed to encourage investment (Smith, 2001).[2] Australia does not have an FTA nor a tax agreement with Mexico. NAFTA, which Mexico joined in 1994, is the key agreement influencing import and export growth. This agreement also helped raise many trade and investment policy standards towards US levels. Other major developments include signing an FTA with Chile in 1998 and with the EU in 2000. In December 1999, Uruguay and Mexico signed an Executive Agreement that may set the stage for a future FTA through which Mexico could access Mercosur.[3]

Maquiladora Industry Growth

The *maquiladora* industry is flourishing. In 1999, 4 636 Mexico based bonded plants employed over 1.25 million workers; these generate a significant part of Mexico's trade growth (Mexican Investment Board, 2000).[4] Between 1990 and 2000, *maquiladora* exports growth averaged 19 per cent per year, while their imports grew by 22 per cent.[5] *Maquilas* imported raw materials, parts and components, accounting for 36 per cent of all raw material imports in 1999 (National Institute of Geography and Statistics, 2001).

FTAs also boosted *maquiladora* imports. Under NAFTA rules of origin, inputs sourced in NAFTA partner countries entered Mexico duty free, providing the Mexican assembled final product was re-exported to a NAFTA country. Thus, the United States shipped automotive parts to Mexico; Mexico assembled them into cars and re-exported them to the United States. Similar patterns occurred in textiles and clothing. These requirements clearly favoured NAFTA partners over non-NAFTA countries.

However, at the end of 2000, NAFTA required Mexico to terminate the *maquiladora's* duty free status. As compensation, Mexico implemented sectoral promotion programs so companies could import inputs from anywhere in the world at very low tariffs, provided they used them in the companies' sector of operation (Secretaria de Comercio y Fomento Industrial, n.d.). Qualifying capital goods enter duty free, while raw materials carry either a zero or 5 per cent tariff. Consequently, strong growth in *maquiladora* imports should continue.

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2 This includes agreements with North America, the EU, other Latin American countries and Israel.

3 Mexico recently completed an agreement with Brazil covering the car sector.

4 Bonded plants can import inputs duty free so long as they export their output.

5 In 1999, the in-bond industry imported US$50.5 billion worth of intermediate goods and produced US$63.8 billion in manufactured exports, thus adding US$13.3 billion worth of value domestically, more than double the pre-NAFTA levels (National Institute of Geography and Statistics, 2001b; and Naftaworks, n.d.).

Multilateral Trade Liberalisation

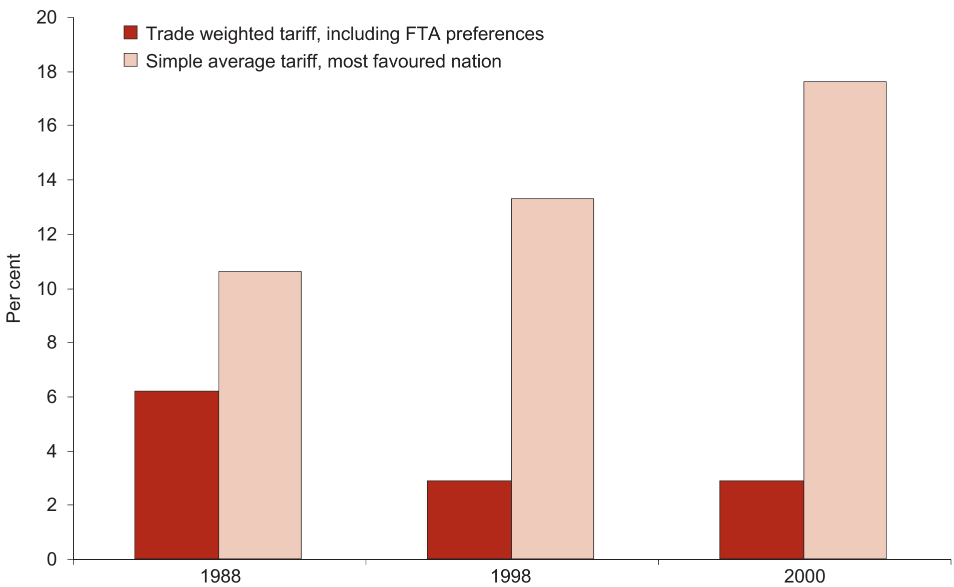
Mexico liberalised its trade regime after following a highly restrictive policy for several decades. It liberalised trade substantially after the 1982 debt crisis. Mexico's entry to the General Agreement on Tariffs and Trade, GATT, (now the World Trade Organization) in 1986 hastened reform and trade policy became an integral part of economic stabilisation. By 1988, the simple average tariff was down to 9.7 per cent and the trade weighted average tariff was down to 6.2 per cent, and by 1989, tariff lines requiring licences had shrunk from 100 per cent to 14 per cent (OECD, 1996).

Despite Mexico entering the GATT, Mexico's simple average tariffs actually rose between 1988 and 1998 even though trade weighted tariffs fell (Figure 6.3). This indicates that after joining NAFTA in 1994, internal NAFTA tariff rates dropped to virtually zero, and imports from United States exploded, but most favoured nation tariffs facing non-FTA partners actually increased; in 2000, these duties ranged from zero to 35 per cent (Economist Intelligence Unit, 2001).

Figure 6.3

Average Tariffs Rose in Late 1990s

Mexico's Trade Weighted and Simple Average Tariffs, 1988, 1998 and 2000



Notes: Trade weighted data are from Asia Pacific Economic Cooperation, 2000; and Economist Intelligence Unit, 2001; 1988 and 1998. Simple average tariff data are from Honggue, 2000; and 2000 data are from Department of Foreign Affairs and Trade, 2001a.

Source: Department of Foreign Affairs and Trade, 2001a; Asia Pacific Economic Cooperation, 2000; Economist Intelligence Unit, 2001; and Honggue, 2000.

MAJOR MERCHANDISE IMPORT TRENDS

NAFTA and the *maquiladora* boom shifted Mexico's import structure even more strongly towards manufactures. In 1990, manufactured goods represented 65 per cent of imports. By 1999, boosted by 22 per cent average annual growth, manufactures' share of imports reached 88 per cent, as rapidly expanding *maquiladoras* demanded more industrial inputs.

Primary products only comprised 9 per cent of Mexico's imports in 1999, down from 24 per cent in 1990. However, after being flat in the early 1990s, commodity imports grew, averaging a healthy 13 per cent per year between 1995 and 1999, rising from US$8.4 billion in 1995 to US$13.6 billion in 1999 (Figure 6.4).

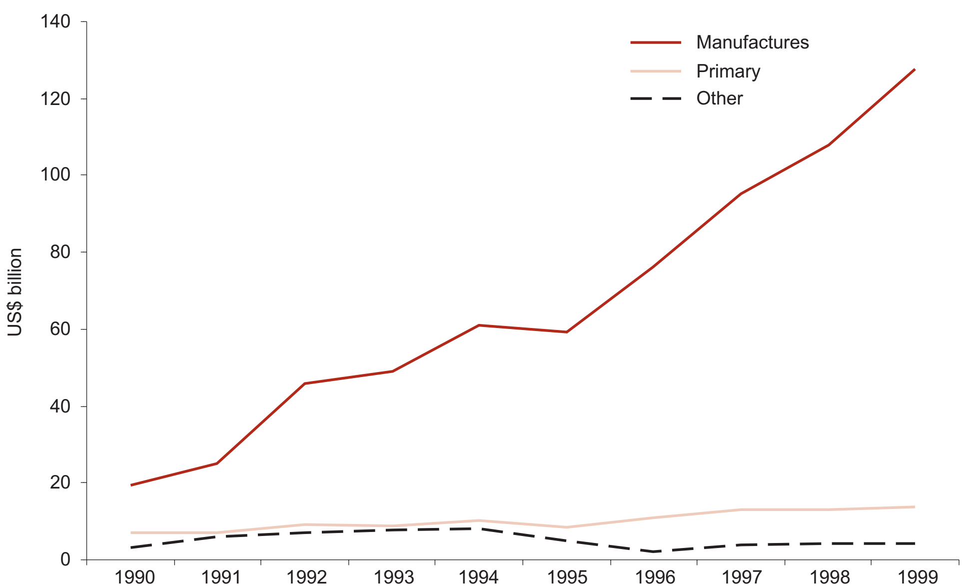
ETMs

Within manufacturing, elaborately transformed manufactures, ETM, imports are the main growth area. ETMs comprised 91 per cent of manufactured imports in 1999 and grew at an annual average rate of 24 per cent between 1995 and 1999.

Figure 6.4

Most Mexican Imports Are Manufactures

Mexican Imports by Major Commodity Group, 1990-99, US$ billion



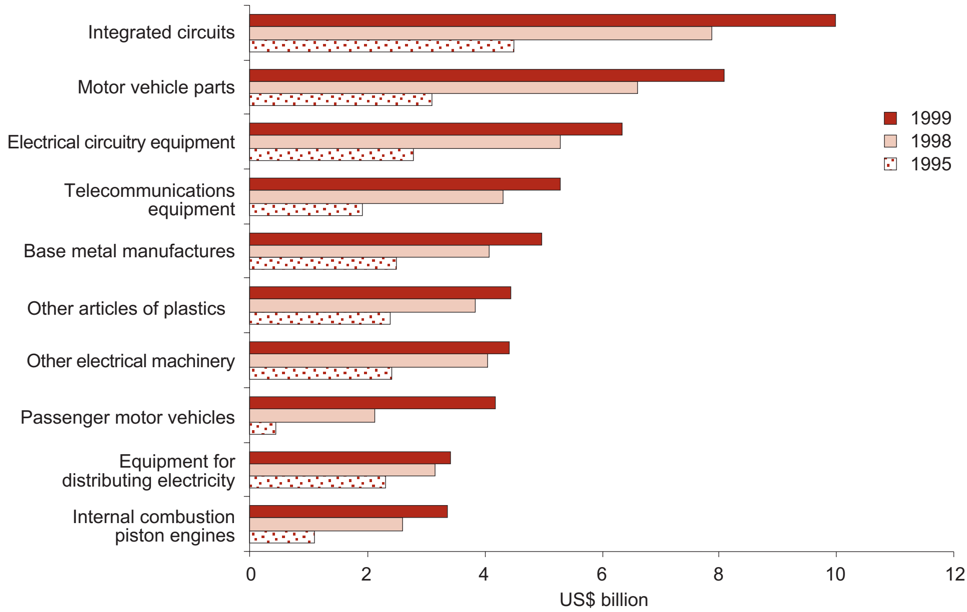
Source: Department of Foreign Affairs and Trade, 2001b.

In 1999, Mexico's top ETM imports by value included integrated circuits, automotive parts, electrical equipment for circuits and telecommunications equipment (Figure 6.5). These imports were mainly parts for use in Mexico's assembly operations.

Figure 6.5

Parts and Circuits Major ETM Imports

Mexico's Top Ten ETM Imports, 1995, 1998 and 1999



Source: Department of Foreign Affairs and Trade, 2001b.

Australia exports many of the other Mexican ETM imports which grew rapidly between 1995 and 1999 (Table 6.1).

STM Imports

Imports of simply transformed manufactures, STMs, were flat between 1990 and 1995, but grew at an annual average rate of almost 15 per cent between 1995 and 1999, as economic performance improved and NAFTA stimulated trade and income growth, and Mexico's industrialisation deepened. Main STM imports include paper and paperboard, aluminium, chemical products and hydrocarbons (Figure 6.6).

Table 6.1

Medicines, Tools and Instrument Imports Growing Strongly

Other Fast Growing ETM Imports, 1995-99

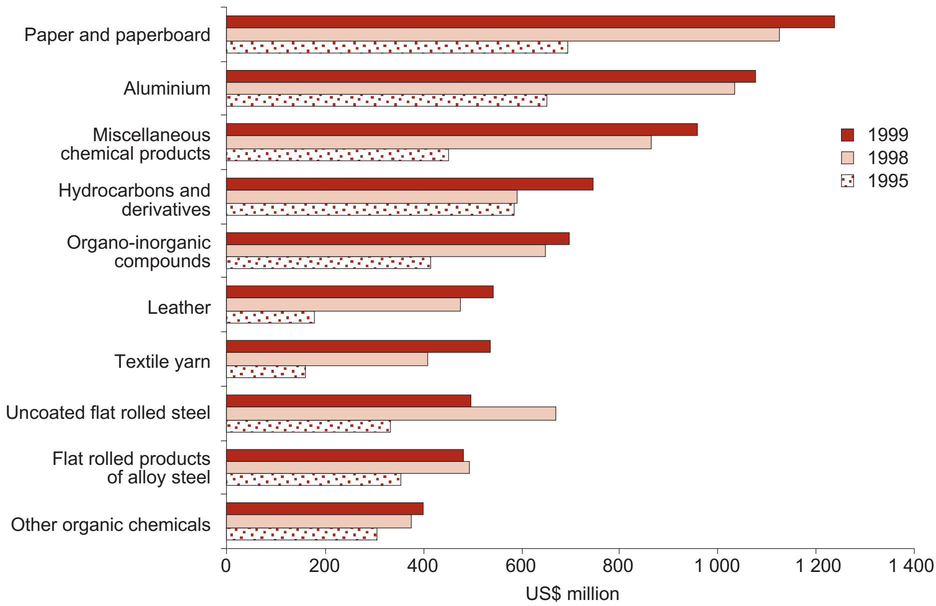
	Annual average growth, 1995-99 (per cent)	1999 Import level (US$ billion)
Medicines	33	0.64
Hand and machine tools	29	0.81
Copper	26	0.74
Computer parts	22	1.6
Measuring and controlling instruments	22	2.2
Heating and cooling equipment	22	1.3

Source: Department of Foreign Affairs and Trade, 2001b.

Figure 6.6

STMs Also Growing Strongly

Mexico's Top Ten STM Imports, 1995, 1998 and 1999



Source: Department of Foreign Affairs and Trade, 2001b.

Primary Imports

Primary product imports are growing more slowly than manufactures, but in the second half of the 1990s, major primary imports still grew at an annual average rate of 13 per cent or more (Figure 6.7). Other commodities of interest to Australia that grew rapidly between 1995 and 1999 included copper ore and beef (Table 6.2). This broad range of rapidly growing primary imports offers Australia many opportunities to expand its exports. However, preferential trading provisions governing resources could dampen some prospects.

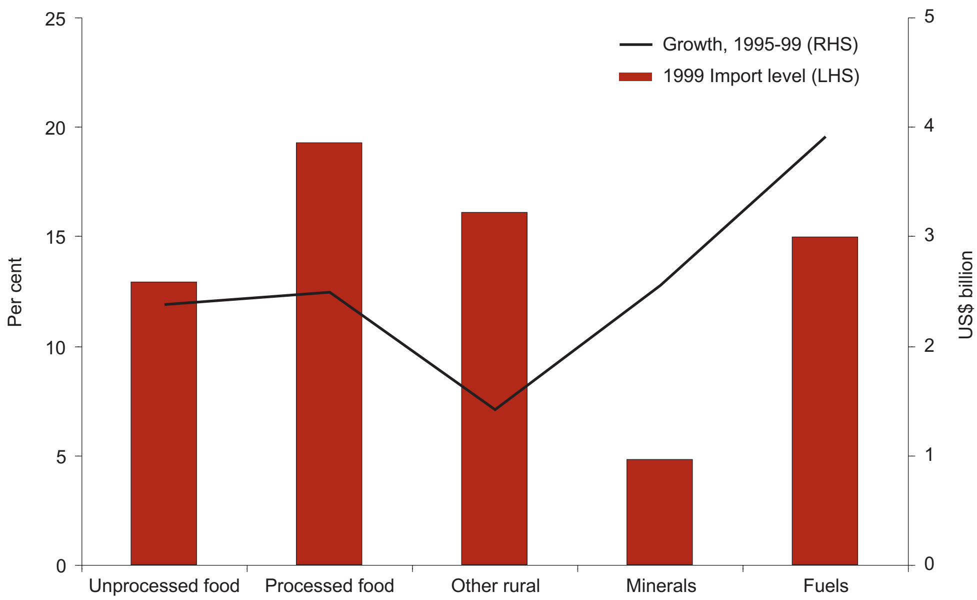
Major Import Sources

The United States is Mexico's dominant trading partner; in 1999, it absorbed 89 per cent of Mexico's exports and supplied 73 per cent of its imports (Secretaría de Comercio y Fomento Industrial, 2001a). The United States' size, geographical proximity and preferential treatment under NAFTA confer huge competitive advantages. Japan is Mexico's second largest import source (Figure 6.8).

Figure 6.7

Primary Import Growth Broadly Based in Late 1990s

Primary Imports by Broad Category, 1995-99, Growth and 1999 Level, Per cent and US$ billion



Source: Department of Foreign Affairs and Trade, 2001b.

Table 6.2

Copper, Iron Ore, Beef and Cheese Imports Growing Strongly

Other Fast Growing ETM Imports, 1995-99

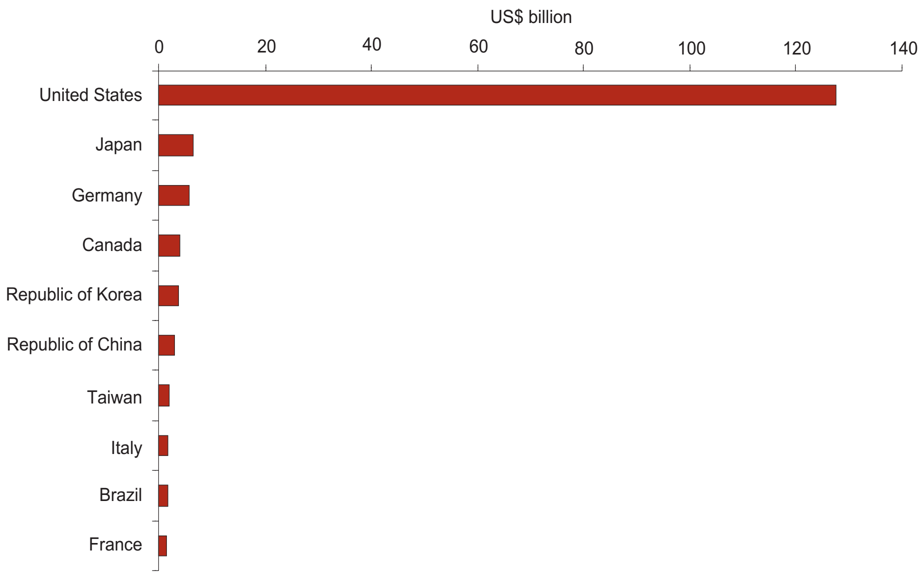
	Annual average growth, 1995-99 (per cent)	1999 Import level (US$ billion)
Copper ores	83.7	215
Bovine meat	55.7	591
Liquefied propane and butane	47.1	323
Live animals	41.4	192
Hides and skins	24.0	187
Iron ore	21.8	75
Cheese and curd	20.6	99

Source: Department of Foreign Affairs and Trade, 2001b.

Figure 6.8

United States Supplies Most Mexican Imports

Top Ten Mexican Import Sources by Economy, 2000



Source: Secretaría de Comercio y Fomento Industrial, 2001c.

The FTA with the EU may boost trade with EU nations, particularly Germany, France, and Spain. However, proximity, economic complementarity and NAFTA will ensure the United States dominates Mexican trade.

TRENDS IN AUSTRALIAN EXPORTS TO MEXICO

Since 1996, Australian merchandise exports to Mexico increased rapidly, averaging 29 per cent per year to reach A$339 million by 2000, making Mexico Australia's second largest Latin American trading partner after Brazil. Mexico exported goods and services worth A$455 million to Australia, making two-way trade A$794 million. However, a considerable share of two-way trade actually occurs via the United States; this may have boosted 2000 bilateral trade to A$1 billion (Hamilton, 2001). In 2000, Mexico was only Australia's thirty fourth largest export market, and Australia was Mexico's twenty sixth largest import supplier, supplying only 0.2 per cent of its imports (Secretaria de Comercio y Fomento Industrial, 2001a).

Primary Product Exports

Primary commodities dominate Australia's exports to Mexico, with A$248 million or 73 per cent of total exports (Figure 6.9). Primary exports grew at an annual average rate of 29 per cent between 1990 and 1994 due to GDP growth. After the implementation of NAFTA and the Mexican crisis in 1994-95, Australia's primary exports to Mexico fell by 69 per cent compared to manufactures falling by 43 per cent; however, between 1996 and 2000, primary exports again grew rapidly, averaging an annual rate of 31 per cent (Figure 6.9).[6] This was well above the average growth of Mexico's primary imports from all sources.

In 1999, Australian primary exports to Mexico grew by only 2 per cent, due to higher tariffs on non-FTA trading partner imports.[7] However, primary products' export growth rebounded to 18 per cent in 2000.

In 2000, Australia's top ten primary export items to Mexico were diverse and included meat, wool, coal, dairy products, oilseeds and livestock (Figure 6.10). In 2000, Australian commodity exports growing most rapidly were fresh vegetables (up 422 per cent to A$4 million), milk and cream (up 207 per cent to A$29 million), bovine meat (up 78 per cent to A$21 million), non-bovine meat (up 57 per cent to A$61 million), wool (up 55 per cent to A$38 million), coal (up 20 per cent to A$35 million), live animals (up 37 per cent to A$13 million) and cheese and curd (up 16 per cent to A$9 million).

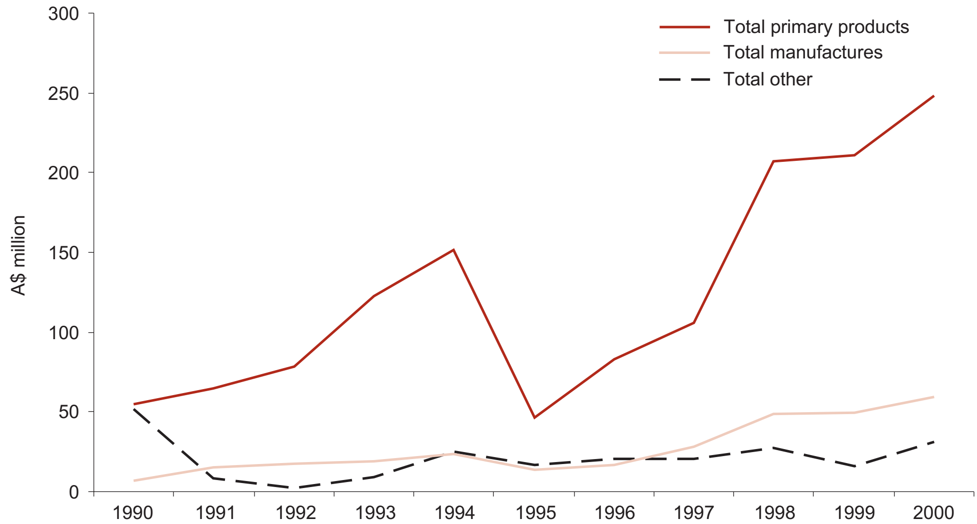
6 In 1995, total Mexican manufactured imports fell by 3 per cent while primary imports fell by 19 per cent.

7 In January 1999, Mexico imposed an additional 3 per cent tariff on capital and intermediate goods, and a 10 per cent tariff on specific consumer items from non-FTA partners (TradeWatch, 2000a). This hit Australian exports, including butter, milk and cream, wool and coal. As of January 2001, Australian wool is exempt from this 3 per cent temporary tariff.

Figure 6.9

Primary Products Dominate Australian Exports to Mexico

Australian Exports to Mexico by Major Commodity Group, 1990-2000, A$ million

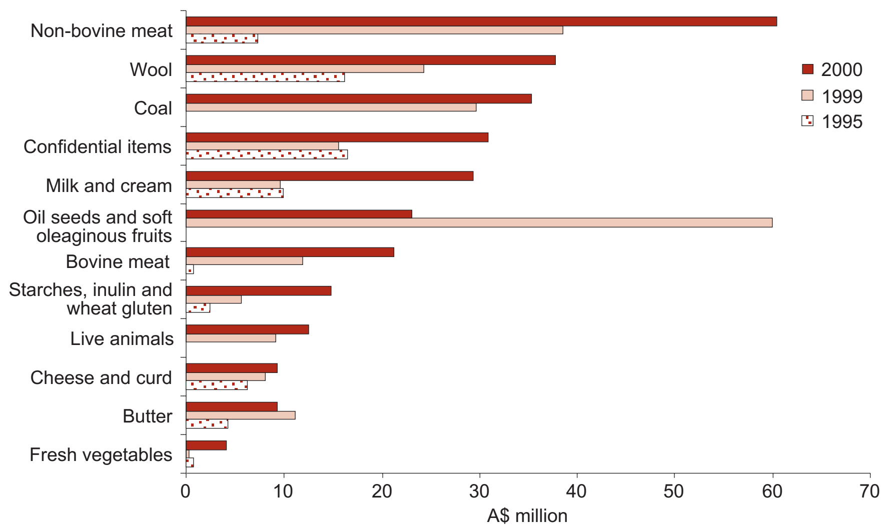


Source: Department of Foreign Affairs and Trade, 2001b.

Figure 6.10

Australia's Primary Exports to Mexico Diverse

Top Australian Export Items to Mexico, 1995, 1999 and 2000



Source: Department of Foreign Affairs and Trade, 2001b.

Trends in Manufactures

Australia exported to Mexico manufactures worth A$59 million in 2000, up from only A$14 million in 1995. In 2000, some exports grew exponentially, with other electrical machinery reaching A$6.9 million (up over 2 000 per cent), automotive parts reaching A$6.7 million (up over 5 000 per cent) and medicines reaching A$3.7 million (up 238 per cent) (Figure 6.11). However, Australia's major manufactured export was starches, inulin and wheat gluten, which grew 159 per cent, reaching A$14.9 million.

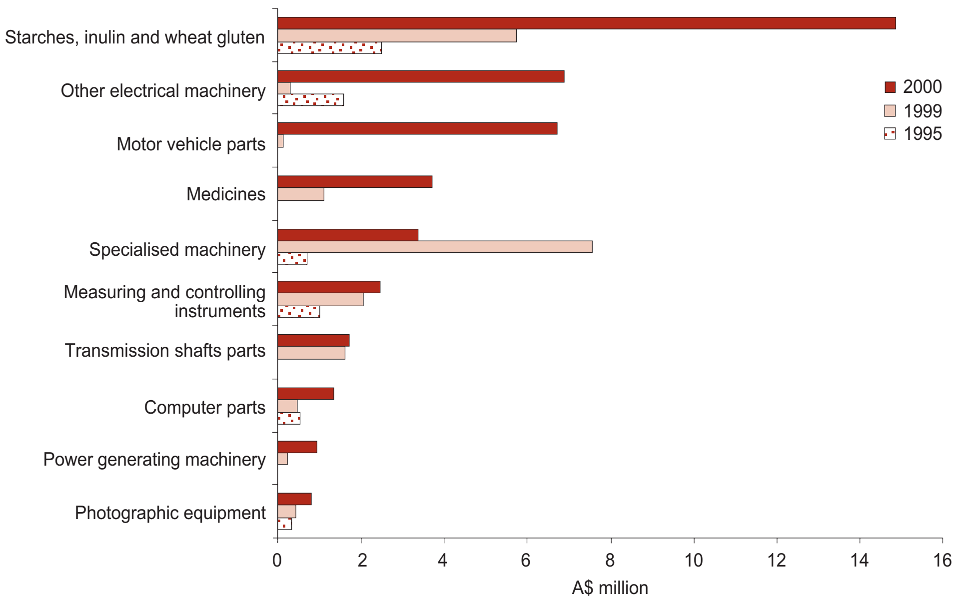
FDI REFORMS, DIRECTION AND TRENDS

Mexico's liberal FDI regulations, preferential access to North America and Europe, and proximity to Latin America make it highly attractive for FDI. FDI inflows to Mexico have increased dramatically in the 1990s.

Figure 6.11

Starches, Inulin and Wheat Gluten Major Manufactured Exports

Top Ten Australian Manufactured Exports to Mexico, 1995, 1999 and 2000



Source: Department of Foreign Affairs and Trade, 2001b.

FDI Liberalisation

Between 1993 and 1998, the Mexican Government significantly eased foreign investment restrictions. It eliminated performance requirements, exchange controls and profit repatriation restrictions, and permitted foreign investment in most sectors. However, FDI restrictions still apply to:

- 11 strategic, state reserved sectors, including petroleum and hydrocarbons, electricity, nuclear energy generation and radioactive minerals
- six sectors reserved for Mexican nationals, including radio and television broadcasting (other than cable television), domestic passenger land transport, tourism and freight, retail petrol sales and liquefied petroleum gas distribution
- 24 sectors permitting only minority (49 per cent) foreign investment, including domestic air transport, leasing, retirement funds management and newspapers
- 12 sectors, including cellular telephony, petrol pipeline construction, petroleum and gas well drilling, and insurance, for which majority foreign investors must seek approval. For example, the National Foreign Investment Commission must pre-approve majority participation in insurance; however, it approves around 95 per cent of these requests (National Foreign Investment Commission, 2001).

FTAs

Mexico's FTAs give Mexican based companies preferential access to North, South and Central America, as well as Europe and the Middle East, subject to relevant rules of origin. NAFTA significantly influences FDI patterns. Between 1994 and 2000, lower labour costs and preferential access to the North American market annually attracted 23 per cent of FDI inflows to the *maquiladora* sector. Consequently, this sector now employs almost 20 per cent of Mexico's FDI stock.

As worldwide production rationalisation continues, FTAs enhance Mexico's prospects of becoming a regional or global production base. For example, Kodak now produces all its high quality x-ray and graphic art film in Guadalajara, Mexico, for worldwide shipping.

FDI Flows

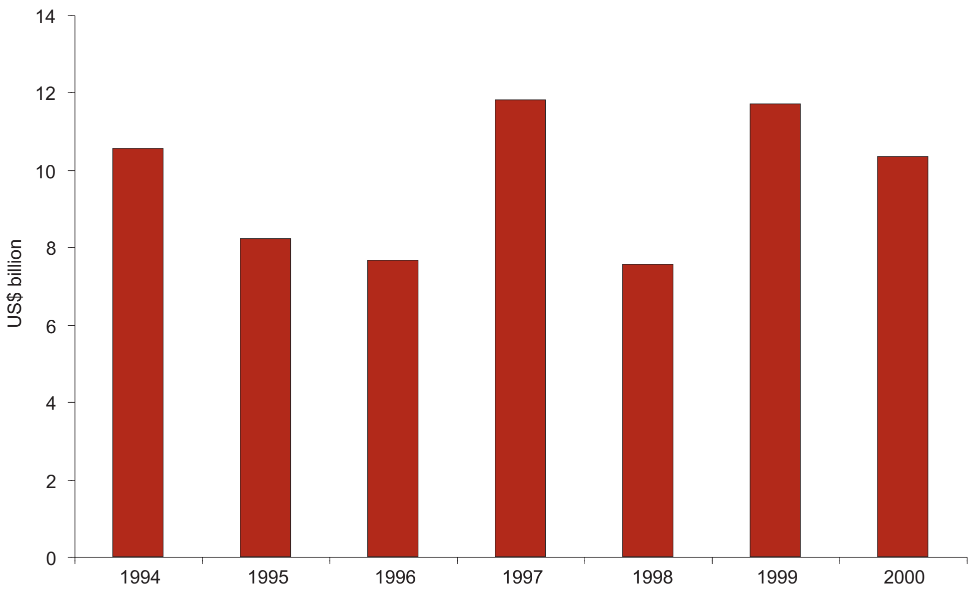
Between 1994 and 2000, Mexico attracted an average of US$9.7 billion per year in FDI (Figure 6.12). In 1999, Mexico's FDI inflow of US$11.7 billion was emerging markets' fifth largest, and Latin America's third largest, after Brazil and Argentina. Mexico is set to become Latin America's second most attractive FDI destination, as inflows into Argentina may drop in 2000 and 2001, due to its ongoing crisis (Secretaria de Comercio y Fomento Industrial, 2001c; and United Nations Conference on Trade and Development, 2000).[8]

8 Among emerging markets, Mexico ranked fifth in FDI inflows behind China (US$40.4 billion), Brazil (US$31.4 billion), Argentina (US$23.5 billion) and Hong Kong (US$23.1 billion).

Figure 6.12

FDI Strong but Volatile

Mexican FDI Inflows, 1994-2000



Note: Data are official statistics from the National Registry of Foreign Investment in the Ministry of Economics. Data before 1994 are not available due to changes in methodology.

Source: Secretaria de Comercio y Fomento Industrial, 2001c.

Source Countries for FDI

The United States owns 63 per cent of Mexico's FDI stock. European companies also have a strong presence, led by the Netherlands with 8 per cent of FDI stock in 2000. Japan's share of 4.4 per cent includes large, globally focused electronics factories (Secretaría de Comercio y Fomento Industrial, 2001c) (Figure 6.13). Australia presently has a negligible share of Mexico's FDI.

FDI BY SECTOR

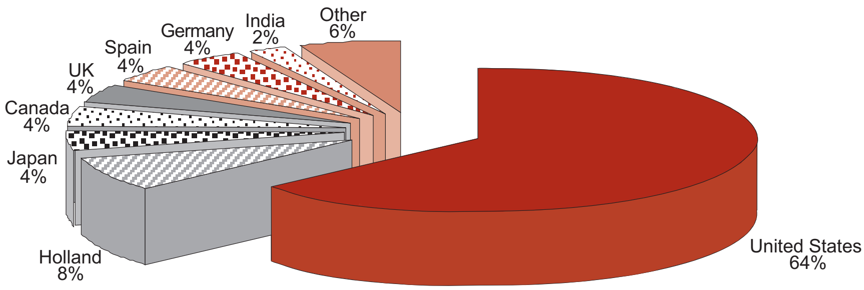
Most FDI goes to manufacturing, then services (Figure 6.14). Manufacturing attracted 63 per cent of FDI flows between 1994 and 2000, with FDI ranging from US$4.7 billion in 1996 to US$8.6 billion in 1999. The export-oriented *maquiladoras* attract most manufacturing FDI.

Financial services and commerce attract most service sector FDI. Financial services received 14 per cent of FDI inflows between 1994 and 2000, peaking at US$4 billion in 2000 when two Spanish banks took over Mexican banks. Commerce received 12 per cent of FDI inflows (US$8 billion) between 1994 and 2000, peaking at US$1.5 billion in 2000.

Figure 6.13

United States Dominates Mexico's FDI

Share of Total Mexican FDI Stock by Country, 2000

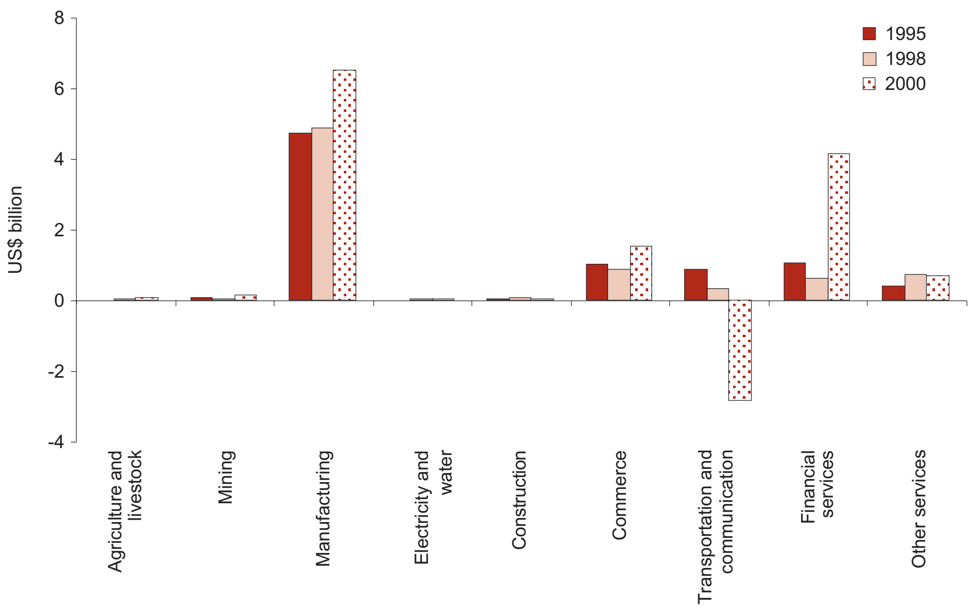


Source: Secretaría de Comercio y Fomento Industrial, 2001c.

Figure 6.14

FDI Concentrated in Manufacturing

Mexican FDI Inflows by Sector, 1995, 1998 and 2000



Note: Other services includes social services, hotels and restaurants, professional services, and technical and personal services.

Source: Secretaría de Comercio y Fomento Industrial, 2001c.

FDI in mining rose slightly after Mexico's 1992 mining law liberalisation. Private domestic and foreign investors can invest in mining any substance anywhere in Mexico, with 6 year exploration concessions, 50 year production concessions and low annual fees (Escamilla, 2000). So far, over 300 foreign firms have entered the sector. If current prospecting projects reach the production stage, mining FDI should rise considerably.

AUSTRALIA'S INVESTMENT IN MEXICO

Total Australian direct investment in Mexico between 1994 and June 2000 was US$39 million, only 0.06 per cent of Mexico's FDI inflows (Secretaría de Comercio y Fomento Industrial, 2000). As at 30 June 2000, 59 Australian companies were registered in Mexico; 51 of these were Australian majority owned (Secretaría de Comercio y Fomento Industrial, 2000).

Australian FDI in Mexico is concentrated in manufacturing, with 16 manufacturing firms accounting for US$32.5 million or 83 per cent of Australia's Mexican investment. The food processing sector has the largest representation; other major Australian manufacturers include Orica, Pacific Dunlop and Howe Leather.

Fifteen Australian firms are in the mining sector, including exploring, such as MIM, and providing mining services, such as Surpac, Orica and Warman Pumps (Table 6.3).[9] Australian mining companies have invested only US$2.75 million in Mexico since 1994, indicating their exploration activity is minimal to date (Secretaría de Comercio y Fomento Industrial, 2000). Most investment is in non-ferrous metallic minerals.

ORICA'S MEXICAN PRESENCE IN INDUSTRIAL EXPLOSIVES

In addition to its other Latin American operations, Orica recently opened a new explosives detonator plant in Mexico; it will supply products domestically and export to Central America and the Caribbean. Combined with this new investment, and the expansion of one of its packaging plants to increase exports to the United States, Orica has secured several new contracts for explosives and blasting services. The largest involves excavating 60 million cubic metres of rock per year. In 1999, 2000 and 2001, Orica received the Mexican Chemical Industry Association ResponsibleCare® award, to recognise its commitment to the industry.

Source: Farías, 2001.

[9] Warman Pumps was taken over by North Ltd several years ago; North Ltd recently sold Warman to Weir Slurry Group, a Scottish company. Hence, the South American businesses do not now report directly to Australia.

Table 6.3

Australian Companies Mainly Involved in Mining and Manufacturing

Major Australian Companies Operating in Mexico

Company	Type	Sector
Caravanserai Enterprises	Manufacturing	Furniture and home accessories
Education Australia (IDP)	Services	Education, training, and professional development
Explosivos Mexicanos, SA de CV (Orica Ltd)	Manufacturing	Industrial explosives and supplies
Fares Management Services	Services	Business services
Forgecast Australia Pty Ltd	Manufacturing	Non-ferrous forging
Howe Leather	Manufacturing	Leather processing
MIM Exploration Pty Ltd	Mining	Mineral exploration
Mincom International	Services	Business consulting and information technology
Pacific Dunlop Ltd	Manufacturing	Surgical gloves
PBL Ltd	Services	Cinema industry
Presence Online	ICT	Software
Qantas Airways Ltd	Transportation	Passenger and cargo air transport
TNA	Manufacturing	Packaging equipment
Walkers Ltd	Manufacturing	Sugar processing equipment
Warman Pumps	Mining	Mining equipment and supplies

Note: Mexican law prohibits the National Registry of Foreign Investment from disclosing the names of the 59 Australian companies in Mexico. This list was compiled from secondary sources.

Source: Various press articles and Australian Government information.

TRADE AND INVESTMENT OPPORTUNITIES IN MEXICO

Mexico could become a much more important market for Australian trade and investment. Trade opportunities largely flow from Mexico's growing resource imports as its industrialisation gathers pace. The cost competitiveness and supply capacity of competitors, like the United States, Canada and Chile, which have preferential access, will strongly influence opportunities.

The main factors likely to increase Australian FDI are:

- Mexico's trade agreements with the United States, the EU and Latin America, which open opportunities to improve access to these markets via Mexico
- world competitive Australian resource and agricultural companies leveraging investments off their expertise in these sectors.

The most prospective sectors for Australian FDI include manufacturing, mining, services, agriculture and agribusiness, energy and infrastructure.

Mining

Mexico's fastest growing mineral imports from the world are iron and copper ore; each grew by over 100 per cent annually between 1990 and 1998 to US$98.5 million and US$50.5 million. Although this growth is likely to continue, Australia faces stiff competition in increasing its market share. For example, Chile will dominate copper imports as it has an FTA with Mexico and is the world's largest copper producer.

However, the opportunity for mining investment is large. Mexico is the world's largest silver producer and is in the top nine in copper, zinc, gold and antimony. Only one quarter of its territory is explored and its regulatory framework allows 100 per cent foreign investment in both exploration and mining production, and yearly area based fees are competitive.

Substantial Mexican mining sector investment also would generate mining services trade and investment opportunities (Austrade, 2000c). From 1995 to 1999, land concessioned for exploration and exploitation increased 416 per cent. As in Chile, if production grows rapidly, then companies establishing an early presence will be best placed to expand their business rapidly. Particular areas of opportunity include providing laboratory equipment, anti-pollution equipment, mining materials, raw materials and reactants, machinery and equipment, and components and spare parts. These sectors imported Australian products worth US$1.6 million in 1999, with materials and accessory imports the largest item (Austrade, 2000c). As the domestic mining service industry strengthens, wholly Australian owned and joint venture operations should become increasingly attractive (Austrade, 2000c).

Energy

Foreign companies already can compete in Mexico's significant natural gas industry, supplying gas transport, storage and distribution services, and further privatisation is expected.[10] Australian resource and construction companies may be able to apply their experience in extracting and transporting liquid natural gas as opportunities arise for constructing gas ports, pipelines, storage and transport infrastructure.

In addition, the need for additional energy opens opportunities to supply fuel to generate electricity.[11] Although Mexico uses hydrocarbons to generate 60 per cent of its electricity, increasingly it employs coal and geothermal generators to meet new demand, with coal providing 2 600 MW of power in 1999 (Austrade, 2000a). Facing a tariff of only 3 per cent for bituminous coal, a multinational company sourced coal in the Hunter Valley, and won the initial contract to supply more than a million tonnes of thermal coal to Petacalco power station. The Australian coal industry is well placed to win future coal contracts in Mexico (Vaile, 2001).

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10 Mexico's natural gas industry produces 4 791 million cubic feet daily.

11 Mexico's energy consumption grew an average of 4.6 per cent annually from 1980 to 1999. The Federal Energy Commission estimates energy production must increase more than 75 per cent (22 000 MW) from 2000 to 2010 to meet demand (Austrade, 2000b).

Agriculture and Agribusiness

Mexico is a net importer of grains, cereal, canola, soybeans, wheat, sunflower seeds, cotton, fruit, vegetables and cottonseed. However, Australian agricultural exporters must compete with preferential trade from Mexico's FTA partners, particularly the United States and Canada. For example, Australian wheat exports face a 67 per cent most favoured nation tariff compared to a 4.5 per cent tariff for US and Canadian wheat.

FARES RURAL: IMPORTING LIVESTOCK FOR BREEDING

The Fares Group, established in the 1950s, trades livestock around the world using its own fleet of specialised livestock carriers. It established rural operations in Australia in 1976, to prepare livestock for export. It acquired properties in Western Australia and South Australia, and developed feedlot, breeding and fodder producing facilities, together with a ship management company, established in Fremantle, Western Australia.

In the early 1990s, the Fares Group started supplying sheep and cattle for breeding in the Mexican Government's repopulation programs. Mexico is one of Australia´s largest breeding sheep and cattle markets, as most other markets (Middle East) require slaughter animals. Mexico applies very strict health rules to livestock imports due to its proximity to the United States.

The group's initial sales contracts in Mexico were with federal and state governments. However, over the last five years, the Fares Group has sold a higher proportion of livestock to the private sector, avoiding disruptions to shipping programs changes in government policy cause. Political manoeuvring during state and federal elections is common and senior policy makers constantly change.

The Fares Group also supplies Mexico technical assistance, project development and financial planning for clients from four offices in the main livestock regions of the country staffed by locals and Australians.

Good legal representation is a must in doing business in Mexico. A good tax consultant also is useful. Over the years, the Fares Group has sold large numbers of livestock in Mexico, with payment collection based mainly on close liaison with clients supported by legal assistance in contract design and enforcement. Mexico's port infrastructure is efficient, and port operators are professional, particularly in privatised ports.

Companies attracted by Mexico's cheap labour should analyse closely the efficiency of their industry in Mexico, to ensure they will benefit from real savings. Middle and senior management salaries are comparable to salaries in Australia. Mexican employees can be loyal, hard working and respond positively to professional management. However, work ethics and culture are very different to Australia. A mix of local and expatriate personnel can work well; Australian staff provide technical expertise in livestock handling and management, while local personnel handle sales, debt collection and administration.

Source: Mata, 2001.

Nonetheless, promising agricultural trade developments exist. In 1998, Australia's canola exports to Mexico resumed after a three year hiatus, peaking at A$60 million in 1999 but falling by 32 per cent in 2000. In March 2001, Mexican authorities approved special import permits for Australian sorghum and malting barley. Barley exports could grow as Mexican beer sales rise.

Mexico imports both live cattle and sheep. Australian cattle exports to Mexico began in 1996, with fluctuating values due partly to adverse weather conditions in Mexico's main northern cattle region. NAFTA prohibits the export of Australian or other foreign cattle to the United States. However, government supported technology transfer and breeding improvement programs offer opportunities.[12] Fares Rural, an Australian livestock shipper, is capitalising on these, providing ancillary services such as pregnancy testing and health checks (Mata, 2000).

A government driven program already operating in 12 states uses imported sheep to restock and improve the genetic quality of local mobs. The program's expansion will raise sheep imports, and Australian producers may boost exports beyond their 2000 level of US$6.7 million and their 1997 peak of US$10.6 million (Secretaria de Comercio y Fomento Industrial, 2001b).

ALPHARMA ANIMAL HEALTH: EXPORTING PIG GROWTH HORMONE

Alpharma, an Australian based company, began exporting Reporcin, a naturally occurring UN approved pig growth hormone product, to Mexico in October 2000. These exports were made through Allabinc, a US distributor of animal health products based in Guadalajara, Mexico.

The hormone reduces pig fat by between 8 and 10 per cent. Alpharma estimates 80 per cent of Mexico's pigs contain excess dorsal fat. Consequently, Alpharma's sales have soared, due to the market's ready acceptance of its product.

Source: de la Cruz, 2001.

Exports of sugar processing equipment could increase as Mexico's sugar industry needs to be modernised to become internationally competitive. However, the sector's lack of available capital and limited credit availability for Mexican farmers make working with a local partner prudent.

Processed Food

In processed food, dairy and meat processing offer opportunities. Mexico's dairy industry is highly inefficient; low cattle fertility rates and very high domestic demand for milk make Mexico one of the world's largest milk importers (Austrade, 2000b). Powdered milk is the most common milk import and possibly the best channel to expand Australian exports, as the US share of Mexican milk imports is small. However, Australia faces an MFN tariff rate of 10 per cent versus 3 per cent for the United States and zero for Canada and Chile.[13] Despite facing higher tariffs than FTA partner exports, Australian exports of cheese grew at an annual average rate of 28 per cent over the 1990s.

12 These programs include the Alliance for Agriculture program and the Better Cattle Program under the Ministry of Agriculture.

13 For hard cheeses, the United States faces a 12 per cent tariff compared to Australia's 125 per cent; for beef, the United States, Canada and Chile face a zero tariff while Australia faces a tariff of 25 per cent on frozen beef and 20 per cent on fresh beef; for poultry, the United States faces a zero tariff within the tariff rate quota and 98.8 per cent over that amount; whereas, Australia faces a 240 per cent tariff and requires an import licence.

A service export opportunity, unaffected by tariff discrimination, is to upgrade the slaughtering and meat processing sector. Many Mexican abattoirs do not conform to government standards, and need upgrades to modernise cold rooms, meat cutting systems, and product and by-product classification systems (Austrade, 2000b).

STMs

While Australian exports of STMs are small, some are growing rapidly. Starch, inulin and gluten exports grew strongly to A$15 million in 2000. Aluminium provides another opportunity; Mexican aluminium imports expanded at an annual average rate of 19 per cent from 1990 to 1998, reaching US$1 billion, but Australia supplied no product. Housing projects and public works should drive further growth.

ETMs

ETM export opportunities largely centre on supplying parts to Mexico's booming assembly industry. While Australian companies are unlikely to gain a large share of this market, the huge trade creates opportunities for unique, niche automotive and electronic parts exports. In 1999, the Mexican automotive parts market topped US$115 billion, as motor vehicle exports skyrocketed. Mexico imports 31 per cent of its automotive parts, with 66 per cent coming from the United States (United States and Foreign Commercial Service, 2001). US producers are weakest in higher technology products like fuel injection systems, emissions control devices, computerised controls, and safety devices such as air bags and anti-lock braking systems (United States and Foreign Commercial Service, 2001). Nonetheless, with Europeans receiving duty free access for automotive parts, and US automotive component manufactures responding by opening plants in Mexico, competition will intensify.

Exports of electronic components are another area of opportunity. In 1999, Mexico produced only 1.9 per cent of the electronic components it needed, with the United States supplying 86 per cent of these imports. Nonetheless, as finished goods sectors, such as televisions and computers, continue to grow, so too will input supply opportunities, allowing Australian exporters of other electrical machinery and computer parts to build on recent growth (Figure 6.11).

As in Brazil, Argentina and Chile, new opportunities will emerge in Mexico's telecommunications industry. Analysts estimate that by 2005, Mexico must invest over US$5 billion to install 8.6 million new lines; 60 per cent of these are likely to be fixed (Expansion Factor, 2000). Competition will be fierce, and while Australian exporters face tariffs ranging between 10 and 20 per cent, their US, Canadian and European competitors face zero tariffs. Nevertheless, Australia is an increasingly competitive supplier of telecommunications equipment to other markets.

Private Infrastructure

Mexican infrastructure has not kept pace with population growth or the manufacturing boom; Mexico will need to develop infrastructure rapidly over the next decade. The need to build or modernise water treatment facilities and pipelines, roads, airports, railways, telecommunications networks, and ports ensures new tender opportunities in infrastructure development and construction, as well as markets for imported inputs construction and equipment contactors need (United States and Foreign Commercial Service, 2001).

Electricity generation capacity must grow 61 per cent, or 21 743 MW, by 2007, to meet demand (United States and Foreign Commercial Service, 2001). The Federal Energy Commission will tender around 12 297 MW of turnkey projects valued at US$4.9 billion to the private sector; this should translate into 14 plants each with a capacity of around 900 MW (United States and Foreign Commercial Service, 2001). Also, the outdated and inefficient transmission and distribution networks need upgrading, opening opportunities to bid for this work and supply related equipment. Foreign investment is restricted in electricity generation and distribution.

Other key areas include expanding the number of highways, tendering seven new build, operate and transfer schemes for wastewater treatment plants, and upgrading potable water distribution and sewage systems in at least 50 urban areas (United States and Foreign Commercial Service, 2001). In addition, opportunities exist to operate and develop port facilities; so far, the government has offered only six of Mexico's 76 maritime ports as concessions.[14]

Services

Service sector opportunities also exist. NAFTA provides major US investors with advantages in financial services, but FTAs are unlikely to penalise other Australian service suppliers. Mexican engineering firms do not specialise in mining techniques, so mining services have potential. Qualified engineers consulting with mining companies could design advanced mining engineering systems and train workers on these systems (Austrade, 2000c). In addition, the livestock industry could benefit from consultative services in improved animal husbandry techniques, breeding technology, pasture improvement and drought management techniques.

The fast growing information technology professional services sector offers foreign firms considerable opportunities. Many large US firms compete in the hardware and software sectors, but few foreign firms yet supply the information technology service sector (United States and Foreign Commercial Service, 2001). Presence Online, an Australian company, successfully operates in this sector offering web content management services. For example, it recently achieved a US$150 000 sale to Bital, one of Mexico's largest banks (Presence Online, 2001).

LOOKING FORWARD

Over the 1990s, Mexico's rapid output and trade growth, and Australian competitiveness, helped Australian exports to Mexico expand over 150 per cent faster than Australia's overall export growth. This rapid growth occurred despite barriers Australian exporters face as a non-FTA member and Mexico's poor trade liberalisation performance on a multilateral (or most favoured nation) basis. Furthermore, Australia's small initial market presence and Mexico's rapid income and trade growth mean many trade opportunities will arise. In addition, NAFTA is improving the business environment and making Mexico an attractive investment destination. Australian investment in manufacturing, particularly targetting NAFTA and EU markets, mining and mining services has most potential, although in future, opportunities also will exist in infrastructure, services and agribusinesses.

[14] The authorities next plan to tender the ports of Guaymas, Acapulco, Puerto Vallarta, and Topolobampo.

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ARGENTINA'S ECONOMIC PERFORMANCE AND PROSPECTS

KEY POINTS

- **From 1991 to 1998, Argentina undertook major economic reforms, dramatically reduced inflation and achieved strong GDP growth. These achievements formed a strong foundation for future performance.**
- **Convertibility, introduced in 1991, pegged the peso to the US dollar and purged Argentina of inflation, but with the peg, the peso appreciated 33 per cent in real effective terms in the last decade, undermining competitiveness. Argentina has been in recession for three years.**
- **In June 2000, the Government changed the exchange rate on trade transactions to a 50:50 peg with the US dollar and the euro, causing an 8 per cent devaluation.**
- **Achieving fiscal discipline and reducing external debt are the other major challenges the Government faces. Argentina holds 25 per cent of emerging market foreign debt, and market concerns are growing that it cannot continue to service this, raising sovereign spreads to extremely high levels.**
- **In 2001, government debt servicing obligations absorb about 78 per cent of foreign capital inflows and crowd out private borrowing in local capital markets, forcing up interest rates.**
- **This negative outlook currently overshadows significant economic reforms made earlier in the decade, and threatens a major crisis which could lead to the Government defaulting on its debt in the short to medium term. However, the Economy Minister, well respected Domingo Cavallo, reappointed in March 2001, is committed to avoiding this and pushing forward with a new reform agenda.[1] His success will have a crucial impact on Argentina's medium term prospects.**

[1] As Economy Minister from 1991 to 1997, Cavallo introduced the Convertibility Plan which beat hyperinflation, and implemented wide ranging privatisation, trade and regulatory reforms. However, Minister Cavallo resigned in 1997 because he received inadequate political support from the President and other members of the Government.

Argentina is an economy with huge, but as yet poorly realised potential. In the 1930s, Argentina's abundant natural and human resources and open economic policies gave it one of the seven highest per capita incomes in the world (Clark, 1940). However, the Depression cut Argentina off from world trade, and subsequent inward looking trade and economic policies, profligate government spending and authoritarian governments steadily eroded this leading position. In 2001, Argentina is a middle income country; its per capita GDP of about US$7 500 is less than half of Australia's.

Determined to reverse this decline, in 1991, the Menem Administration began broad ranging economic reforms, enabling Argentina to overcome many competitive disadvantages. The reforms ended hyperinflation, slashed trade and investment barriers, and deregulated and privatised major sectors of the economy. The economy responded by growing rapidly from 1991 to 1998, reflecting the country's strong natural and human endowments.

However, in the late 1990s, vital reform efforts slowed. The pegged currency, the growing government deficit and many other structural ridigities undermined international competitiveness and growth. By mid 2001, international market concerns that Argentina would default on debt payments virtually cut it off from capital inflows, and greatly increased the cost of international borrowing.

This chapter analyses the strengths and weaknesses of the Argentine economy, so readers can interpret how future short term developments and policy changes may affect Argentina's long term growth prospects. First, it assesses the direction and sources of Argentina's growth in the 1990s, then analyses the country's external vulnerability. It reviews how the Convertibility Plan reduced inflation and stimulated economic reform from 1991 to 1997, but increasingly constrained economic growth and increased financial vulnerability in the late 1990s. The chapter highlights major influences on Argentina's economic prospects, including deregulation and privatisation, the Government's fiscal problems and financial sector developments. Finally, it analyses future growth prospects and major risks. For details on trade and investment reforms, see Chapter 8 - *Argentine Business Opportunities*.

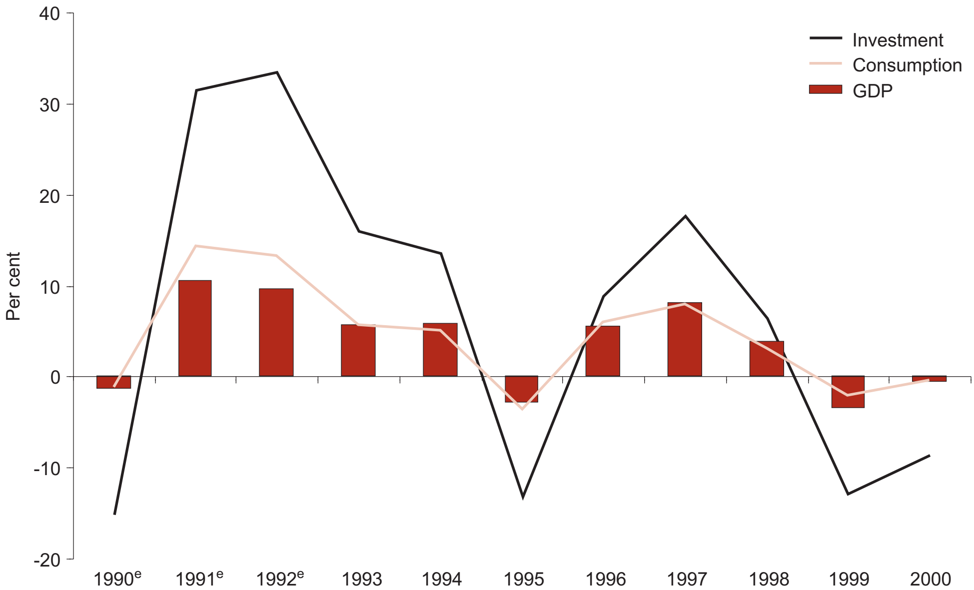
GROWTH PERFORMANCE IN THE 1990s

From 1990 to 1998, Argentina's real annual GDP growth averaged around 5.7 per cent, well above Latin America's average of 3.5 per cent. This growth performance also was very creditable compared to Argentina's 1980s annual average growth of minus 0.7 per cent. However, external shocks, growing peso overvaluation and the expanding fiscal deficit's impact on interest rates destabilised growth. While growth was particularly strong in 1991 and 1992, in 1995, the Mexican crisis caused output to contract 2.8 per cent. By 1997, growth had rebounded strongly, only to be hit again in 1998 and 1999 by the Brazil crisis and peso overvaluation (Figure 7.1).

Figure 7.1

A Decade of Strong but Volatile Growth

Real GDP Growth, Per cent



Note: e denotes estimate of IERAL of Fundación Mediterránea. Only in 1993, after the end of hyperinflation, was a proper system of national accounts established.

Source: Instituto Nacional de Estadística y Censos (National Statistics and Census Institute), 2001.

Over the decade, pegged to an increasingly strong US dollar, the peso appreciated by 33 per cent in real trade weighted terms, against the currencies of Argentina's major trading partners, including Brazil and the EU. Labour market rigidity and inefficiency, the taxation regime, government administration and service delivery, and anti-competitive corporate behaviour also prevent Argentina from improving international competitiveness. Combined with growing government deficits, which crowded out private sector borrowers, falling competitiveness pushed Argentina into recession by 1999, where it has remained for almost three years.

Switching Growth Sources

Over the decade, Argentina's growth sources switched markedly (Figure 7.1). Between 1991 and 1994, consumption and investment contributed significantly to growth. Confidence increased and the Convertibility Plan released repressed demand, stimulating consumption, while privatisation, deregulation, and trade and foreign investment liberalisation spurred investment. Between 1996 and 1997, Brazil's GDP grew strongly, Mercosur provided trade access, the Brazilian real appreciated, and Argentine terms of trade improved (mainly due to oil and agricultural commodity prices), so net exports drove growth. In contrast, between 1997 and 1998, as domestic confidence rose and mortgage loans expanded, investment and the construction sector drove growth.

Income Distribution

By international, especially developed country standards, Argentina's income distribution is skewed towards high income individuals; this limits the growth potential and development of a larger consumer market. However, compared to the rest of Latin America, Argentina's income distribution is more progressive. The top 20 per cent of households control 48.5 per cent of income, while the lowest 20 per cent control only 6.1 per cent of income. Around half the population consider themselves to belong to the middle class (SIEMPRO, 1997). The middle class is well educated with an annual household purchasing power of US$17 000 (Economist Intelligence Unit, 2001). Weak taxation and social service delivery systems, previous hyperinflation and current peso overvaluation all contribute to skewed income distribution.[2]

VULNERABILITY TO EXTERNAL SHOCKS

Argentina's economic structures make it vulnerable to international shocks: persistent current account deficits, external debt financing and large government financing requirements often consume capital inflows. These problems significantly increase the cost of raising capital and, by May 2001, effectively cut off Argentina from international capital inflows.

Throughout the 1990s, despite higher growth, Argentina remained vulnerable to external shocks. The Mexican crisis in 1995 and the Russian and Brazilian crises in 1999 all significantly tightened international credit availability, raised sovereign risk spreads and dramatically increased Argentina's debt servicing costs. Brazil's January 1999 real devaluation spurred further real trade weighted appreciation, further reducing trade competitiveness (Figure 7.2).

Current Account

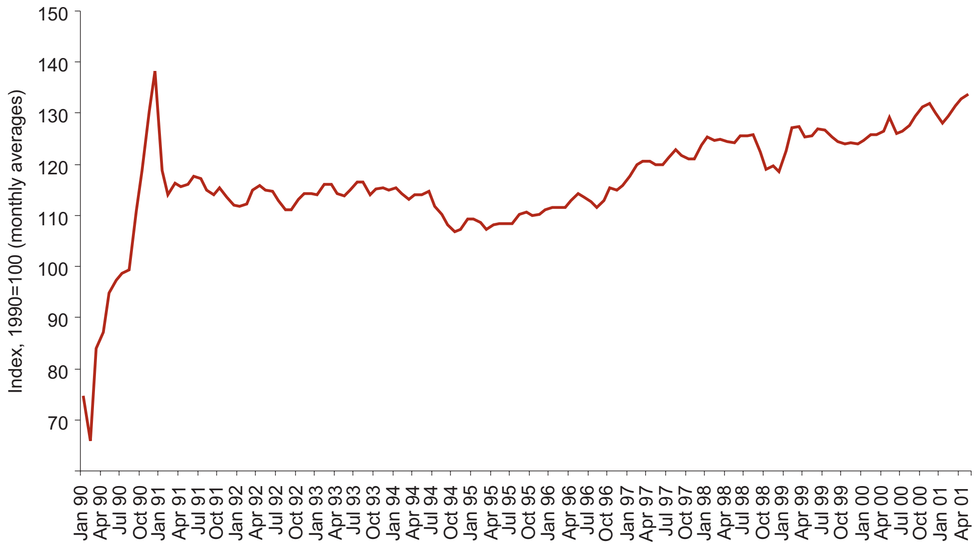
This is a major source of weakness; throughout the last decade, Argentina ran a significant current account deficit. While it contracted in 1995, a recession year, it expanded again as the fiscal deficit grew (Figure 7.3).

2 On balance, the higher income groups probably benefit from the overvalued exchange rate, as it enables them to access cheap imports, spend freely on overseas trips and build up large stores of US dollar assets (abroad and in Argentine banks). Lower income groups, employed in traded goods sectors, like agriculture and industry, generally bear the costs of the current policy, as it reduces the value of these sectors' exports and increases their exposure to imports. They also bear the brunt of rising unemployment, which the peg partly generates.

Figure 7.2

Peso's Real Exchange Rate Appreciating Rapidly

Peso Real Effective Exchange Rate, 1991-2001, 1990=100



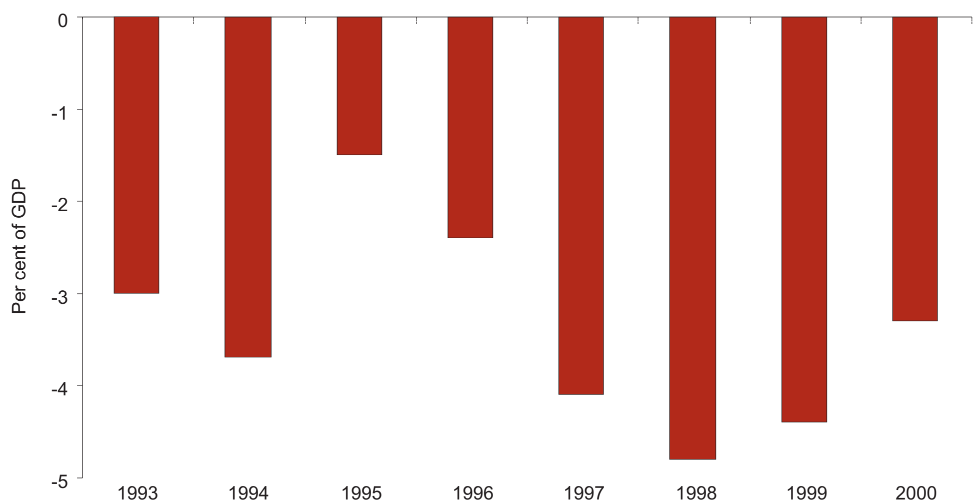
Note: This index is based on 1990 trade patterns, which place a lower weight on trade with Brazil than now is the case; hence actual peso appreciation is understated.

Source: JP Morgan, 2001.

Figure 7.3

Current Account Remains Highly Negative

Current Account Deficit, Ratio to GDP, Per cent, 1993-2000



Source: International Monetary Fund, 2001b.

Capital Account

Reforms over the 1990s encouraged large foreign capital inflows, mostly as foreign direct investment, FDI. This turned the capital account positive and financed the trade deficit. However, in recent years, increasingly, the Government has financed its deficit with foreign issues of sovereign bonds, with receipts boosting the capital account's bottom line. By 2000, the Government used 100 per cent of net capital inflows, squeezing the private sector out of this additional source of investment funding (Figure 7.4).

External Debt

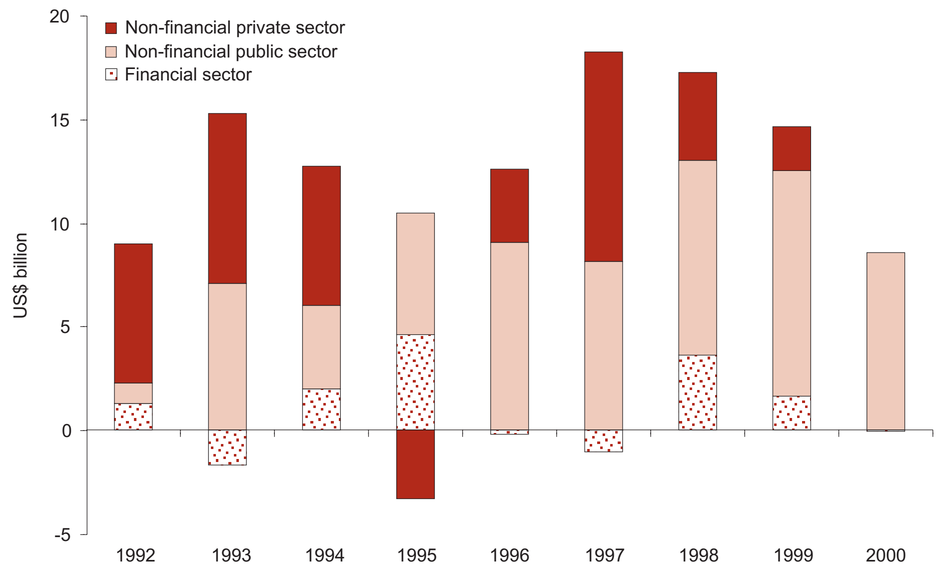
In the early to mid 1990s, growing private sector external debt reflected growing foreign confidence in Argentina's economy, and local private borrowers' renewed access to international financial markets. From 1990 to 1998, the Government's share of external debt fell from 86 per cent to a low of 58.6 per cent, although in 2000, it increased again to 59.4 per cent (Figure 7.5). However, from 1990 to 1999, Argentina's public and private external debt increased from US$67 billion to US$145 billion, or from around 30 per cent to more than 50 per cent of GDP.

In 2001, markets became increasingly concerned the Government would not be able to make payments on its US$128 billion debt and may be forced into debt restructuring or default. Due to a high risk premium markets now attach to Argentina's debt, borrowers face high costs raising finance in foreign and local capital markets. In mid July 2001, Argentina's risk premium, measured by the spread paid on its sovereign debt compared to similar maturity US Treasury bonds, rose rapidly to around 1 580 basis points well above Russian sovereign risk spreads. The Emerging Markets Bond Index for Argentina shows high risk premiums (Figure 7.6). Spreads now equal Argentine levels during the Mexican crisis.

Figure 7.4

Public Debt Financing Dominates Capital Account

Destination of Foreign Capital Flows, 1992-2000

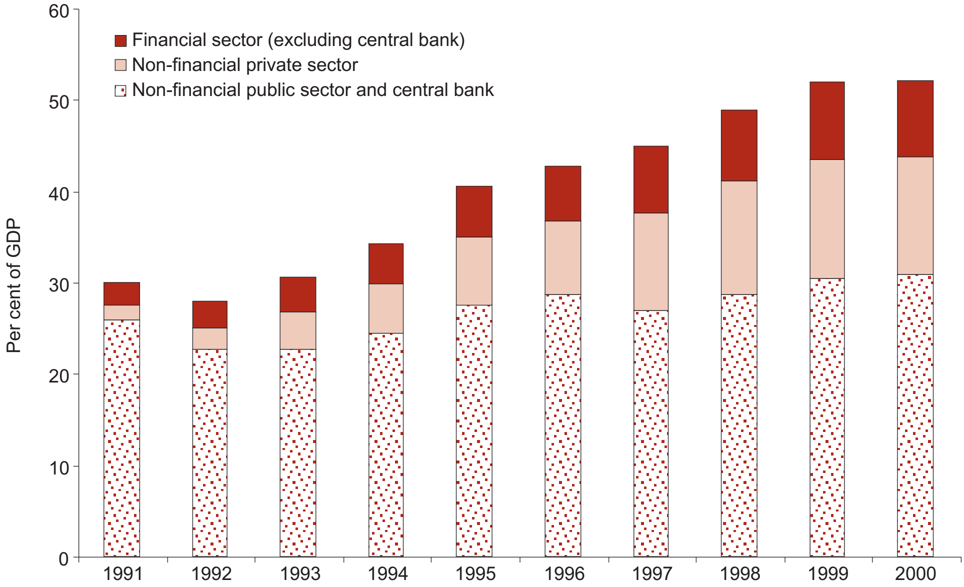


Source: Dirección Nacional de Cuentas Internacionales (National Directorate of International Accounts), 2001.

Figure 7.5

External Debt Growing

External Liabilities, Per cent of GDP, 1991-2000

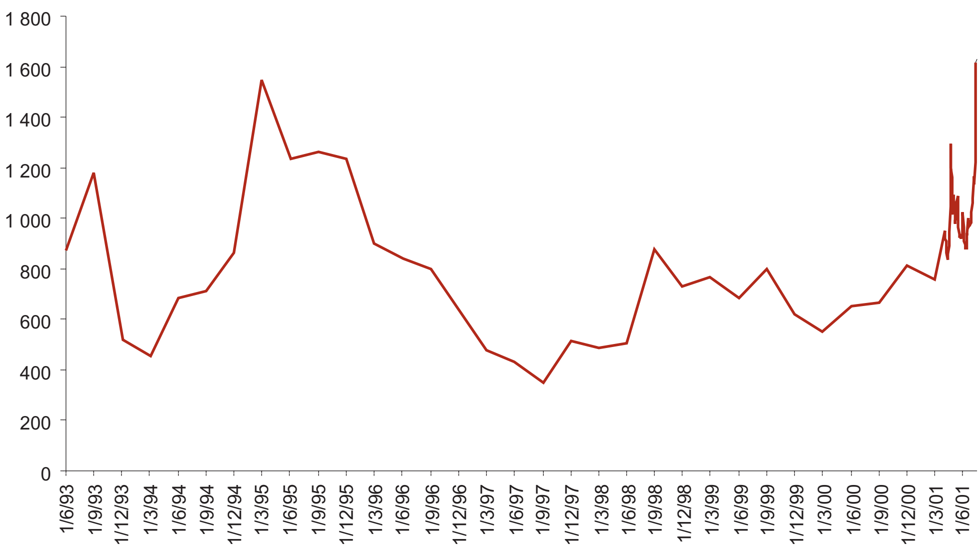


Source: Ministry of Finance, 2001.

Figure 7.6

Argentina Faces High Risk Spreads

Emerging Markets Bond Index for Argentina, Basis Points over US Treasury Bonds



Note: Data from April 2001 is daily.

Source: JP Morgan, 2001.

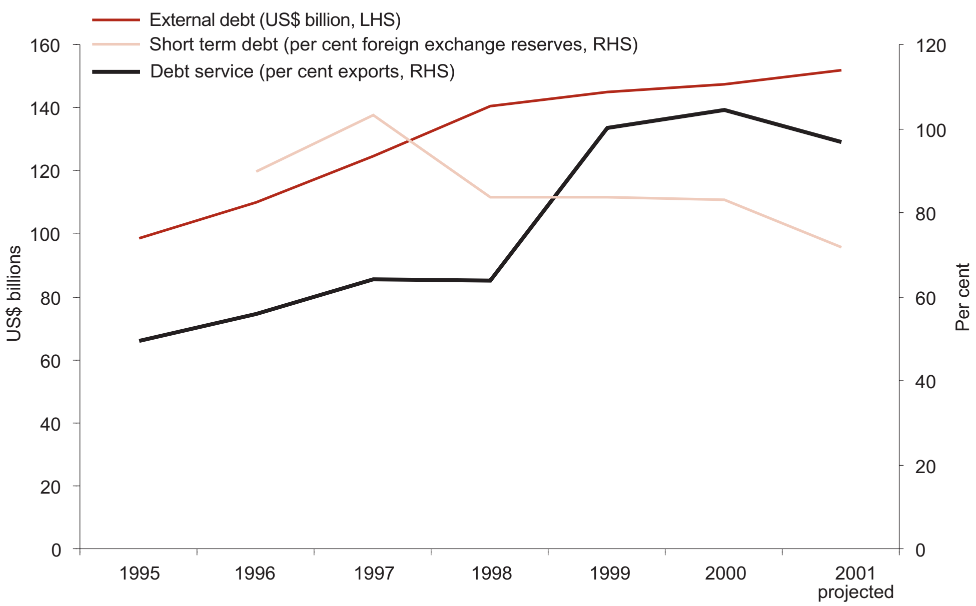
In early May 2001, Standard and Poor's downgraded Argentina's sovereign debt ratings from B+ to B, then to B- in July with a negative outlook. In July, Fitch also downgraded it to B-, which is speculative grade. By mid 2001, external debt servicing reached around 104 per cent of export earnings, up from 100 per cent in 2000 and 50 per cent in 1990 (Figure 7.7).[3] Debt servicing jumped in 2000 and 2001, from US$27 billion to US$32 billion.

In 2001, while only 15 per cent of all foreign obligations were short term, one year or less, short term debt represented 70 per cent of foreign exchange reserves, another crucial concern for markets (International Monetary Fund, 2000a; and International Monetary Fund, 2001b).

Figure 7.7

External Debt and Debt Servicing Increases Rapidly

External Debt, Debt Service Ratio and Short Term Debt to Foreign Exchange Reserves, US$ billion and Per cent



Source: International Monetary Fund, 2001a; and 2001b.

[3] External debt as a percentage of goods and services' exports grew from 426 per cent in 1991 to 476 per cent in 2000 (International Monetary Fund, 2001d).

CONVERTIBILITY PLAN

The April 1991 Convertibility Law pegged the nominal exchange rate at Ps1:US$1. It reduced inflation and interest rates dramatically and allowed Argentina to commit to important structural reforms, including market opening and financial sector reform. However, US dollar movements also determined trade competitiveness, and convertibility severely limited independent monetary policy. Coupled with structural rigidities in fiscal policy, this significantly reduced the Government's flexibility in determining macroeconomic policy; these problems became increasingly evident in 2000 and 2001.

CONVERTIBILITY LAW

The convertibility law:

- pegged the Argentine peso to the US dollar, formalising existing currency substitution for the US dollar
- is a currency board style arrangement, rather than just a fixed exchange rate regime; the stock of currency issued is limited to the stock of gold, foreign exchange and liquid, marketable US dollar denominated assets held by the central bank[4]
- establishes free exchange of the peso against the US dollar; for all transactions the peso is fully convertible
- allows all contracts, except wages, taxes and government expenditures, to be written in any currency
- overhauls the central bank's role; it cannot finance public sector deficits or act as a lender of last resort, but can manipulate liquidity ratios of financial institutions, providing short term liquidity flexibility in an extreme crisis.

The convertibility law reduced inflation and lifted growth by preventing the Government from borrowing from the central bank (printing money), increasing fiscal discipline on the federal Government, and making government commitments to reduce inflation credible.[5] Full convertibility also increased domestic and foreign investor confidence.

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4 In an emergency, the money in circulation can exceed the stock of foreign exchange by a maximum of 33 per cent. Hence, monetary and exchange rate arrangements under the convertibility law are somewhat less than a full currency board arrangement.

5 Convertibility required the central bank to back all currency issued with gold, foreign exchange or US dollar denominated securities, ensuring the central bank and government could not print money. In particular, this curtailed the infamous quasi-fiscal deficit, whereby the central bank accumulated debt with the banking sector in the form of reserve requirements. However, some state governments still effectively print money by borrowing from their own provincial banks.

Reduced Inflation

Under the Convertibility Plan, inflation plunged to below 5 per cent in 1994 and has continued to fall. Before the plan, monthly inflation peaked at 20 266 per cent in March 1990 (National Statistics and Census Institute, 2001). Since 1992, wholesale price inflation generally has been lower than consumer inflation, showing the pressure to regain competitiveness (Figure 7.8). However, since 1999, with confidence, wages and consumption falling, and unemployment rising, commodity prices weakening and the effective exchange rate rising against the Brazilian real and the euro, deflation has occurred. With the currency pegged, wages and prices must fall to enable Argentina to regain international competitiveness.

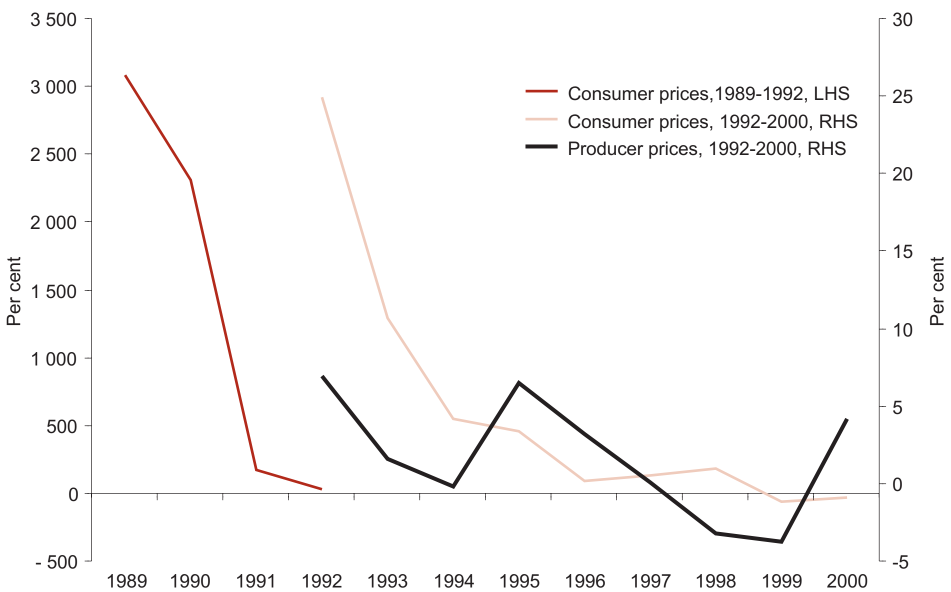
Reduced Interest Rates

By slashing inflation and increasing confidence, the Convertibility Plan helped interest rates plunge (Figure 7.9). Rising confidence in the banking system and currency stability also sustained deposit and lending growth. However, after mid 2000, interest rates started to increase again, reflecting rising sovereign risk associated with the growing government deficit, public sector debt financing needs crowding out private borrowers, and the tight foreign debt repayment schedule in 2001 and 2002. High and rising interest rates are further depressing low economic activity.

Figure 7.8

Winning the Battle against Inflation

Consumer and Producer Price Inflation, Per cent per Year

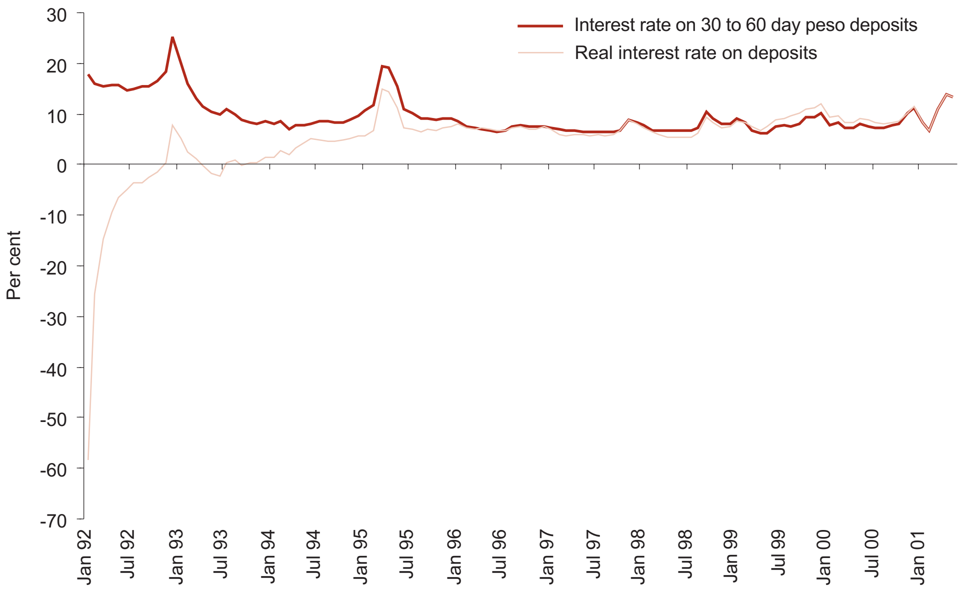


Source: Instituto Nacional de Estadística y Censos, (National Statistics and Census Institute), 2001.

Figure 7.9

Interest Rates Fell but Rising Again

Interest Rate for 30 to 60 Day Peso Deposits and Annual Real Interest Rate on Deposits, Per cent



Source: Banco Central de la República Argentina, 2001; and Instituto Nacional de Estadística y Censos (National Statistics and Census Institute), 2001.

Current Issues with Convertibility

Pegging the peso to the US dollar curtails independent monetary policy, and increases Argentina's vulnerability to internal and external shocks. Also, when the US dollar appreciates, the peg restricts economic activity by reducing competitiveness. The peg became particularly onerous after Brazil, Argentina's largest trading partner, floated the real in January 1999; by July 2001, the real had depreciated by over 140 per cent in nominal terms.

The need to reduce domestic prices to maintain competitiveness necessitates wage cuts which, with rising interest rates, reduced private consumption by 2.1 per cent in 1999 and 0.4 per cent in 2000, with a further fall in the first quarter of 2001. Deflation and weak consumption depressed domestic investment; investment fell by 12.8 per cent in 1999 and 8.6 per cent in 2000, and continued to fall in the first quarter of 2001.

Exports fell by 11.8 per cent in 1999. While they rose by 13.2 per cent in 2000 and increased in the first two quarters of 2001, this mainly was because depressed domestic demand forced producers to export surplus production and several large export-oriented mining and other projects were commissioned (International Monetary Fund, 2001b). New investment in export-oriented sectors is limited.

The move in June 2001 to introduce the euro into a basket peg, on a 50:50 basis with US dollar will increase flexibility in future, but only resulted in an 8 per cent depreciation of the peso.

Public support for the peg

Despite the peg's current negative economic effects, politicians and the public support the arrangement because it eliminated hyperinflation and disciplines government behaviour. Furthermore, many argue removing convertibility would be costly and chaotic; 70 per cent of liabilities, including many home mortgages and much company borrowing, are denominated in US dollars and many exposures are unhedged. Delinking the peso is likely to cause loan defaults and bankruptcies, and could threaten banks' viability.[6] However, as 61 per cent of bank liabilities (mainly deposits) are in US dollars, compared to 67 per cent of assets (mostly loans and government bond holdings), depreciation also would produce winners, lessening its macroeconomic impact.[7]

The Government does not believe delinking the currency from the US dollar is a policy option, because the economy is highly dollarised and this move would diminish political credibility. Analysts also fear Argentine firms would quickly raise prices to re-establish their value in US dollars, rekindling inflation, although current depressed demand makes this unlikely. Consequently, the Government is likely to pursue all possible options, including debt renegotiation, before considering unpegging from the US dollar and the euro.

PRIVATISATION AND DEREGULATION

In the first half of the 1990s, the Government privatised and deregulated many industries and sectors. However, by the late 1990s, deregulation slowed, although the Government introduced full competition in telecommunications and began to reform labour markets.

Privatisation

Between 1991 and 1994, the Government privatised around 90 per cent of state enterprises, collecting more than US$20 billion in proceeds. Privatisation aimed to reduce the size of the public sector and concentrate government responsibilities in specific functions. The national airline; banks; railways; oil, gas and electricity producers; telecommunications, ports, water and sewage disposal authorities; steel; and defence industries were all privatised. The few national enterprises yet to be privatised include Banco Nación, the largest state bank and the only federal public retail and commercial bank, and several nuclear plants.

6 Large companies, which can access bank funds, usually have substantial US dollar assets in Argentina and abroad, and frequently have export income, at least partially hedging them against any devaluation. However, most small and medium businesses are highly leveraged. Hence a depreciation might cut the chain in payments, weakening the position of banks. Another serious impact would be on householders who have US dollar denominated mortgages.

7 A similarly highly dollarised Philippine banking system before the Asian financial crisis insulated that economy from the worst macroeconomic impacts of the peso's 1997 40 per cent depreciation (East Asia Analytical Unit, 1998).

Privatisation produced many gains:

- privatised infrastructure firms generally slashed production costs and inefficiency, improved resource allocation and lowered infrastructure costs (Table 7.1). Privatised companies also dramatically improved productivity as they more than halved their 300 000 strong workforce in 1989 to 138 000 in 1994; staff reductions in the rail, oil and steel sectors were largest
- most privatised firms produced better quality goods and services, increased output and introduced new technologies
- systemic corruption fell, subsidies declined and tax collection increased; these eliminated a major cause of fiscal deficits.

Table 7.1

Effects of Economic Deregulation

Reduction in Service Costs, 1991-96

Services	Percentage change
Postal services	-30
Electricity	-26
Water and sewage disposal	-14 to -24
Ports	
Containers	-67
Other	-48
Sea freight	-43
International land freight	-33
Commercialisation of grains	-75
Long distance road transport	-6
Insurance	-20

Source: Llach, 1997.

Before 1991, privatising the national airline, Aerolíneas Argentinas, and the national telecommunications carrier, ENTEL, did not produce the most efficient market outcomes. Generally, companies were sold as monopolies to maximise bid prices and ensure higher mandatory investments. After 1991, the privatisation process improved with bidding processes giving priority to competition, lower tariffs for consumers and higher quality outputs.

Government still is improving the regulatory environment of privatised infrastructure, although more slowly than in the early 1990s. The public sector now produces relatively few goods and services, increasing private sector opportunities. However, the impetus for privatisation has weakened and some sales, such as Banco Nación's, have met political resistance. Privatisation is least advanced at the provincial level, especially with provincial government owned banks and public utilities.

Sectors with strong private sector participation, including electricity, gas and water, are growing rapidly (8 per cent in 2000); transport and communications also grew 11 per cent in 1997, but have slowed during the current recession.

Deregulation

In the early 1990s, along with privatisation, the Government eliminated widespread price and wage controls, and closed several anti-competitive regulatory and marketing bodies, including for beef and wheat. The deregulatory drive also allowed freer foreign and local private sector entry into mining, fishing, wholesale and retail sales, pharmaceuticals, cement, transport (freight and passenger services for air, water and land), ports, river and sea navigation, insurance, postal services, and professional consultancy and technical services. More recent reforms extend this into telecommunications, labour markets and health insurance.

Telecommunications

In November 2000, the two regional telecommunications duopolies created in 1990 were exposed to full competition in fixed line local and national markets. The government also introduced further competitive mechanisms, such as number portability and international call competition, although the former is only available at a high cost.

Labour market reform

The formal labour market remains rigid, with high severance entitlements and payroll taxes. For this reason, 45 per cent of employees work in the informal sector, or black economy, paying no tax or social security and receiving no working condition protection. The Government has started to reduce formal sector entitlements. For example, since June 2000, workers must be employed for six months, rather than one month, before they are to due for severance pay. However, reform progress has been slow.

Health insurance

Public hospitals and private medical insurers now can compete, in a limited way, with the trade union managed health care insurers. However, this reform is still partial.

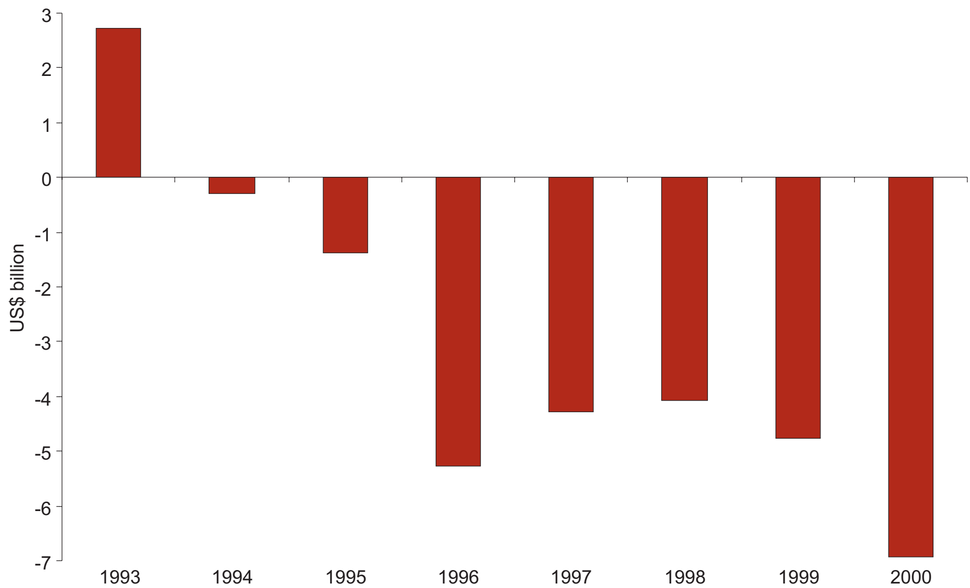
FISCAL POLICY

The Government recognises public finances must improve dramatically if Argentina is to boost its growth prospects and avert future crises. In the early 1990s, the Government significantly improved its fiscal position, particularly through privatising, consolidating debt and making public accounts more realistic and transparent. However, in the second half of the 1990s, reform commitment slackened and the public deficit increased (Figure 7.10).

Figure 7.10

Growing Fiscal Deficit

Federal Fiscal Surpluses and Deficits, US$ billion, 1993-2000



Note: Deficit shown as negative figure.

Source: Ministry of Finance, 2001.

Debt Restructuring

Its early 1990s, debt restructuring and consolidating significantly improved its fiscal accounts, allowing Argentina to tap international markets for credit after 1992.[8] However, the Government has not yet achieved a balanced budget, particularly as debt servicing costs jumped after the Russian and Brazilian crises, and revenues fell with the recession.

Public Deficit

Since 1998, with expenditure growth exceeding revenue growth, the fiscal gap is increasing, severely hampering efforts to stabilise the economy (Figure 7.12). Despite rising debt service costs, the Government limited some outlays in 2000, but poor tax enforcement and the recession constrained revenue growth. In 2001, the central government deficit is expected to reach 2.6 per cent of GDP (International Monetary Fund, 2001b). Provincial governments particularly are reluctant to address this problem.

8 In consolidating and capitalising domestic public debt, the Government recognised off budget debt and issued bonds to pay for it. With the IMF, World Bank and Inter-American Development Bank, it also restructured its foreign public debt (under the Brady Plan). Argentina swapped unsecured loans for high quality bonds with longer maturities and received some debt forgiveness.

Over the last decade, as deficits accumulated, public debt as a ratio to GDP skyrocketed from around 30 per cent in 1990 to over an expected 53 per cent in 2001. In 2001, Argentina's public sector financing needs are around US$22 billion, with many bonds maturing in late 2001 and 2002. In June 2001, a successful rollover of US$29.5 billion of short term government bonds appeared to reduce this refinancing task. Through this 'mega swap', the Government converted maturing short term debt to a longer term profile and backloaded interest payments. However, the swap increased the nominal debt stock by US$2.2 billion and interest terms average a high 15 per cent. Moreover, the success of the 'mega swap' was very short lived; by 13 July, Argentina's sovereign risk had again climbed to 1 580 basis points, signalling the market's clear expectation of a default and/or devaluation.

Consequently, the Government is using new strategies of fiscal management to reduce the growing deficit, such as the Fiscal Responsibility Law, a fiscal pact with the provinces, major public sector wage cuts and a zero deficit strategy.

FISCAL RESPONSIBILITY LAW

Under the 1999 Fiscal Responsibility Law, the Government pledged to balance the federal budget by 2003 and created a fiscal stabilisation fund. The law specifies public spending cannot grow by more than real GDP and, if GDP contracts, at worst, spending must remain constant. The budget has to include three year spending projections. The fiscal stabilisation fund is designed to fund a deficit in emergencies, and is funded by 2 per cent of treasury resources, fiscal surpluses and 30 per cent of privatisation proceeds with total resources of up to 3 per cent of GDP.

However, Argentina's severe recession caused the Government to postpone the target for fiscal equilibrium until 2005; the IMF sanctioned this delay. Also, the Government has yet to establish the counter cyclical fiscal fund. Finally, unlike Brazil's new Fiscal Responsibility Law, Argentina's law does not include civil or criminal penalties for federal or state governments failing to meet targets. Analysts fear these factors undermine the credibility of the Government's commitment to fiscal reform.

2000 fiscal pact

The 1998 Federal Revenue Sharing Law requires government to transfer revenue to provincial and municipal governments in line with increases in national tax revenues. However, this law has undermined the federal Government's ability to meet its deficit reduction target. Furthermore, provincial governments typically run deficits, which contribute significantly to the overall public sector borrowing requirement.

In November 2000, to help achieve fiscal solvency, federal and provincial governments signed a fiscal pact, requiring governments to:

- cap federal transfers to provinces
- freeze provinces' primary expenditures at current levels until 2005
- ensure provinces elaborate their own fiscal responsibility laws and reach a balanced budget by 2005
- restructure the debt of highly indebted provinces; harmonise provincial taxes; and improve the quality and timeliness of fiscal accounts.

However, extending the national fiscal balance target date also diminishes the pact's credibility, particularly as some provinces strongly resist fiscal restraint. Nevertheless, in May 2001, the largest and highest spending province, Buenos Aires, announced significant cuts to public sector wages.

Expenditure

Although government expenditure decreased slightly in 2000, public expenditure grew strongly in 1997, contrary to IMF agreements, substantially contributing to the current fiscal deficit (Figures 7.11 and 7.12). Between 1995 and 2000, consolidated central and provincial government expenditure increased by 22 per cent; debt interest payments rose 139 per cent accounting for most of the increase.[9]

Pension reforms

In 1994, the Government began to reform the pension system, using the Chilean model. It scaled down the pay as you go system, so employer contributions would finance a basic minimum pension for all current and future old age pensioners. It simultaneously created a supplementary employee financed private pension system. In the longer term, this reform may reduce public sector pension liabilities, but during the transition, it reduces funding for pay as you go pensions, as private contributions are not available to pay current retirees. These transition costs amount to around 1 per cent of GDP per year, contributing to the deficit.

In January 2001, the Government introduced reforms to reduce the scheme's costs from 2005.[10] However, the system's relatively high cost is pushing many out of the formal labour market. When these people retire, they will not be covered by the private pension scheme and, if they are to receive benefits, there will be a significant charge on the unfunded pension system. One advantage of the private employee funded pension system, which is managed privately with government prudential oversight, is it stimulates growth in the local financial sector.

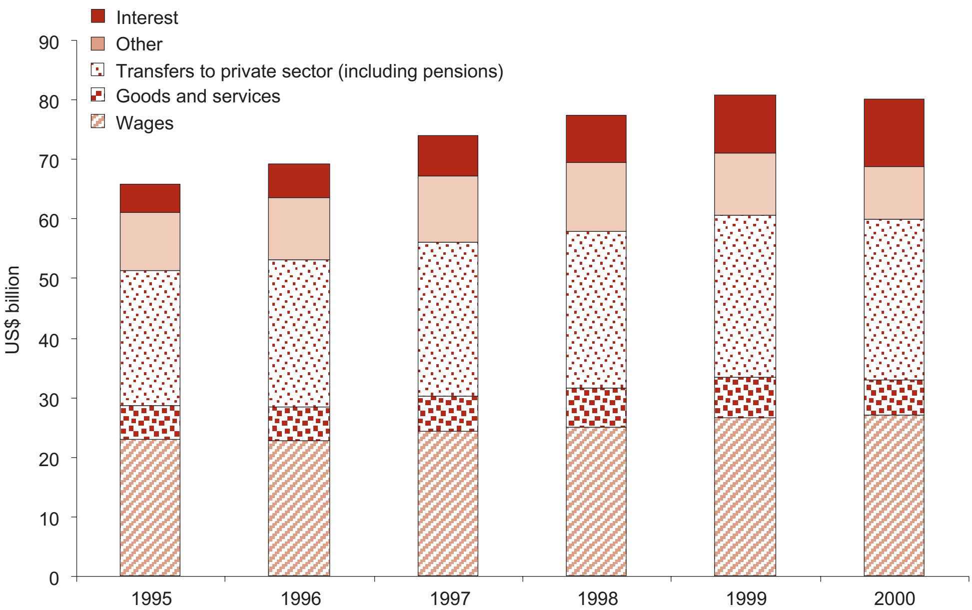
9 Public sector salaries grew by 18 per cent between 1993 and 1998; transfers to provinces, pensions and others, which account for more than 60 per cent of federal outlays, grew by 15 per cent.

10 These will eliminate the universal basic benefit for pensions over US$800 per month and raise women's retirement age to 65 years. Other measures aim to distribute pensions more fairly and tackle fraud.

Figure 7.11

Public Expenditure Up Sharply in 1990s

Federal Fiscal Primary Outlays



Source: Ministry of Finance, 2001.

Taxation

Despite efforts in the 1990s to improve the taxation regime, it remains administratively very complex, burdensome and poorly enforced, imposing serious efficiency costs on business and the economy, and constraining public deficit reduction.[11] Only 16 per cent of the population pay income tax, increasing the burden considerably on those who do pay. Penalties for tax evasion are weak and do not include criminal sanctions. Tax moratoriums and other amnesties are used frequently, undermining incentives to comply. Multiple taxes and social security payments push 45 per cent of the workforce into the informal sector, where they pay no tax. Furthermore, the bias towards indirect rather than direct taxation makes the tax system regressive in terms of income, and only slightly progressive in terms of consumption (Fundación de Investigaciones Económicas Latinoamericanas, 1998).

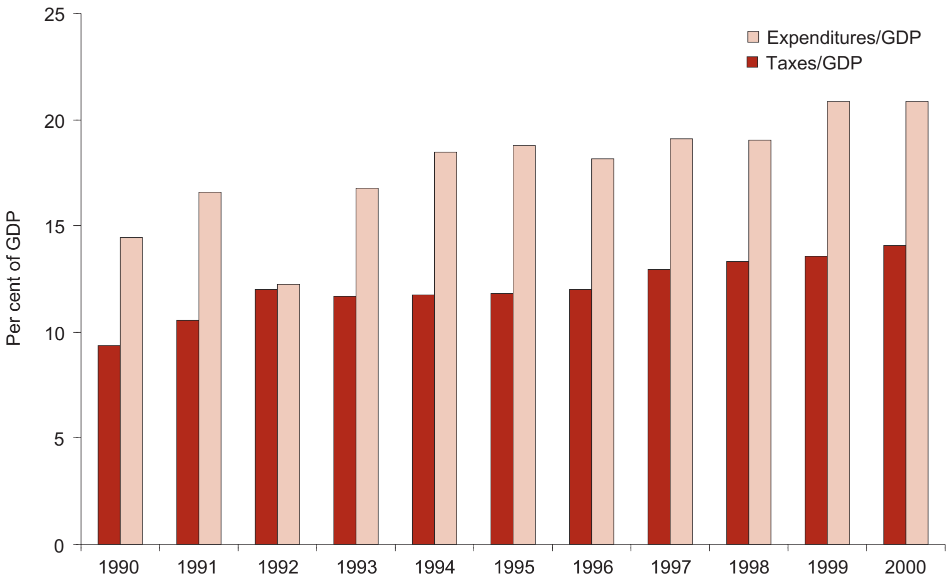
Due to these problems, over the 1990s, tax revenues grew only from 9 to 14 per cent of GDP (Figure 7.12). Nevertheless, the tax structure progressed towards a consumption base, from a production base. The value added tax, VAT, was generalised and increased to 21 per cent, and social security contributions and payroll taxes increased.

[11] Widespread evasion and lack of transparency mean broad based personal and company income and value added taxes are not collected; consequently, federal and provincial governments attempt to levy over 200 inefficient taxes on a wide range of items and activities. Many taxes overlap, cascade and accumulate, have no economic rationale and discourage employment, saving, investment and exports, adding significantly to the so-called 'Argentine cost' of doing business and undermining competitiveness and growth.

Figure 7.12

Spending Rising More Quickly than Revenue

Tax Revenues and Fiscal Outlays, Per cent of GDP, 1990-2000



Source: Ministry of Finance, 2001.

In 1996, the Government created a new public tax agency, the AFIP, to collect all customs, tax and social security contributions. However, at US$1 billion per year, its administrative costs, as a proportion of tax collected, are among the highest in the world, and commentators believe transparency and accountability remain unsatisfactory. Efforts to reduce tax evasion apparently remain ineffective.

FINANCIAL AND BANKING SECTOR

After the 1994 Mexican crisis, the Argentine banking system lost 18 per cent of its deposits and the central bank lost 33 per cent of its foreign exchange reserves. Twelve banks were liquidated and 41 merged with healthier banks (Calomiris and Powell, 2000). Subsequently, the government tightened prudential regulations, strengthening the banking system.

ARGENTINA'S BANKING SECTOR REFORMS

1995 banking sector reforms included:

- requiring banks to hold at least 20 per cent of most banking liabilities as liquid assets
- requiring banks to strengthen their capital adequacy ratios, based on weighting credit, market and interest rate risks to 11.5 per cent (above the Basle Accord's 8 per cent minimum)
- introducing a rating mechanism, CAMEL, requiring lower capital adequacy ratios from sounder entities. The Superintendency of Banks uses information from financial companies and external audits to determine the rating
- establishing a privately managed deposit insurance scheme, SEDESA, funded by compulsory contributions from financial institutions
- introducing a contingent repurchase facility, allowing the central bank to place government securities in the international credit market to ensure liquidity, if a credit crunch occurs
- establishing a centralised credit risk bureau detailing the credit history of debtors
- requiring banks to provide public access to bank balance sheets and performance ratings, increasing public awareness of risk and enhancing competition
- encouraging more general use of banking services by requiring firms employing over 100 staff to pay wages through bank accounts
- introducing heavier penalties for cheque defaults
- introducing electronic, real time interbank payments and settlements (International Monetary Fund, 1998).

In addition, in 2000, the Government introduced a new corporate bankruptcy law protecting banks from bad loans and widespread bankruptcy by making corporate restructuring more flexible (Díaz Frers, 2000).

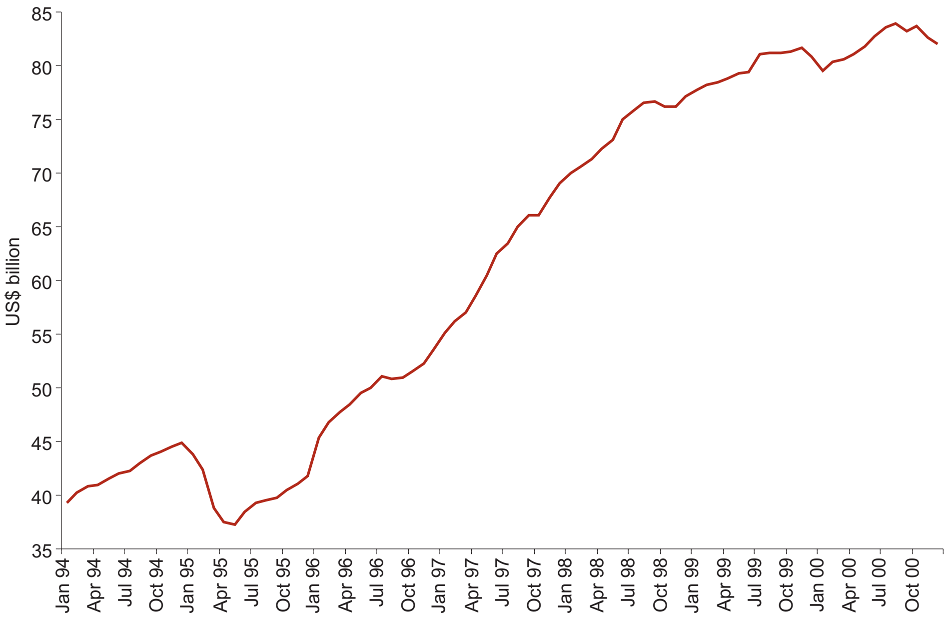
Although the Asian crisis, then the Russian crisis and Brazilian devaluation caused a deeper and longer recession than the Mexican crisis, banking system deposits continued growing at least until late 2000 (Figure 7.13). Also, from 1999 to 2001, only a couple of banks have been suspended. However, the 6.4 per cent fall in bank deposits during the March 2001 crisis preceding Minister Cavallo's appointment, put banks under pressure, but probably reflected lack of confidence in the peso rather than the banking system. Deposits increased 0.2 per cent in April but fell by 1.4 per cent in May; pressure on deposits continued in July.

As a result of the Mexican crisis and foreign competition, the banking system consolidated, with the number of banks falling from 205 in 1994, to 143 in 1997 and to 94 in 2000. Foreign banks significantly penetrated the market, increasing their share in total deposits from 16 per cent in 1994 to 39 per cent in 1997 to around 50 per cent in 2000. Staff numbers also fell from 123 000 in 1994 to 104 000 at the end of 1999, and several provincial banks were privatised.

Figure 7.13

Deposits Growing during Most of the 1999-2001 Recession

Level of Total Deposits, US$ billion



Source: Banco Central de la República Argentina, 2001.

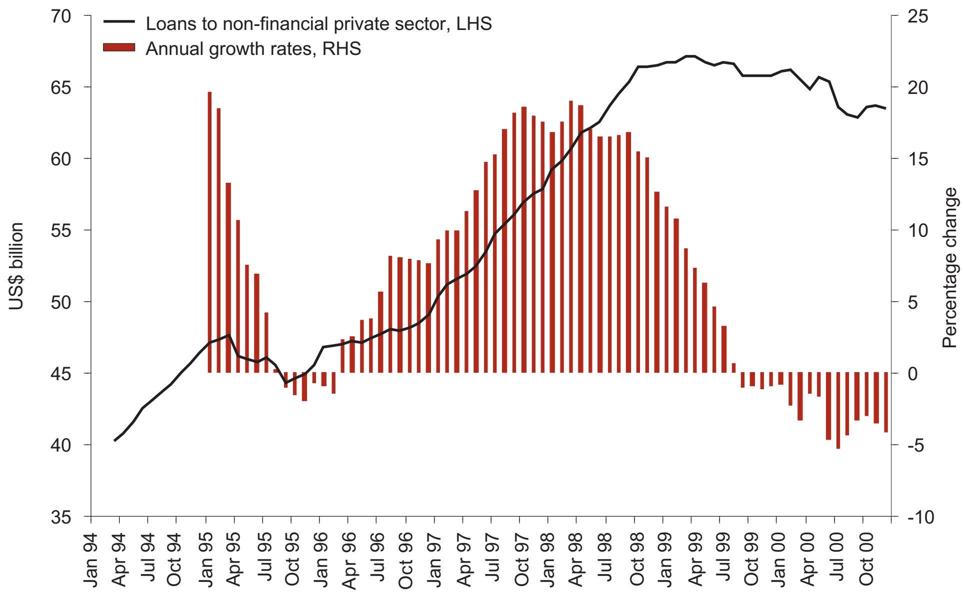
Since September 1999, caution and the availability of a large stock of high yielding government bonds has caused banks to contract lending to the private sector (Figure 7.14). More than 60 per cent of new bank lending is to the public sector via bond purchases, although only 20 per cent of bank asset stocks are held in bonds (International Monetary Fund, 2001b). In early 2001, reflecting the Government's tough prudential reforms, caution about exposure to corporate lending during the recession and banking sector consolidation, banks' actual capital adequacy ratios were 20 per cent and liquid assets exceeded 30 per cent of total liabilities (International Monetary Fund, 2000b).

By 2001, bank profits were low and falling; non-performing loans had grown to around 12.7 per cent of total loans (International Monetary Fund, 2001a). So far, the recession has affected the banking sector less severely than the Mexican crisis. However, as 67 per cent of bank assets, mostly loans to local firms and households, are denominated in US dollars, if the peso devalues significantly, many borrowers could default.

Figure 7.14

Lending to the Private Sector Shrinks since 1999

Total Loans to Non-financial Private Sector



Source: Banco Central de la República Argentina, 2001.

Further Directions and Challenges

Re-establishing growth in bank credit to the private sector requires further fiscal consolidation to reduce the crowding out effect from government bond sales and stronger economic activity to increase demand for loans. The other major challenge is to reduce bank spreads, particularly for small and medium businesses, to make bank loans more affordable. While interest spreads are very low for large, well run corporates, they are very high for small and medium businesses, resulting in borrowing rates of 40 to 50 per cent. In part, these spreads reflect the high credit risk of these borrowers, but high spreads also reflect banks' high margins and high taxes.

Government recognises the financial system could come under increasing stress if the recession deepens (and the peg is abandoned) so it signalled it intends to further strengthen the regulatory system by:

- strengthening coordination of supervisory agencies (banks, stock exchange, insurance and pension funds)
- developing a domestic capital market by simplifying procedures for bond issues, strengthening corporate governance, protecting minority shareholders' rights and introducing fair business practices
- strengthening the central bank's ability to handle troubled financial institutions (International Monetary Fund, 2001b).

ARGENTINA'S FUTURE GROWTH PROSPECTS

In sharp contrast with the dismal economic performance of the 1980s, during the first seven years of the 1990s, growth was strong and macroeconomic reforms, stabilisation, deregulation, privatisation and trade liberalisation were far reaching. However, since the recession began in late 1998, the government has found it difficult to institute reforms and deal with external shocks, undermining future growth prospects and placing Argentina in a vulnerable situation.

Recent Policy Changes

After being re-appointed as Economy Minister, Cavallo secured emergency powers from Congress to resolve some of Argentina's most pressing economic problems. Under these powers, he can alter taxes and reform government, but he cannot cut jobs, wages or pensions or privatise assets.

COMPETITIVENESS AND EXCHANGE RATE POLICIES

Cavallo's competitiveness package, released since March 2001, includes measures aimed at reducing the deficit and restoring competitiveness in the absence of a devaluation. It includes:

- introducing a tax on all cheque account debits and credits, initially at 0.25 per cent and later raised to 0.6 per cent and extended to VAT and income tax contributions, and lowering the limit for cash transactions from $10 000 to $1 000 to reduce tax evasion[12]
- applying income tax to unlisted share sales and offshore companies
- extending VAT to all previously exempted activities, and halving VAT for all imported and locally produced trucks, buses, tractors, agricultural machinery and other capital goods, including information technology and telephone equipment
- lowering, mostly to zero, tariffs on capital goods, to encourage investment and exports
- raising tariffs to 27 per cent on imports of non-Mercosur consumer goods to dampen imports and encourage import substitution
- introducing 'competitiveness' packages for sectors including machine tools, automotive parts, footwear, textiles, clothing, information technology and telecommunications, tourism and paper, involving lower taxes and employer contributions, tax deferrals and exemptions, and softer credits or better financing terms.

In June 2001, Minister Cavallo announced a new package to improve tax collections, increase competitiveness and boost demand. The main element, the 'Convergence Factor', reimburses exporters but penalises importers to reflect the new US dollar euro peg.[13]

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12 Companies and individuals can deduct this from VAT and income tax obligations.

13 The amount to be reimbursed is calculated daily as the difference in the US dollar parity and the dollar-euro average basket. Investment transactions still will be converted at US dollar parity. This applies prior to the passage, through the Senate, of the bill to replace the dollar peg for a dollar-euro basket, which becomes operative if and when the US dollar and euro reach par. The convertibility law remains unchanged.

Drastic adjustment package

On 11 July 2001, President De la Rúa announced a dramatic adjustment to reach a zero deficit in the second half of the year. The Government will only pay for expenditures with collected funds, removing access to the markets to fund the deficit, and it will create special courts to deal with tax evasion (ArgenMedios, 2001). By late July 2001, this had yet to be approved by Congress.

IMF targets

In December 2000, the IMF agreed on a new arrangement with the Argentine Government.[14] This includes commitments to cap public spending and balance the federal budget by 2005, and implement a fiscal stabilisation fund to soften the swings external shocks create (Appendix Table 7.1).

Priorities for Further Reform

Major future priorities are:

- overcoming the chronic structural deficit by increasing the tax system's coverage, enforcement, fairness and efficiency, reducing excessive public administration costs, and increasing productivity and competitiveness
- enlisting provinces' support to reduce administration, justice and defence expenditures to overcome the structural deficit
- increasing the quality of education, health, justice and security services
- increasing the flexibility of exchange rate arrangements to boost international competitiveness and drive long term growth
- opening the economy to international trade, not only by free trade agreements but also by unilaterally reducing tariffs and adopting a realistic exchange rate
- reforming rigid, formal labour markets to promote employment creation and income growth, particularly for low skilled workers
- refining utilities reforms in telecommunications, gas, water and electricity to enhance competition, minimise prices and maximise service
- enforcing competition and intellectual property right protection to generate greater productivity gains.

Minister Cavallo has flagged his intention to tackle most of these major policy issues. For example, he is canvassing the need for broad based tax reform and second generation institutional reforms in public administration, justice, security, social assistance, public education and health.[15] However, at present, the Government will consider only relatively minor reforms to the Convertibility Plan.

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14 The new IMF letter of intent recognised the recession's impact on the fiscal deficit. It maintains the agreed fiscal deficit target for 2001 at US$6.5 billion and anticipates Argentina will wind back the US$1.3 billion overshoot in the first quarter by the fourth quarter.

15 First generation reforms included privatisation, deregulation, trade liberalisation and convertibility. Second generation reforms target increased efficiency in sectors where only government can operate and hence where it should concentrate its efforts.

Risks and Prospects

In mid 2001, the main risk facing the Argentine economy is the Government's perceived lack of commitment to achieving fiscal balance, which could permanently isolate Argentina from international financing. This could provoke a foreign payments crisis and a run on reserves, forcing debt default or restructuring. Given time, Government commitments to the IMF and recent reform proposals could produce positive results. However, to provide that time and reassure markets, Congress needs to pass proposed reforms with fewer modifications.[16]

External risks are of a lower order of magnitude, but include recurring debt repayment problems in Brazil, continued US dollar strength, continued euro and real depreciation, further slowing of global growth, and falls in agricultural and mineral prices. Indicators for the United States do not provide clear evidence of the strength of a slowdown, but given Argentina's severe structural weaknesses, Argentina will be vulnerable if US growth continues to slow.

Although the economy was expected to move out of recession in 2001, first quarter GDP results still show negative growth, and growth is likely to remain below zero in 2001 and recover slightly in 2002. Even if Argentina could lift consumer sentiment, in the absence of concerted reforms to overcome the deficit and free the exchange rate, Argentina is unlikely to reachieve growth levels of the early 1990s. However, if the Government can deliver on these crucial reforms, Argentina's ample and well developed physical and human resources should help it grow rapidly and prosper in the future. Given the risk of a major crisis, possibly involving debt default and peso devaluation in the short term, investment in Argentina should be considered in the medium term, with prospects good if Argentina can deal successfully with the current situation.

[16] Congress amended bills to promote labour market, social security and health reform, and the Fiscal Pact, impoverishing them. Consequently, these laws have disappointed initial expectations for reform.

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Appendix Table 7.1

Government Commits to Major Reforms

Government's Letter of Intent with the IMF, January 2001

Area	Means	Objective
Fiscal	Reform revenue sharing agreements (coparticipation) and tax administration	Progressively reduce the consolidated public sector deficit; improve spending management; reduce provinces' fiscal deficits; reach equilibrium in 2005; freeze nominal spending; limit debt; and increase transparency
Public services	Bring in the private sector to develop basic infrastructure	Deliver higher quality and more cost effective public services
Social	Create temporary employment programs	Improve the unemployed and poor's conditions; and improve management of emergency situations
Social security	Reduce preferential pensions	Make social security more equitable and ensure its long term fiscal solvency
Health		Increase efficiency
Labour	Modernise labour laws	Promote job creation
Financial markets	Introduce new financial instruments; strengthen the regulatory framework for non-bank financial intermediaries; and improve ties with other financial markets in Latin America	Develop the domestic financial market
	Change the central bank's charter	Strengthen the central bank's ability to deal with potentially troubled financial institutions
	Develop cooperation agreements with supervisors in industrial banks	Strengthen bank supervision
	Strengthen the capital base of Banco Nación	Strengthen Banco Nación and its lending activities; increase its transparency; and limit exposure
Real sector	Create revolving funds to extend guarantees and provide risk capital to small and medium businesses; and provide partial interest rate subsidies	Foster small and medium businesses

Source: International Monetary Fund, 2001d.

TRADE AND INVESTMENT OPPORTUNITIES IN ARGENTINA

KEY POINTS

- **In the short term, Argentina is gripped by a serious debt crisis and recession caused by its overvalued exchange rate. This reduces short term trade opportunities, particularly for consumer goods.**

- **However, over the medium term, Argentina's major early 1990s trade and investment reforms, the highest per capita income in Latin America, and ample human and natural resources underpin commercial opportunities for Australian business in this Argentine market.**

- **The possibility Argentina will devalue its currency in response to this crisis also deters foreign investors in the short term. However, in the medium to long term, Australia's strengths in mining, agribusiness, leisure, information technology and financial service sectors imply profitable direct investment opportunities.**

Over the 1990s, Argentina's economy opened significantly to trade and investment flows. However, the reform process is only partly complete, threatened by the unrealistically high exchange rate. This undermines short term growth prospects, and trade and investment opportunities.

Despite low bilateral trade flows, trade opportunities for Australian business do exist in Argentina. As Argentina is a competitive producer in many of Australia's traditional commodity export areas, export opportunities lie mainly in elaborately transformed manufactures, ETMs, tourism, business, financial, leisure and information technology services, and goods and services Argentina's agricultural and mining sectors require.

Australian companies have significant investments in Argentine mining, ports and entertainment sectors. Opportunities also lie in other infrastructure sectors, particularly telecommunications services, and agribusiness, particularly wine production.

This chapter examines Argentina's ongoing trade liberalisation, particularly via Mercosur membership. It identifies areas where trade opportunities are likely to emerge for Australian exporters. Then it analyses the foreign investment regime and details Australian company investments in Argentina. Finally, it highlights prospective Argentine trade and investment opportunities for Australian business.

TRADE POLICY AND TRADE STRUCTURE OVER THE 1990s

Argentina liberalised its trade regime during the 1990s, although recent tariff changes increase the level of protection. Argentina's membership of Mercosur, the free trade agreement between Brazil, Argentina, Paraguay and Uruguay (with Chile and Bolivia as associate members), significantly affects Argentina's trade regime and flows.

Changing Trade Policy

Argentine governments initially liberalised trade through unilaterally reducing trade barriers; later reforms involved regional and multilateral liberalisations. Between 1987 and 1988, Argentina reduced average tariffs from 45 per cent to 29 per cent, reduced quotas and eliminated import licences on around 3 000 tariff items.[1] Between 1989 and 1991, average tariffs fell to 12 per cent and import licences were eliminated. However, imports flooded in, and with its exchange rate held at parity to the US dollar, in late 1992, the Government partly reversed liberalisation. Overall, unilateral liberalisation reduced average tariffs from 45 per cent in 1987 to around 13 per cent in 1994 (Berlinski, 1998).

From 1995, Mercosur membership determined Argentine trade policy, with most intra-Mercosur tariffs removed and common external tariffs phased in. The common external tariff ranges from 0 per cent to 30 per cent and, until recently it averaged 17 per cent. (See *Chapter 12 - Regional Economic Integration*.)

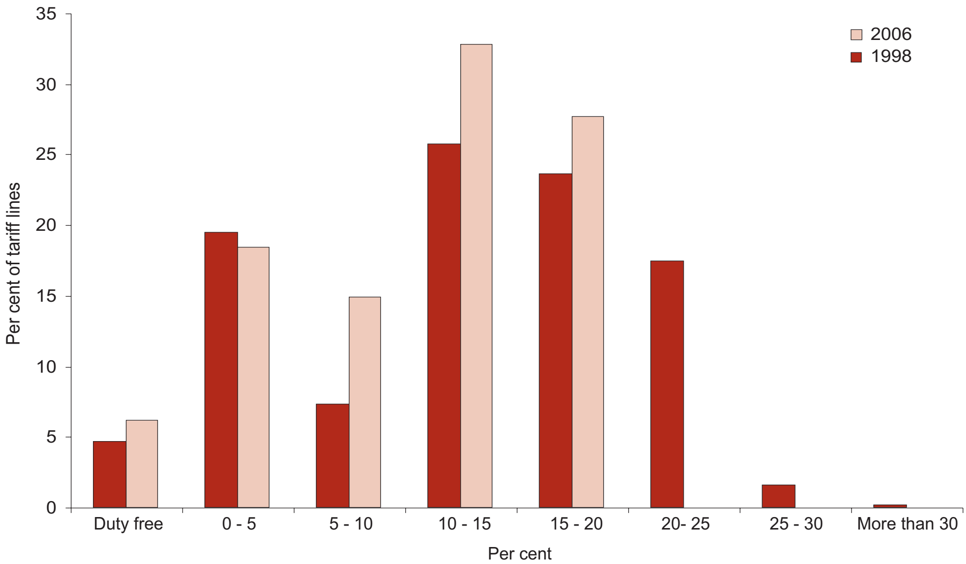
[1] Previously, import licensing covered about 90 per cent of import items and sheltered over 50 per cent of domestic production from foreign competition.

Argentina's average tariff rate rose above 14 per cent by 2000, with nominal protection highest in textiles and lowest in mining and information technology. Tariffs were set to decline over the five years to 2005 (Figure 8.1). However, in 2001, to compensate for its overvalued exchange rate, the Government introduced new trade barriers, including increasing tariffs on consumer goods to 27 per cent while reducing tariffs on most capital goods to zero.[2] In June 2001, the Government eliminated most non-tariff trade barriers, including indirect and direct taxes on selected traded goods; however, some non-tariff trade barriers remain in the automotive, textile, clothing and footwear industries. Tariffs on raw materials, industrial intermediate goods and primary products generally are low.

Figure 8.1

Tariff Peaks Planned to Fall by 2006

Distribution of Most Favoured Nation Rates, 1998 and 2006 (Projected)



Note: Calculations for 1998 include the 3 percentage point increase in most favoured nation, MFN, tariffs on many items applied until 2000.

Source: World Trade Organization, 1998.

[2] In June 2001, the Government effectively devalued the exchange rate for the international trade transactions by 8 per cent by effectively introducing a dual exchange rate pegging the Argentine peso to the US dollar and the euro on a 50:50 basis; the new rate is implemented by charging importers a convergence factor of 8 per cent and reimbursing exporters by the same amount.

FREE TRADE ZONES OFFER GOOD CONCESSIONS

Free trade zones offer outstanding advantages to importers; goods brought into the zones enter free of taxes and duties. Since 1997, the Government has permitted each province to establish one free trade zone; zones now operate in La Plata, San Luis, Córdoba, Tucumán, Mendoza, Santa Fe, Comodora and Rivadavia, and Tierra del Fuego has a special customs area.

For importers, goods entering the zones enjoy tax free status until they enter the Argentine market, for up to five years. This allows firms in zones to release goods depending on demand, avoiding import duties and taxes until they actually are sold. Also, incoming goods can be split up, used in further processing and may be re-exported to any part of the world without attracting duty or tax. These goods can receive import verification directly at the zone, rather than at the port of origin. Free trade zone users also can display their goods in a showroom at the zone to facilitate marketing. The Tiera del Fuego Special Customs Area allows duty free imports of some capital goods and other goods to be assembled in local plants for sale in Argentina. All other imports entering through this area, which will keep its duty free status until 2013, receive a 50 per cent tariff reduction.

Exporters can import duty free all equipment needed to build a plant in the zone. They also can import all raw materials and intermediate goods duty and tax free. Basic utilities like electricity, telephones, gas and water used by exporters also are VAT exempt.

Source: US Department of State, 2000.

Imports from Mercosur enter at zero tariffs and tariff preference averages 14.5 per cent; however, this should fall to 11 per cent by 2006. Intra-Mercosur trade liberalisation does not apply to the sugar and automotive sectors because Argentine and Brazilian policies for these sectors diverge significantly. A managed trade arrangement applies to cars; it favours local content, concessional entry of parts, and export balancing.[3]

In the Uruguay Round, Argentina considerably expanded its commitments to bind tariffs covering its entire tariff structure, and reducing the maximum bound tariff rate from 140 per cent to 35 per cent.[4] However, after 1999, when the Brazilian real depreciated and Argentina entered its prolonged recession, pressure to increase protection intensified. Mercosur does not allow a unilateral rise in tariffs; consequently, Argentina increased its use of anti-dumping actions, and raised tariffs to the maximum 35 per cent (reduced to 27 per cent in June 2001) on items excluded from the Mercosur agreement.

3 At the beginning of 2000, members agreed in principle on a common regime for cars. It established free trade within the region, a common external tariff of 35 per cent for final products and a lower rate (around 14 per cent) for parts and components. Finally, it established requirements for local and regional content. Still, some aspects of the agreement remain controversial, delaying its application.

4 During the 1990s, Argentina implemented bound tariff rates and amended its anti-dumping, subsidies and countervailing measures legislation. Argentina also adopted many Trade Related Aspects of Intellectual Property Rights, TRIPS, including strengthening its patent and intellectual property regime for pharmaceuticals.

Argentina's non-tariff barriers include import licensing; import prohibitions for human health, animal and plant life, environment, or essential security and military reasons; anti-dumping measures; and countervailing duties. Apart from the free trade zones, Argentina also maintains some concessional entry regimes to promote domestic processing and product diversification, and meet input supply shortages. Customs authorities are aggressive in applying safeguards and specific duties, and have introduced onerous new inspection requirements and product standards licensing procedures (US Department of State, 2000).

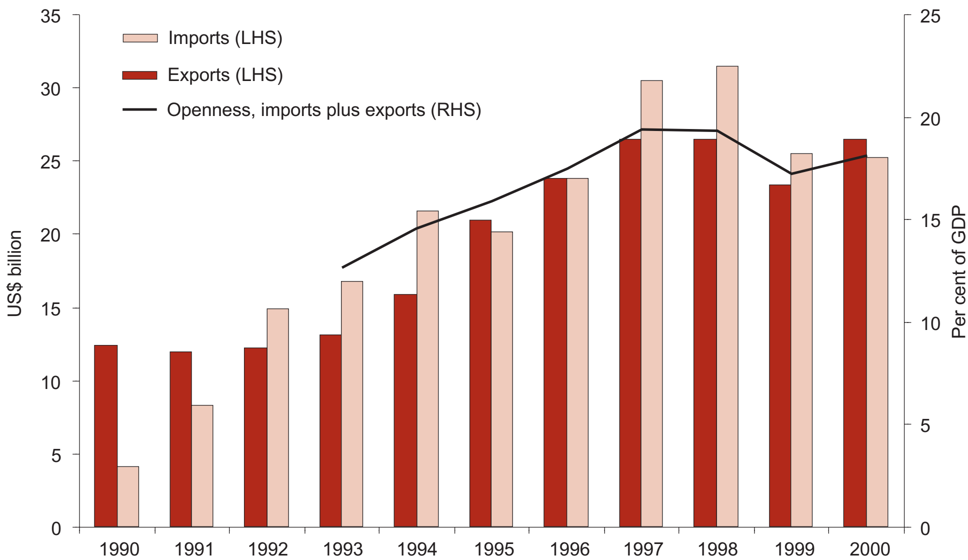
Impact on Trade Flows

Prior to the 1998-2000 recession, Argentina's early 1990s trade reforms, Mercosur membership, strongly growing incomes and export-oriented foreign direct investment, FDI, particularly in mining, rapidly expanded its trade. While global trade increased by around 60 per cent between 1991 and 1999, Argentine trade (exports plus imports) grew by around 140 per cent and trade with Mercosur partners quadrupled. Argentina's openness to trade, measured by the ratio of exports plus imports to GDP, improved from around 10 per cent in 1985-87 to almost 18 per cent in 1998-2000 (Figure 8.2). This share is similar to large economies such as the United States (18.5 per cent), Brazil (18.4 per cent) and Japan (16.7 per cent), but well below similar sized economies such as Australia (30.8 per cent) and the Republic of Korea (64.7 per cent).[5] (See *Chapter 2 - Asia-Pacific Comparisons*.)

Figure 8.2

Argentina's Rapid Trade Growth Halted after 1998

External Merchandise Trade and Openness, 1990-2000, US$ billion and Per cent



Source: Ministerio de Economia, 2001.

5 1999 data.

After 1998, trade declined due to the overvalued peso, high trade barriers and the recession. However in 2000, despite the peso's continuing appreciation, exports recovered 13 per cent, as some large export-oriented projects came on stream and domestic demand remained depressed.

IMPORT STRUCTURE AND TRENDS

The exchange rate, GDP growth, regional trade preferences reinforcing geographical proximity, and trade liberalisation drive changes in the level and pattern of Argentine imports. Imports grew strongly until 1998 but, like exports, fell away in 1999 as the peso appreciated in real effective terms and recession set in. Capital goods and parts for capital goods dominate imports; their share grew as economic reform stimulated investment. Intermediate goods' import share fell as domestic mining industries developed and consumer goods imports grew with trade liberalisation and growing affluence (Table 8.1).[6] In 2000, around 90 per cent of Argentine imports, worth US$22 billion, were manufactures.

Table 8.1

Capital Goods, Parts and Consumer Goods Growing

Argentine Imports, by Main Categories: Value, Shares and Growth (US$ million and Per cent)

Classification	Average 1984-88	Average 1993-97	1998	1999	2000	Change (per cent) 1984-88 to 2000	Change (per cent) 1993-97 to 2000
Consumption goods	297 (6.1)	3 743 (16.6)	4 859 (15.5)	4 501 (17.6)	4 609 (18.3)	1 450	23
Intermediate inputs	2 300 (47.4)	7 395 (32.8)	10 016 (31.9)	8 354 (32.8)	8 443 (33.4)	267	14
Capital goods	800 (16.5)	5 635 (25.0)	8 500 (27.1)	6 748 (26.5)	5 887 (23.3)	641	5
Parts for capital goods	944 (19.4)	3 843 (17.1)	5 521 (17.6)	4 197 (16.5)	4 449 (17.6)	359	13
Petroleum, gas and oil	495 (10.2)	722 (3.2)	853 (2.7)	730 (2.9)	1 035 (4.1)	109	43
Vehicles	8 (0.2)	1 157 (5.1)	1 628 (5.2)	957 (3.8)	799 (3.2)	9 888	-31
Other	8 (0.2)	26 (0.1)	26 (0.1)	21 (0.1)	23 (0.1)	200	-6
Total	4 582 (100)	22 522 (100)	31 404 (100)	25 508 (100)	25 243 (100)	449	12

Source: Ministerio de Economia, 2001.

6 Due to changes in nomenclature in 1991, homogeneous disaggregate data are not available for the entire 1990-2000 period. Thus, data for Argentina start in 1992.

ETM Imports

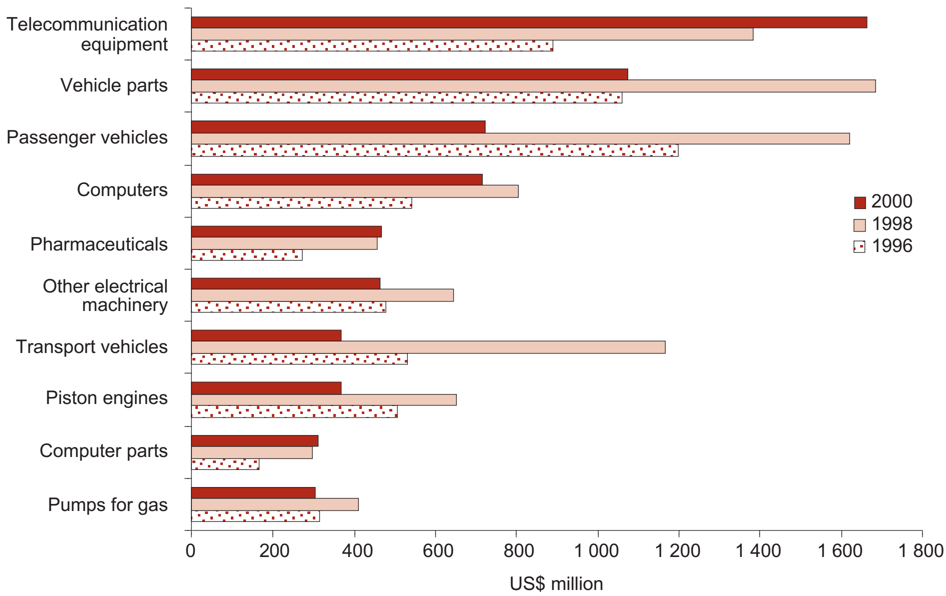
Elaborately transformed manufactures, ETMs, account for around 73 per cent of manufactured imports, with their share increasing over the 1990s, until the recession. In 2000, the most important ETM imports were telecommunications equipment, motor vehicles and parts and computers (Figure 8.3). Only telecommunications equipment imports continued to grow, as industry deregulation continued.

From 1992 to 1998, perfumery and cosmetics, furniture, other optical goods, knitted or crocheted fabrics and ethylene polymers grew by over 200 per cent, reflecting growing affluence and lower tariff barriers. However, after 1998, the recession then hit consumer goods imports, as did additional tariffs on non-Mercosur consumer goods (Table 8.2).

Figure 8.3

Telecommunications, Computers, Vehicles and Capital Equipment Dominate Imports

Argentina's Top Ten ETM Imports, US$ million



Note: Ranked by 2000 figures.

Source: Department of Foreign Affairs and Trade, 2001; and Instituto Nacional de Estadistica y Censos, 2001.

Table 8.2

Consumer Imports Boom in 1990s

Argentine High Growth ETM Imports

	1992	1998	2000		Change	
	US$ millions	US$ millions	US$ millions	1992-98 (per cent)	1998-2000 (per cent)	1992-2000 (per cent)
Perfumery and cosmetics	25.7	139.2	109.4	442	-21	326
Furniture	47.1	177.9	177.2	278	0	277
Other optical goods	15.9	53.0	58.4	234	10	268
Knitted or crocheted fabrics	13.7	60.5	48.4	340	-20	253
Ethylene polymers	69.0	224.0	239.6	225	7	247
Glass	24.7	77.8	65.8	214	-15	166
Other base metal manufactures	80.7	273.2	207.5	239	-24	157
Soap and cleansing preparations	45.6	133.4	113.3	192	-15	148
Other textile manufactures	42.5	100.3	101.8	136	2	139
Plastic tubes, pipes and hoses	23.3	73.1	55.1	214	-25	137
Paper manufactures	81.8	202.1	179.6	147	-11	119
Pigments, paints and varnishes	79.9	210.5	175.2	164	-17	119
Plastic plate, sheet film and strip	96.5	238.5	203.4	147	-15	111
Essential oils, perfumes and flavours	16.2	44.7	32.9	176	-26	103
Cutlery	34.0	78.6	68.4	131	-13	101
Travel goods and handbags	21.9	48.5	43.3	122	-11	98
Rubber tyres	117.9	242.7	225.4	106	-7	91
Lighting fixtures and fittings	18.1	43.9	33.7	143	-23	86
Meters and counters	18.9	39.6	35.1	109	-11	85

Source: Department of Foreign Affairs and Trade, 2001; and Instituto Nacional de Estadistica y Censos, 2001.

Non-ETM Imports

Major non-ETM imports included paper and paperboard (US$560 million), organo-inorganic compounds (US$476 million), crude and refined petroleum (US$314 million and US$282 million), and fertilisers (US$250 million). Rapidly growing non-ETM imports include leather, silver platinum, prepared or preserved meat, other inorganic chemicals, cork manufactures, and radioactive and associated materials; all grew by over 300 per cent from 1992 to 2000.

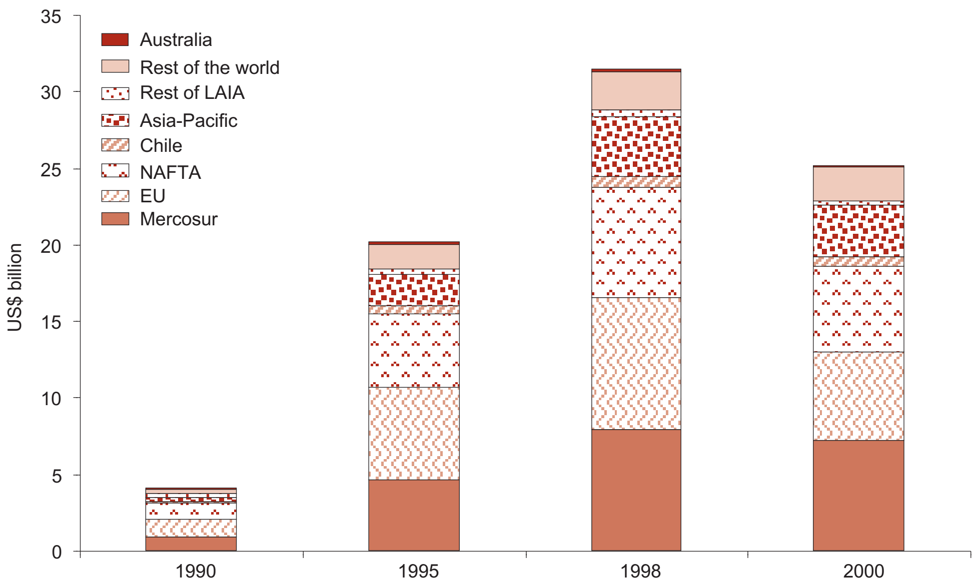
Sources of Argentine Imports

Argentine imports from Mercosur countries grew steadily from 17 per cent in 1987 to 25 per cent in 1992, then stabilised until 2000. In 1999-2000, North American Free Trade Agreement, NAFTA countries and the EU supplied import shares of 23 per cent and 27 per cent respectively (Figure 8.4). In 2000, Brazil was the main country source of imports with a 25 per cent share, then the United States with 19 per cent. Australia is not a significant source for Argentine imports, supplying only US$87 million of imports in 1999 and US$65 million in 2000, about 0.3 per cent of total imports.

Figure 8.4

United States, Mercosur and EU Dominant Import Suppliers

Argentine Imports, by Region, US$ billion



Note: 2000 data are preliminary.

Rest of Latin American Integration Association, LAIA, excludes Brazil, Chile, Mexico, Paraguay and Uruguay.

Asia-Pacific comprises Japan, Republic of Korea, China, Philippines, Indonesia, Malaysia, Singapore, Thailand and Vietnam.

Source: Instituto Nacional de Estadistica y Censos, 2001.

TRADE IN SERVICES

During the 1990s, total trade in services increased much more slowly than merchandise trade; service imports grew only 60 per cent to almost US$9 billion (Figure 8.5).

Services imports

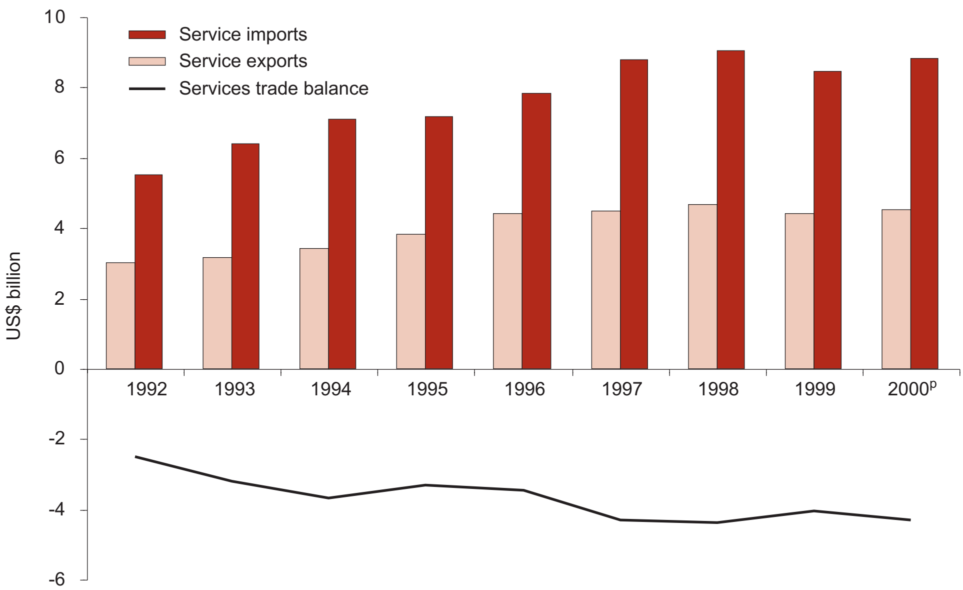
In the 1990s, travel and transport represented almost 80 per cent of Argentine service imports (Figure 8.6). Their shares of total imports remained relatively stable.

However, many other service imports showed dynamic growth in the 1990s. The most rapidly growing included computer data processing and information services (537 per cent), insurance services (356 per cent), cultural and entertainment services (150 per cent), financial services (85 per cent), and business, professional and technical services (74 per cent); travel increased by only 68 per cent. Communications services fell by 15 per cent, as domestic deregulation increased local supply capacity.

Figure 8.5

Services Imports Far Exceed Services Exports

Argentine Trade in Services, 1992-2000



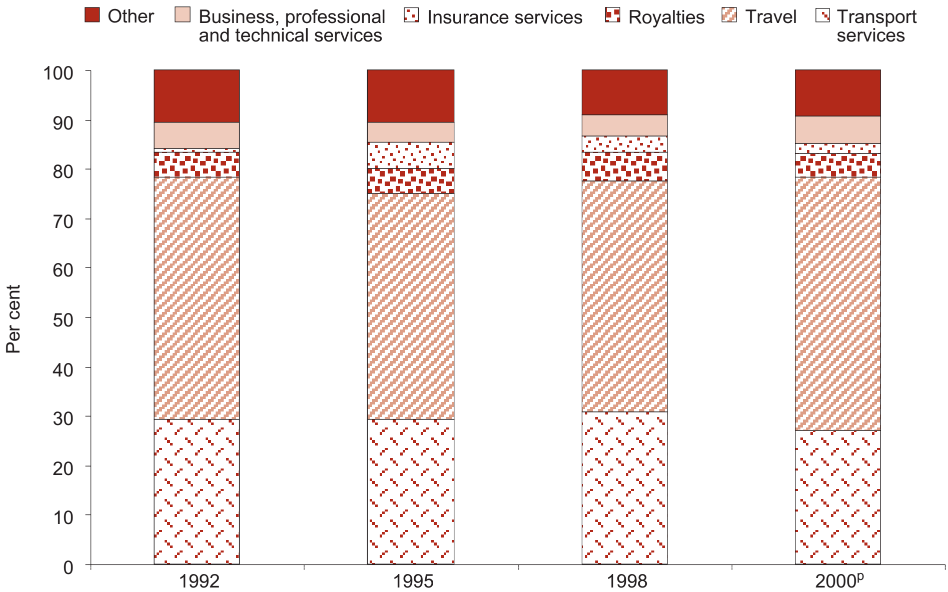
Note: p means provisional data.

Source: Ministerio de Economia, 2001.

Figure 8.6

Travel and Transport Dominant Services Imports

Argentine Imports of Services, 1992-2000, by Component



Note: p means provisional data.

Source: Ministerio de Economia, 2001.

AUSTRALIA'S MERCHANDISE TRADE WITH ARGENTINA

The similarity of Australian and Argentine economic structures and dominance of traditional import suppliers makes Australia a minor trading partner for Argentina, accounting for less than 0.3 per cent of its trade. Bilateral trade is in Australia's favour; in the 1990s, erratic Argentine exports to Australia averaged around US$50 million. Declining Australian exports to Argentina were around US$120 million in 1990, but only US$65 million in 2000 (Figure 8.7).

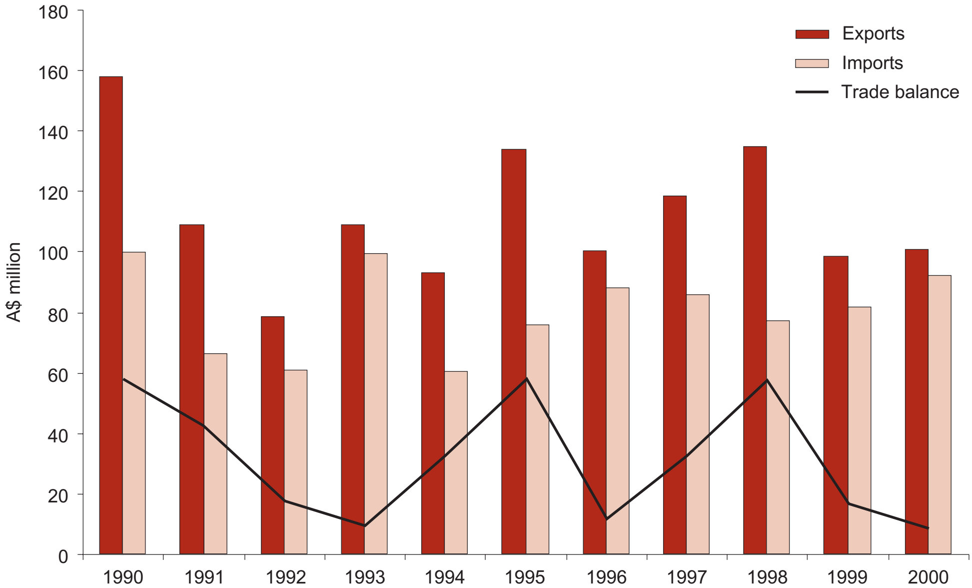
The composition of Australian merchandise exports to Argentina changed significantly during the 1990s, but by 2000, 44 per cent were primary and 33 per cent were manufactures. Confidential exports declined from 85 per cent of exports in 1990 to 22 per cent in 2000.[7]

[7] Confidential items are so classified because they are supplied by a single company, and release of this data would compromise commercial confidentiality.

Figure 8.7

Bilateral Trade Volatile and Declining

Australian Exports, Imports and Trade Balance with Argentina, A$ million



Source: Department of Foreign Affairs and Trade, 2001.

Primary product exports doubled in the 1990s, from US$16 million to US$33 million, due mainly to fuel exports (Table 8.3). From a very low base, manufactured exports' share in total Australian exports to Argentina increased sharply during the decade. ETMs drove this growth, comprising around 85 per cent of manufacturing exports in 2000.

Top Imports of Primary Goods

Coal is the single most important primary commodity export (Figure 8.8). In 2000, only five Australian primary commodities' exports comprised around 99 per cent of all Australian primary exports to Argentina. Australian processed food exports were volatile over the decade; they peaked at A$6.3 million in 1992 (8 per cent of total imports) but were only A$0.3 million in 2000.

Table 8.3

Fuel and ETMs Dominate Exports

Australian Exports to Argentina, by Commodity, 1990-2000

	1990		1995		1998		2000	
	Value (A$'000)	Share (per cent)	Value (A$'000)	Share (per cent)	Value (A$'000)	Share (per cent)	Value (A$'000)	Share (per cent)
Primary products								
Unprocessed food	106	0.1	522	0.4	2 625	1.9	178	0.2
Processed food	45	0.0	706	0.5	1 405	1.0	298	0.3
Other rural	3 053	1.9	8 893	6.7	12 334	9.2	14 001	13.9
Minerals	13	0.0	75	0.1	34	0.0	151	0.1
Fuels	18 178	11.5	23 478	17.6	36 805	27.3	30 199	30.0
Total primary products	21 395	13.5	33 674	25.2	53 202	39.5	44 827	44.5
Manufactures								
STMs	65	0.0	1 287	1.0	18 241	13.5	4 825	4.8
ETMs	2 368	1.5	57 868	43.3	47 936	35.6	28 878	28.7
Total manufactures	2 433	1.5	59 154	44.3	66 177	49.1	33 703	33.4
Other (confidential)	134 110	84.9	40 779	30.5	15 418	11.4	22 238	22.1
Total	157 937	100.0	133 608	100.0	134 797	100.0	100 768	100.0

Source: Department of Foreign Affairs and Trade, 2001.

Manufactured Exports

Manufactures represented only 1.5 per cent of Australian exports in 1990, but had climbed to 33 per cent by 2000, and were even higher, 49 per cent, before the recession. This indicates manufactures, particularly ETMs, should grow strongly again when Argentina's economy recovers from the current crisis.

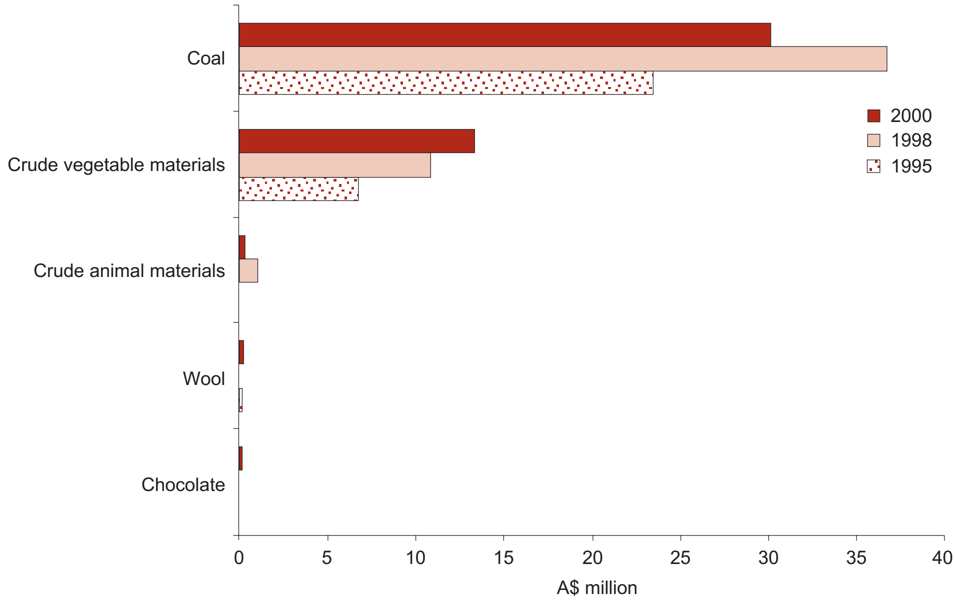
STM exports

STM exports are relatively small and volatile. In 2000, the top five STM exports earned only A$4.5 million, topped by exports of starches, inulin and wheat gluten. In 1998, leather exports reached A$10.7 million, but in 2000, they fell to around A$0.1 million.

Figure 8.8

Coal Dominates Primary Trade

Australia's Top Five Primary Product Exports to Argentina, A$ million



Source: Department of Foreign Affairs and Trade, 2001.

ETM exports

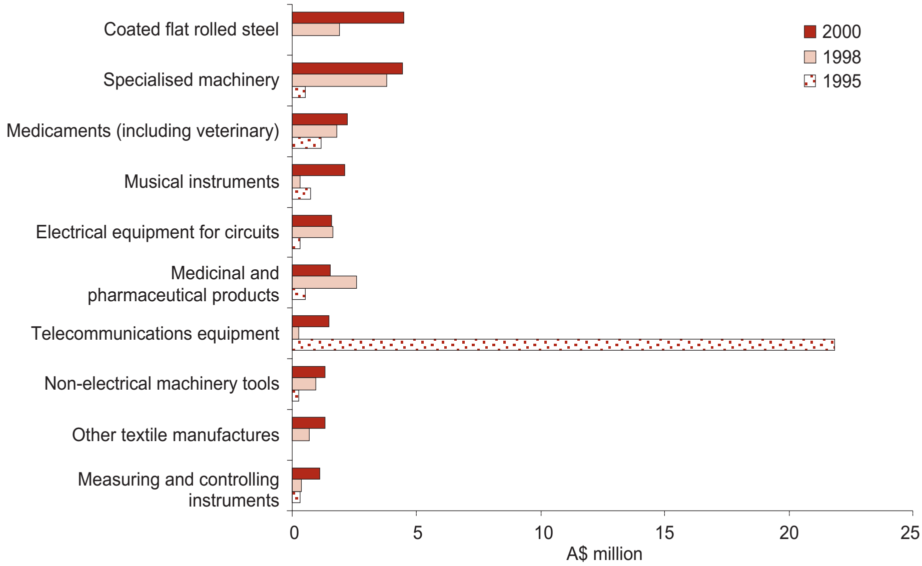
In 2000, Australian ETM exports to Argentina totalled A$28.9 million, down from a peak of A$57.9 million in 1995. ETM exports are quite diverse. In 2000, the main ETM export was coated flat rolled steel. Telecommunications equipment imports peaked at A$21.9 million in 1995, but have since slumped (Figure 8.9).

ETMs delivering high growth over the decade include telecommunications equipment (81 per cent average annual growth), musical instruments (75 per cent), food processing machines (70 per cent), and electrical equipment for circuits (51 per cent). Many of these exports fluctuated over the decade and grew from low bases. Miscellaneous chemical products, other organic chemicals, printed matter and other electrical machinery all grew rapidly from very low bases.

Figure 8.9

ETM Exports Small and Volatile

Argentine Top Ten ETM Imports from Australia, 2000, A$ million



Source: Department of Foreign Affairs and Trade, 2001.

EXPORT OPPORTUNITIES FOR AUSTRALIA

Opportunities are strongest in sectors where Argentine imports and Australia's exports are both growing. An analysis undertaken for this report identifies:

- opportunity items[8]
- challenge items.[9]

From this analysis, 51 opportunity items resulted, accounting for almost 35 per cent of average Argentine imports between 1992 and 2000, and almost 25 per cent of the average Australian exports for the same period.

8 Opportunity items have strong growth potential because the average annual rate of growth for the product in both Argentine imports and Australian exports is higher than growth for the overall category in both Argentina and Australia.

9 Challenge items are where Argentine import growth is higher than growth of the overall category; however, Australian export growth is lower than overall growth in the category. Thus, a potential market exists in Argentina, but Australian producers need to assess the viability of accessing it.

Opportunity items are:

- *unprocessed food*: maize, fresh vegetables, tea, mate and unprocessed tobacco
- *processed food*: fresh chilled or frozen prepared or preserved non-beef meat, salted dried or smoked meat, prepared or preserved meat, cheese and curd, prepared seafood, cereal preparations, preserved vegetables, fruit juices, sugar confectionery, coffee and coffee substitutes, cocoa, other food products, animal oils and fats, soft fixed vegetable fats and oils, waxes and inedible fats or oils
- *other rural commodities*: raw hides and skins (except furs), oil seeds and 'soft' oleaginous fruits, wood rough, pulp and waste paper, cotton, synthetic fibres suitable for spinning, crude vegetable materials
- *minerals*: crude fertilisers, stone sand and gravel, aluminium ores (including alumina)
- *fuels*: lignite briquettes and peat, crude petroleum, liquefied propane and butane
- *STMs*: alcohols, phenols, phenol-alcohols, carboxylic acids and derivatives, organo-inorganic compounds, non-crude fertilisers, miscellaneous chemical products, paper and paperboard, textile yarn, clay construction materials and aluminium
- *ETMs*: medicaments (including veterinary), rotating electric plant, heating and cooling equipment, pumps for gas, telecommunications equipment, electrical equipment for circuits, other electrical machinery, semi-trailers and trucks, motor vehicle parts, measuring and controlling instruments.

The 15 challenge items account for almost 8 per cent of average Argentine imports and 11 per cent of average Australian exports from 1992 to 2000. These include crustaceans, fresh or dried fruit and nuts, spices, animal feed, bovine meat, other ores and crude animal materials. STMs include other organic chemicals, insecticides, rodenticides, herbicides, other mineral manufactures and iron or steel ingots, while ETMs cover mechanical handling equipment, computers, computer parts and printed matter.

Agricultural goods and services

The main prospects lie in seeds, animal genetics, dairy products, snack foods and wine and beer (US Department of State, 2000). Argentine agricultural producers are looking for ways to improve productivity, hence Australian expertise can be applied in these sectors, particularly seeds and animal genetics. Beer consumption has grown significantly; although domestic products have a strong presence, retailers are importing low priced beer. Also, Argentina has a niche market of consumers like to drink quality wines from around the world and sparkling wine demand is booming (US Department of State, 2000).

Telecommunications equipment

As all basic telephony services are open to competition, the fierce competition for customers and new services niches will intensify, presenting huge opportunities for telecommunications firms (US Department of State, 2000). Particularly high potential is in wireless equipment and services, infrastructure equipment and services, software for managing networks, personal communications services and other services.

Tourism

The market for tourism exports to Argentina (and Brazil) is growing strongly, despite the current economic downturn, helped by the strong peso.

AUSTRALIAN TOURISM BOOMING IN LATIN AMERICA

Latin America is rapidly growing market for Australian tourism. Preliminary visitor arrival data for 2000 show 45 500 Latin Americans visited Australia, up 44 per cent over 1999. While this growth was largely spurred by the Olympics, for the six months to June 2001 preliminary arrival data are 19 900, 10.4 per cent more than in 1999. Most visitors to Australia come from Brazil, then Argentina, Chile, and Mexico. Tourists include high income individuals, business people, students and young people on working holidays.

Australia has increased its profile in the key Brazilian and Argentine markets in recent years, due partly to Australian movies, wine and beer, and industrial products. During 2000, the Olympics created 'saturation' coverage across the continent, because of Latin Americans' keen interest in sports. Qantas services to Buenos Aires also boost tourism from the region. The quality image of Qantas and the consistent availability of flights encourages tourist operators to develop Australian programs.

The Australian Tourism Commission's, ATC's, activities in Latin America focus on the core markets of Brazil and Argentina, with more limited activities in Mexico, Chile and Colombia. The ATC has had a presence in Brazil since 1987 and currently maintains representatives in Brazil and Argentina to handle public relations activities, and service consumer and travel trade inquiries.

The ATC uses diverse approaches to develop the Latin American tourist market. It explores opportunities to develop tie-in promotions with Australian brands and entities in Latin American markets. This leverages Australia's presence in the market and helps broaden consumer perceptions of Australia and the holiday experience it offers. The ATC also works with industry partners on cooperative marketing programs to increase Australia's visibility in the marketplace. All joint marketing activities include a partner responsible for handling bookings in Latin America. As the Internet is popular in these markets, particularly Brazil, the ATC has developed Spanish and Portuguese gateways to its global site *www.australia.com*.

Each year, the ATC produces a travel guide for the Latin American market, as the primary source of information on Australia for both consumers and the travel trade. This provides advertising opportunities and is an excellent method for the Australian tourist industry to get its message to the marketplace. The guide, produced in both Spanish and Portuguese, is released in September.

Each year, the ATC also organises a South American Travel Mission. This includes participation on the Australia stand at the annual International Tourism Trade Fair of Latin America in Buenos Aires and in a free flowing trade show for retail agents in São Paulo, Brazil. This helps Australian tourist industry representatives meet and supply information to consumers and travel trade representatives.

Source: Australian Tourism Commission, Sydney, 2001.

QANTAS FLYING INTO A GROWING MARKET

In less than two years after commencing flights to Buenos Aires in November 1998, Qantas has turned a loss into a profit. In January 2001, the Buenos Aires route made over A$3 million profit with only wo weekly flights while Qantas' 32 weekly flights to Los Angeles made a little over A$8 million profit. In June, even before Aerolíneas Argentinas defaulted the route, Qantas announced a third flight was programmed, beginning on 31 October, reflecting Qantas' commitment to the route and high expectations from this emerging market. The market was pleased with this information.

Since starting the route, Qantas has more than trebled the number of seats available, and the market has absorbed the increase. Occupancy is up from 67 to 81 per cent and, in the high season, Qantas can barely meet demand. Initially the route was very seasonal, but now the difference between peaks and lows has flattened considerably.

Qantas believes the Australian tourist industry potential in the Argentine market is tremendous. Argentinians love travelling to developed countries and the 20 per cent of the population who have high incomes already have travelled to the United States and EU. Each year, 0.5 million Argentinians go to the United States and another 0.5 million to the EU. Argentinians see Australia as a mirror for itself and believe they have much affinity with Australia.

Source: Lamas, 2001; and Qantas, 2001.

Other services

Opportunities also exist for supplying financial services including insurance, business services and information technology services. Argentina is not well endowed with information technology experts, so its firms are seeking partners and technical assistance (Vexina, 2001). The private retirement and pension funds and workers' insurance sectors also present opportunities for Australian firms, as many Argentine pension managers lack experience (US Department of State, 2000).

FOREIGN DIRECT INVESTMENT IN ARGENTINA

Argentina's foreign direct investment, FDI, regime is one of Latin America's most liberal. Argentina is a major FDI recipient; third in Latin America after Brazil and Mexico. Foreign investors receive national treatment, investing in Argentina on the same terms as local investors.[10] Foreign firms can own 100 per cent of Argentine companies and foreign banks can establish and operate branches. Prior approval for FDI is not needed unless special laws apply, such as in defence; registration is required for statistical purposes only. Foreign companies also are eligible for incentive programs and state procurement.

[10] In April 1997, Argentina became the first non-OECD Latin American country to apply the same rights and obligations to several OECD investment instruments as OECD members apply.

Figure 8.10

FDI Now Mainly Mergers and Acquisitions

Functional Distribution of FDI, Per cent

Note: Capitalisation represents new inflows of foreign capital to existing foreign invested firms.

Source: Ministerio de Economia, 2001.

Foreign companies do not need to form alliances with local partners for privatisation purchases. Argentina has no foreign exchange controls; investors can repatriate profits and capital immediately; and dividend or profit remittances are tax free. To reduce Argentine sovereign risk for investors, Argentina also has bilateral investment promotion and protection treaties with many European, American and Asian countries, including with Australia since 2000.

In the early 1990s, FDI was concentrated in privatising companies, but with the recession and the winding down of the privatisation program, mergers and acquisitions became the largest part of FDI (Figure 8.10).

Contribution of FDI and Sectoral Distribution

During the 1990s, responding to the newly liberalised environment and other wide ranging reforms, FDI inflows increased rapidly, making a growing contribution to the economy (Figure 8.11).[11] Between 1992 and 1999, total FDI flows amounted to US$63 billion, building a total FDI stock of around US$75 billion. FDI over 2000-02 is estimated at around US$11.1 billion, lower than the 1999 spike,

[11] From 1992 to 1998, capital inflows averaged about 43 per cent of net capital inflows and 60 per cent of the current account deficit.

but higher than all previous years (Fundación Invertir, 2000).[12] The spike in 1999 FDI was due mainly to Spanish firm, Repsol, acquiring the former state owned petroleum company, YPF, for about US$15 billion.

Sectoral Distribution of FDI

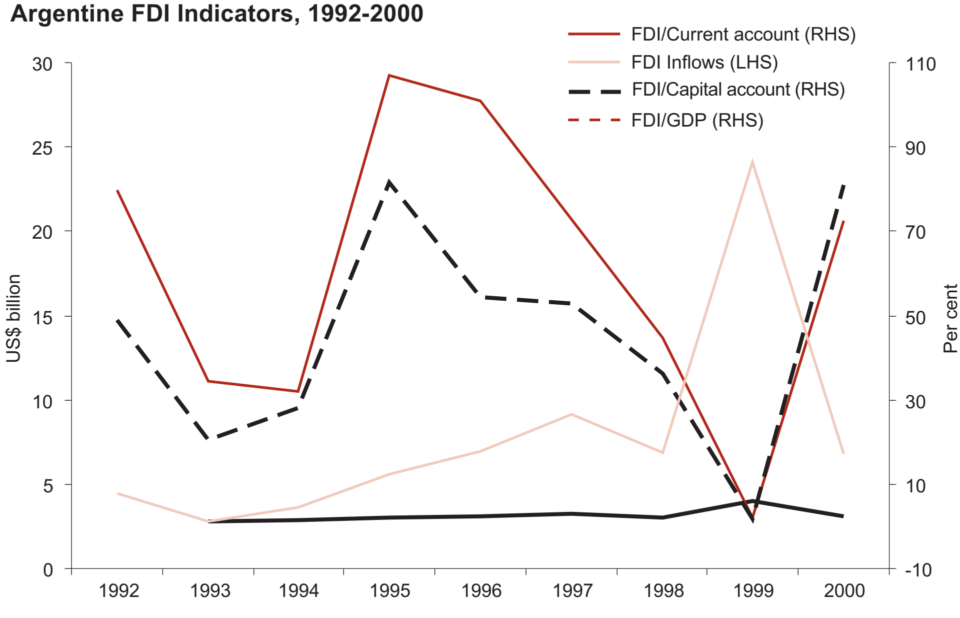
Before 1993, the primary sector and infrastructure services, particularly electricity, gas and water, received most FDI. After 1993, manufacturing and services, particularly the financial sector, received a higher share of FDI inflows (Figures 8.12 and 8.13). 2000 and 2001 FDI is greatest in telecommunications, oil and gas.[13] However, in 1999, the sale of YPF pushed up the share of the primary sector significantly.

As the YPF sale dominates 1999 FDI data, 1992-98 data more accurately show average sectoral distribution (Figure 8.13).

Figure 8.11

FDI's Importance to the Economy Growing

Argentine FDI Indicators, 1992-2000



Note: No official estimates of Argentina's FDI flows exist for 1990 and 1991.

The ratios of FDI as a per cent of the current and capital accounts are distorted due to the sale of YPF to the Spanish Repsol which implied a big increase in FDI but a significant decline in the capital inflows corresponding to investment in stocks.

Source: Ministerio de Economia, 2001.

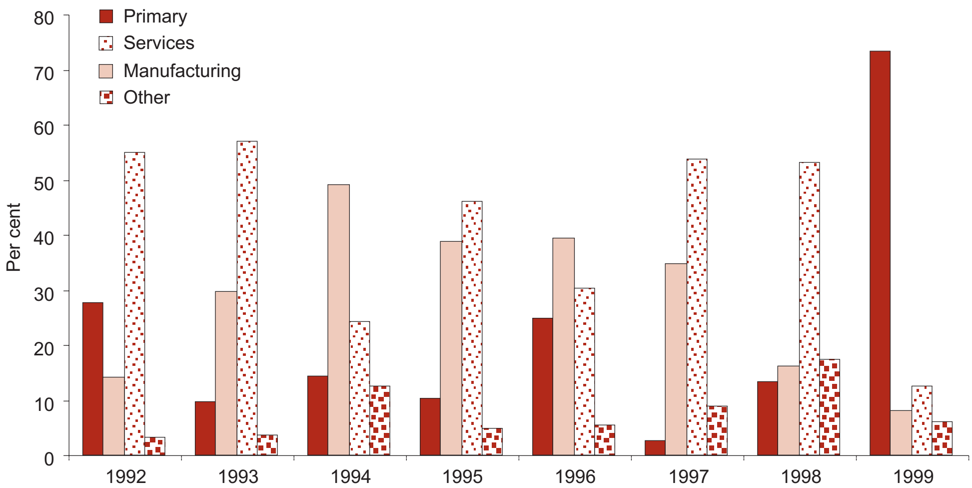
12 Fundación Invertir develops its FDI estimates from newspaper information and informal questioning of foreign firms and considers all investment made by non-residents as FDI, even when it is financed through the local capital market; thus, it tends to overstate the FDI figures.

13 Investment for 2000-01 includes: communications (US$2.2 billion); oil and gas (US$2.1 billion); electricity (US$1.1 billion); construction (US$0.9 billion); automotives and parts (US$0.9 billion); supermarkets (US$0.6 billion); and chemicals (US$0.6 billion) (Fundacion Invertir, 2000).

Figure 8.12

Services and Manufacturing the Main FDI Destinations

FDI by Sector, 1992-99

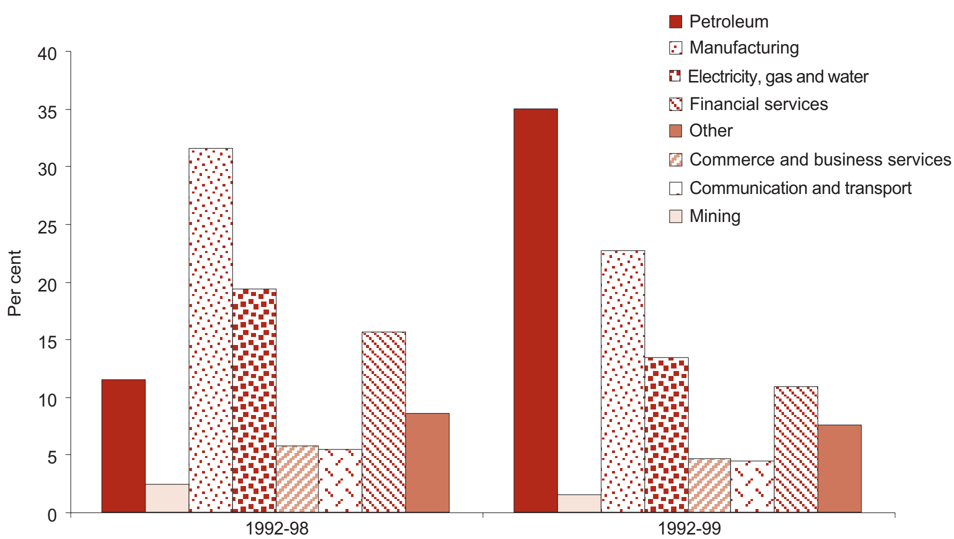


Source: Ministerio de Economia, 2001.

Figure 8.13

Excluding Petroleum, Most FDI Is to Manufacturing

FDI by Industry, 1992-98 and 1992-99, Per cent



Source: Ministerio de Economia, 2001.

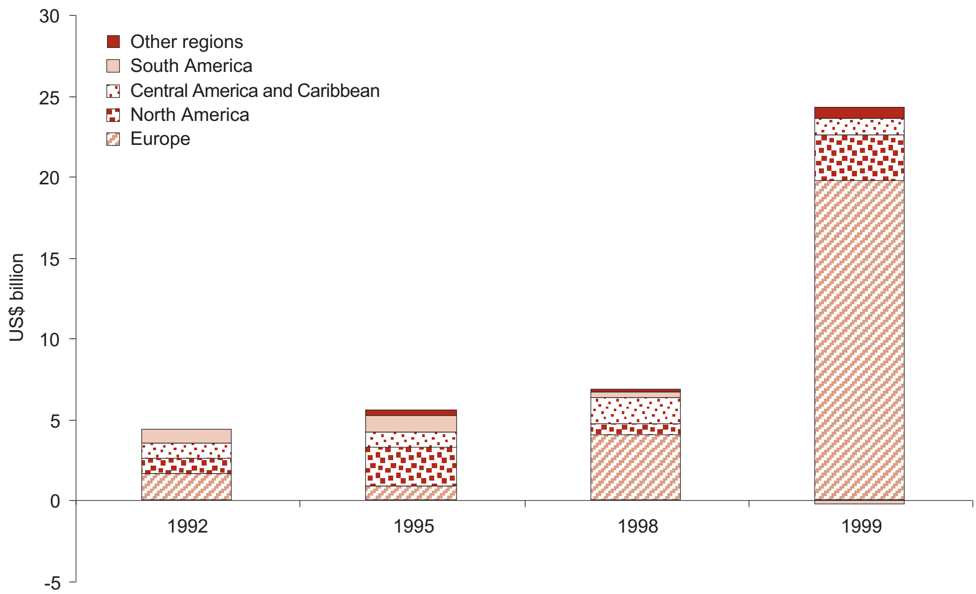
Distribution of FDI by Country

Argentina's main FDI sources are North America, the EU and Chile (Figure 8.14). Spanish companies account for 31 per cent of the total FDI stock and the United States for 20 per cent.

Figure 8.14

Most FDI Sourced from Europe

FDI by Region of Origin, 1992-99



Source: Ministerio de Economia, 2001.

Official statistics do not identify FDI flows from Australia; in most years, Australia's FDI share is below 2 per cent.

FDI applications for 2000-01 indicate US companies plan to invest US$4.0 billion; Spanish companies US$2.3 billion; French companies US$1.0 billion; other EU companies US$2.1 billion; and Chilean companies US$0.7 billion (Fundación Invertir, 2000).

AUSTRALIA'S INVESTMENT PRESENCE AND PROSPECTS

Australian companies invested about US$690 million between 1992 and 1999; before then, Australian firms had a negligible presence (Fundación Invertir, 2000). However, data from individual projects indicates Australia invested considerably more, at least US$1.44 billion between 1994 and 2000 (Table 8.4).[14]

[14] This data probably fails to capture reinvested profits and funds coming in via third countries.

Table 8.4

Mining, Ports and Entertainment Dominate Australian FDI

Australian Direct Investment in Argentina, by Project and Sector, 1994-2000

Sector/ industry	Parent company	Argentine affiliate	Project	Investment US$ millions	Period
Mining	Mount Isa Mines former North Ltd (now Rio Tinto)	Minera Alumbrera SA	Feasibility study; operation of a copper and gold mine	15 1 100	1994 1995-97
Distillery and foodstuffs	Burns Philp	Destilerías del Norte	Acquisition of local company, Destilerías del Norte	13.0	1994
		CALSA Compañía Argentina de Levaduras	Upgrading of Lanus yeast plant, acquiring Renderol firm, new plant	32.7	1994-96
Port infrastructure, catering, cold storage plant	P&O	Terminales Rio de la Plata SA	Construction of a new container terminal	71.1	1994-98
		P&O Catering y Servicios Argentina SA	Establishment in Argentina	na	
		Cool Queen	New cold storage plant	10.0	
Mining	BHP Billiton	BHP	Agua Rica mining exploration; Distrito Julio Verne mining exploration; Mi Vida mining exploration	na 2.0 1.0	1995-97
Cinemas	Village Roadshow	Village Cinemas SA	Construction of cinemas at Mendoza, Pilar, Avellaneda, Rosario and La Plata	73.0	1996-98
Foodstuffs	Goodman Fielder	Leiner Davis Gelatin Argentina SA	Expansion of productive capacity of gelatine industry	5.0	1996-97
Cinemas	Hoyts Cinemas	Hoyts Cinemas	Construction of 34 cinemas in Tucumán and Córdoba	25.0	1997-98
Foodstuffs	Liag	na	na	42.0	2000
Infrastructure	Stericorp	na	Waste treatment	2.2	2000
Cinemas	Hoyts Cinemas/ Village Roadshow	Hoyts Cinemas/ Village Cinemas SA	Construction of cinemas	46.6	2000
Commercial services	Cash Converters International	na	Purchase of sales rooms	3.0	2000
			TOTAL	1 441.6	

Note: HIH is now owned by QBE; Sola Opticals, LIAG, Bovis Lend Lease, Qantas, Chep and Orica are not included in this list. Also, Goodman Fielder has been sold and Rio Tinto is no longer involved in Minera Alumbrera.
na means not available.

Source: Fundación Invertir, 1998.

Dynamics and Composition of Australian FDI

Australia's investments in Argentina are concentrated in mining, entertainment (cinemas), harbour services and communications (Table 8.4). Of Australian FDI, mining attracted 78 per cent;[15] Hoyts and Village Roadshow invested 10 per cent; and foodstuffs, including Goodman Fielder's gelatine plant and Burns Philp's yeast plant, attracted 6 per cent. P&O has the biggest container terminal in the Buenos Aires Harbour, and Qantas has flown between Sydney and Buenos Aires since the end of 1998.

In 2000, Australia's new FDI to Argentina was around US$94 million or 0.5 per cent of total FDI inflows, down considerably from around 4 per cent in 1996 and 3 per cent in 1997. The high peso, low commodity prices and difficulty in dealing with the mining regime and bureaucracy reduced Australian companies' willingness to invest in mining (Fundación Invertir, 2000).

Investment Opportunities

Argentina's abundant human and natural resources and long term commitment to an open and liberal economy should continue to attract FDI, if the exchange rate becomes more competitive, growth resumes and the Government addresses bureaucratic, legal and taxation issues. (See Chapter 11 - *Business Environment*.) Future Australian investments are likely in mining, infrastructure and agribusiness, particularly the wine industry.

Mining

The 1993 mining legislation targeted FDI, guaranteeing mining investors 30 years of stable tax policy, currency remittance and favourable customs treatment.[16] In addition, recent amendments address some problems foreign miners encountered with the mining legislation. In the 1990s, foreign companies responded enthusiastically to the new mining regime. In 1989, four foreign companies operated in Argentina; at the end of 2000, more than 60 operated there. Most are from Canada, Australia and the United States, and include large mining companies and medium sized firms specialising in mining services (Dirección Nacional de Minería, 2000). Total investment in mining from 1996 to 2005 should be around US$4.7 billion; MIM and Rio Tinto's Alumbrera project represents almost 25 per cent of existing investment (Dirección Nacional de Minería, 2000).

Mining is export oriented; mineral exports jumped from only US$30 million in 1994-96 to more than US$700 million per year in 1999-2000. After international metal prices fell in 1998, new investment in exploration fell. However, this should be temporary, and given Argentina's largely un-explored and probably abundant natural resources, and reasonably predictable policy regime, mining and mining services should attract FDI again in the medium term.

15 Around US$1.12 billion went to MIM's investment in the Minera Alumbrera project between 1994 and 1997. In March 2001, BHP evaluated the feasibility of mining project in Catamarca province (*La Nacion*, 30 March 2001).

16 In addition, all capital contributions in mines and mining rights are exempt from assets and profits taxation. Prospecting, exploration and environmental conservation expenses receive income tax deductions and investors can accelerate depreciation on infrastructure and mining equipment investments.

Infrastructure: telecommunications

The ongoing liberalisation of telecommunications creates investment opportunities for many new independent telecommunication firms to service small cities and rural areas, offer mobile phone communication and data transmission, and provide Internet services (Celani, 2000; and FIEL, 1999). (See Chapter 7- *Argentina's Economy*.) While new entry to basic telecommunications still is restricted, opportunities will arise from incumbent companies outsourcing activities and investing in new hardware and operating systems.

P&O PORTS: MOVING SHIPPING CARGO IN LATIN AMERICA

P&O Ports entered the Latin America market in 1994, after Argentina privatised its ports and P&O received the concession to operate a container terminal in the port of Buenos Aires. Argentina's ports are now world's best practice. From this foothold, P&O expanded to other activities in Argentina and is looking to expand elsewhere in Latin America.

P&O Ports believes that, overall, Argentina is a very good place to do business and has tremendous potential because of excellent labour and management. P&O Ports in Argentina exports management services to the United States and Italy to train workers. All managers speak English; however, Spanish is important outside the office. P&O Ports has no difficulty bringing expatriate managers into Argentina.

However, it warns the labour market is very rigid and labour courts favour employees; on-costs are 35 to 50 per cent above salaries. However, unions are not militant and more employer loyalty exists than elsewhere.

Regular liner services operate to Latin America from the Asia-Pacific, usually involving transhipment. P&O Ports notes that trade between Australia and Latin America is limited because the regions have similar production patterns; thus, scope for trade expansion mainly lies in value added and industrial know-how.

Source: P&O Ports, 2001.

Agribusiness: wine

In 1998, Argentina was the world's fifth largest wine producer with 6.5 per cent of world production. However, the Argentine wine industry produced low quality table wine mainly for domestic consumption; exports and imports were very low.

Since the early 1990s, foreign wine companies have helped improve quality and develop export markets. For example, the French company Chandon exports Argentine wines to the competitive US market. Total wine exports jumped from about 20 million litres in 1991-92 to around 120 million litres in 1999-2000 (Instituto Nacional de Vitivinicultura, 2000.) As Australia is at the forefront of wine technology, opportunities exist to invest in the Argentine wine industry, particularly if the peso regains competitiveness.

CONCLUSION

Trade liberalisation and stronger growth caused Argentine imports to grow very rapidly in the 1990s. Imports from the rest of the world grew as much as imports from Mercosur. While Australian exports to Argentina remained low, reflecting the two economies' similar production, potential Australian export opportunities include many ETMs, STMs and services.

Australia has important investments in selected Argentine industries, notably mining, entertainment, port infrastructure and to a lesser extent food processing. Although the fall in international metal prices since 1998 reduced the investment flows to mining, opportunities remain intact and with recent improvements in the regime, investment flows should resume once prices recover and Argentina's current economic crisis is resolved. Beyond mining, new opportunities lie in infrastructure, particularly telecommunication services, and within agribusiness, particularly the wine industry. However, as peso devaluation is a quite likely outcome of the current crisis, Australian investors may be wise to await for resolution of the crisis before investing.

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CHILE'S ECONOMIC PERFORMANCE AND PROSPECTS

KEY POINTS

- Chile pioneered Latin American reform. In the 1970s, it liberalised trade, foreign direct investment, FDI, capital flows and labour markets. Then in the 1980s, it broadened the tax base, started comprehensive privatisation, and reformed the pension system and financial sector.

- This set the foundations for strong economic growth throughout the 1990s, averaging 6.5 per cent per year, faster than any other Latin American economy.

- However, with all major Latin American economies now embracing liberalisation, Chile recognises it must continue reforms to ensure it remains competitive and a market leader.

- Chile's economic reforms provide foreign business people the most 'level playing field' trade and investment environment in Latin America.

- In the early 2000s, export-oriented natural resource industries, particularly mining and fishing, and services continue to drive Chilean growth. However, manufacturing and traditional agriculture lag, generating good FDI opportunities to improve productivity.

- Unlike in Argentina and Mexico, Chile's bank loans to the private sector are growing well, supporting growth. Chile's large, privately managed pension system has assets equivalent to 45 per cent of GDP, which reduces the need for government pension expenditure, encourages workers to stay in the formal sector and assists capital market development. Pension management also generates financial sector FDI and service export opportunities.

- Chile's fiscal position remains strong; after a recession driven deficit in 1999, the fiscal balance improved slightly, with a deficit of 1 per cent of GDP, keeping interest rates and government foreign debt at low levels, and underpinning robust growth.

Chile undertook thorough economic reforms after 1973. In the 1990s, its economy was outstanding in Latin America, growing at an average annual real rate of 6.5 per cent, strengthening its integration with regional and world economies, doubling its total trade levels and receiving very high levels of foreign direct investment, FDI.

Australia's relations with Chile are close. This, along with similar economic specialisation and a highly developed business environment, make it an attractive regional 'gateway' for Australian investment into Latin America. With a population of 15 million and GDP per capita of over US$4 600, Chile's economy is relatively small, only 4 per cent of Latin America's GDP (and 10 per cent of Brazil's, 17 per cent of Mexico's and 25 per cent of Argentina's). Despite this, 9 per cent of Australia's trade with Latin America is with Chile, more than Australian trade with Argentina. While Chilean growth slumped in 1998 and 1999, with the Asian crisis weakening commodity prices and affecting financial markets, it recovered in 2000, growing by 5.4 per cent.

This chapter assesses major Chilean economic issues and prospects from an Australian trader and investor's perspective. First, it briefly reviews the important early reforms of the 1970s and 1980s underpinning today's business environment, then assesses Chile's economic performance over the 1990s. It analyses Chile's vulnerability to external shocks, and highlights major reforms and performance in public finances, privatisation, and financial and capital markets over the decade. Finally it identifies major factors which may affect Chile's future performance, and reviews Chile's economic outlook and prospects. For details on trade and investment, see Chapter 10 - *Chilean Business Opportunities*.

CHILE REFORMED EARLY

Under military rule from 1973 to 1989, Chile pioneered economic reform in Latin America.[1] Growth improved, but it was volatile and income distribution deteriorated. After Chile became democratic in the 1990s, successive governments focused on macroeconomic stability and social development.

Key Reforms in Place by the 1990s

Reforms prior to the early 1980s rapidly liberalised prices, established widespread privatisation, and opened the economy to trade and capital flows. The early 1980s debt crisis temporarily halted reform, caused some transient reversals, but increased the focus on macroeconomic management. From 1984, the military consolidated earlier reforms, unwound reform reversals and developed new institutions. However, between 1973 and 1989, Chile's military systematically repressed social and political opposition to structural reforms.[2]

1 On 11 September 1973, a military coup led by General Augusto Pinochet deposed the democratically elected socialist President Salvador Allende, whose economic policies had been a disaster, beginning 17 years of dictatorial rule. The Pinochet Government implemented the free market policies of Chilean University of Chicago trained economists. Professor Milton Friedman was seen as an unofficial adviser to the 'Chicago Boys' in Chile.

2 During the Pinochet dictatorship, the military consolidated political power, making political opposition or even appeals to human rights impossible. At least 2 000 citizens 'disappeared' during this period.

MAJOR CHILEAN ECONOMIC REFORMS

From 1973 to 1989, the military government:

- removed all non-tariff barriers between 1973 and 1975, and radically reduced tariffs to a single 10 per cent rate by 1979[3]
- radically liberalised FDI in 1974, completely opening Chile to foreign direct investment, and liberalised other capital flows in the late 1970s
- reformed taxation in 1976, including introducing a value added tax of 20 per cent
- privatised agricultural, banking and industrial assets in the 1970s, but renationalised some of these assets in the debt crisis, then reprivatised them in 1984-85[4]
- introduced new labour legislation in the late 1970s to create one of the world's most flexible markets, with only limited collective bargaining
- reformed social security in 1980, replacing Chile's public pay as you go pension system with a privately administered and fully funded system
- reformed financial markets, including liberalising interest rates, privatising banks and, in 1986, introducing a new banking law to define precisely the activities banking institutions could develop and implement stringent precautionary regulation
- privatised traditional public sector utilities, including electricity and telecommunications, between 1985 and 1989
- granted functional and operational central bank autonomy in 1989, and made the bank's overriding mission inflation control
- gradually developed after 1978, an efficient regulatory structure, for privatised utilities, including strong regulatory bodies.

By the time the military left office in 1989, Chile's economy had undergone profound structural change and modernisation; the economy was one of the most open in the world and market forces drove economic decisions. The effectiveness of the policies followed during the period is seen in strong economic growth at the end of the period. Consequently, all influential interest groups agreed market forces should continue to dominate resource allocation, with the economy remaining open to trade and capital flows. The three democratic governments since 1989 have continued this economic policy, thereby reassuring the general public, the business community and foreign investors.[5]

3 In 1973, many quotas existed; tariffs peaked at 750 per cent and averaged 105 per cent (Hachette, 2000a).

4 The public sector through the central bank assumed banks' bad debts; government picked up their devalued assets and later, sold them at subsidised prices. This operation cost about 13 per cent of GDP (Reinstein and Rosende, 2000).

5 The first democratic government after the military left power assumed office in March 1990. It was led by President Patricio Aylwin and supported by a coalition of centre and left parties, Concertación de Partidos por la Democracia. This coalition has governed the country since then under two further presidents, Eduardo Frei (1995-99), and Ricardo Lagos (2000-).

Economic and Social Outcomes

Between 1974 and 1989, real GDP grew at an average annual rate of only 3.2 per cent. Furthermore, growth was highly volatile.[6] Macroeconomic instability, high unemployment, falling real wages and reduced public social spending also widened the income distribution gap and increased poverty levels. In 1987, 45 per cent of the population was living under the poverty line, up from 15 per cent in 1973 (Ffrench Davis, 1999). Thus, the first democratic government in 1990 prioritised increased social investment and macroeconomic stability.

ECONOMIC PERFORMANCE OVER THE 1990s

In contrast to the previous two decades, during the 1990s, macroeconomic performance was stable; economic growth was strong; and inflation fell.

Economic Growth Strong

Average annual real GDP growth was a robust 6.5 per cent over the 1990s, despite the 1999 recession (Figure 9.1). Between 1990 and 1994, growth averaged 7.3 per cent, but in the next five years, growth averaged 5.6 per cent due to the Mexican, Asian and Brazilian crises.

Tight fiscal policy, prudent monetary policy, high domestic savings, strong capital inflows, high investment rates, earlier supply side reforms, high labour productivity and resource transfers to more productive, competitive areas all drove high growth rates. However, the Asian and Brazilian crises hit the economy hard in 1998 and 1999, although Chile now is recovering.

As financial contagion spread, the Chilean Government raised domestic interest rates, in retrospect probably too high, to discourage capital outflows. Also, Chile's terms of trade also deteriorated as commodity prices fell and world growth slowed. In 1998, Chile's GDP growth decelerated, and in 1999, contracted by 1.1 per cent (Figure 9.1).[7]

[6] Key features of Chile's growth performance included: a real GDP contraction of 13.3 per cent in 1975, driven by skyrocketing international oil prices and tight monetary policies; a debt crisis induced real GDP drop of more than 13 per cent in 1982 and 3.5 per cent in 1983; and strong economic growth between 1984 and 1989.
However, overly expansionary monetary and fiscal policies late in the decade drove real growth to an unsustainable 10 per cent in 1988; inflation jumped from 13 per cent in 1988 to 21 per cent in 1989 (Ffrench Davis, 1999).

[7] Chile's terms of trade fell 8 per cent in 1998 (Larraín and Vergara, 2000). Lending rates in Chile rose from 16 per cent in 1997 to 20 per cent in 1998, before falling to 13 per cent in 1999 as the central bank relaxed monetary policy (International Monetary Fund, 2001).

Figure 9.1

Growth Strong, Despite International Crises Late in the Decade

Real GDP Growth, 1990-2000, Per cent

Source: Central Bank of Chile, 2001.

Sectoral Growth Performance

In the 1990s, previous reform and privatisations lifted productivity and rising incomes boosted the service sector; export-oriented industries based on natural resources and service industries led growth. Traditional agriculture and manufacturing lagged behind overall economic performance. Between 1990 and 1999, the fastest growing sectors, all of which have good long term prospects, were:

- fishing with average annual growth of 13 per cent, and growth of 17 per cent in 2000
- transport and communications with average annual growth of 13 per cent, and growth of 10 per cent in 2000
- electricity, gas and water with average annual growth of 12 per cent, and growth of 17 per cent in 2000
- mining with average annual growth of 11 per cent
- commerce, restaurants and hotels with average annual growth of 10 per cent.[8]

[8] In 1999, fishing constituted 1.6 per cent of GDP; transport and communications 9.0 per cent; electricity, gas and water 2.3 per cent; mining 10.2 per cent; and commerce, restaurants and hotels 16.9 per cent.

Inflation Falls Steadily

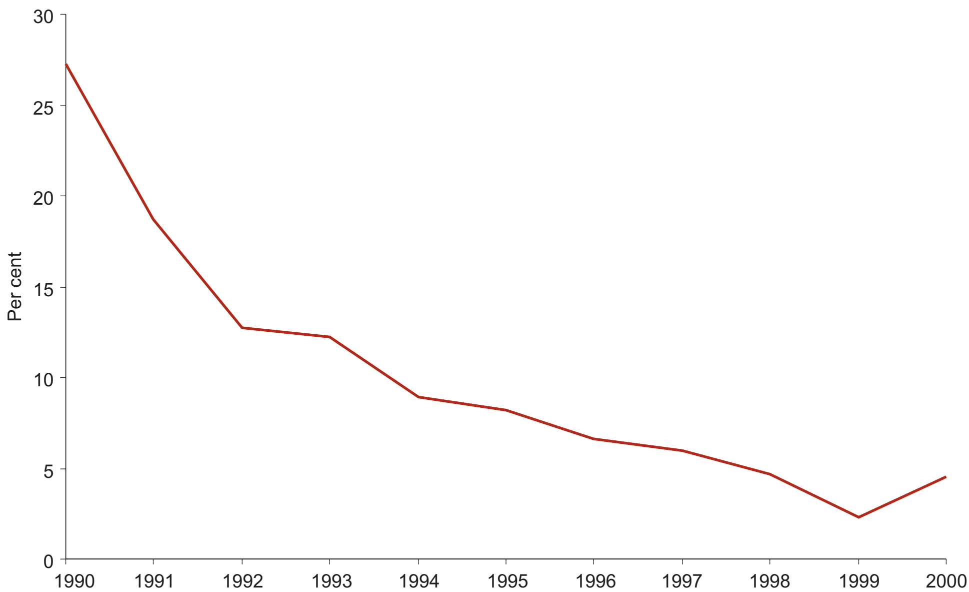
During the 1990s, inflation plunged, from 27 per cent in 1990 to 2.3 per cent in 1999, although it rose to 5 per cent in 2000 (Figure 9.2). Sound fiscal policies, tight monetary control and peso appreciation, in addition to restrained real wage increases, which were well below annual average productivity growth, drove this fall in long term inflation. In the 1990s, Chile successfully pioneered inflation targetting and now uses it as its main objective of monetary policy.

With inflation lower than during the 1970s and 1980s, Chile phased down its use of labour contract and financial instrument indexation mechanisms. While many contracts retain some indexation clauses, increasingly wage bargaining is based on inflation targets. However, while indexation clauses also are less significant in financial contracts, most financial instruments still use inflation adjusted units. If inflation rates continue to remain low and relatively stable, indexation eventually should disappear, further benefitting resource allocation and creating certainty for investment.

Figure 9.2

Inflation Falls Steadily over the Decade

Annual CPI Inflation, Per cent



Note: CPI means consumer price index.

Source: Central Bank of Chile, 2001.

CHILE'S INTERNATIONAL CAPITAL USE

Chile is a small, open economy, heavily reliant on the world economy to finance its current account deficits and thus to boost its investment and growth rates. However, like other emerging economies, Chile's short term capital flows have been problematic. Despite Chile's underlying strength, investors do not totally differentiate it from other emerging markets in Latin America or elsewhere, nor is Chile structurally immune to financial crises.

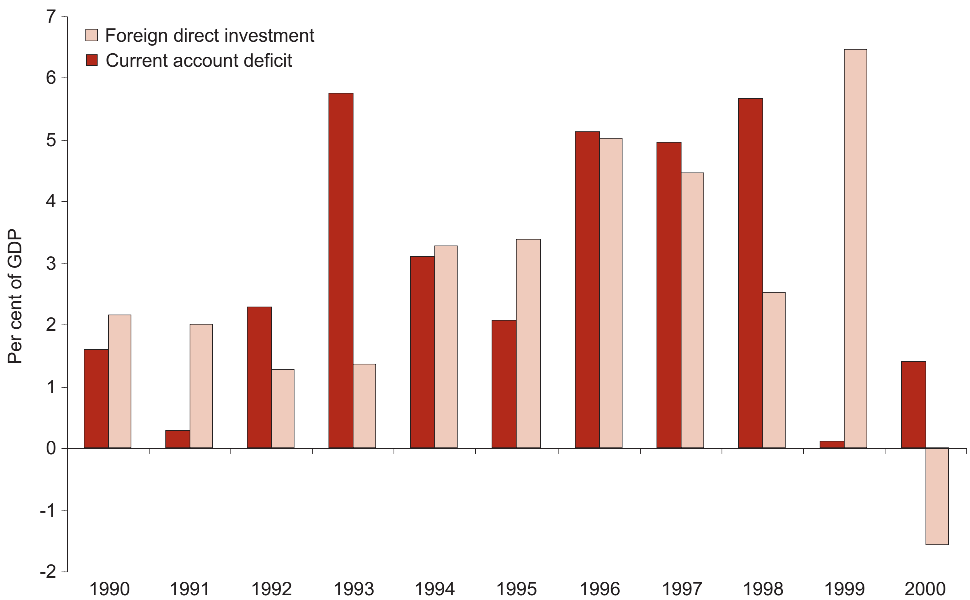
Current Account

Chile's current account deficit fluctuated widely between 0.1 per cent of GDP in 1999 and peaks of 5.7 per cent of GDP in 1993 and 1998 (Figure 9.3). This was driven by income and expenditure related import swings and terms of trade related export value volatility (especially an 11 per cent fall in exports in 1998).

Figure 9.3

FDI Largely Funds Current Account Deficits

Current Account Deficit and FDI, Per cent of GDP



Source: Central Bank of Chile, 2001.

Capital Flows

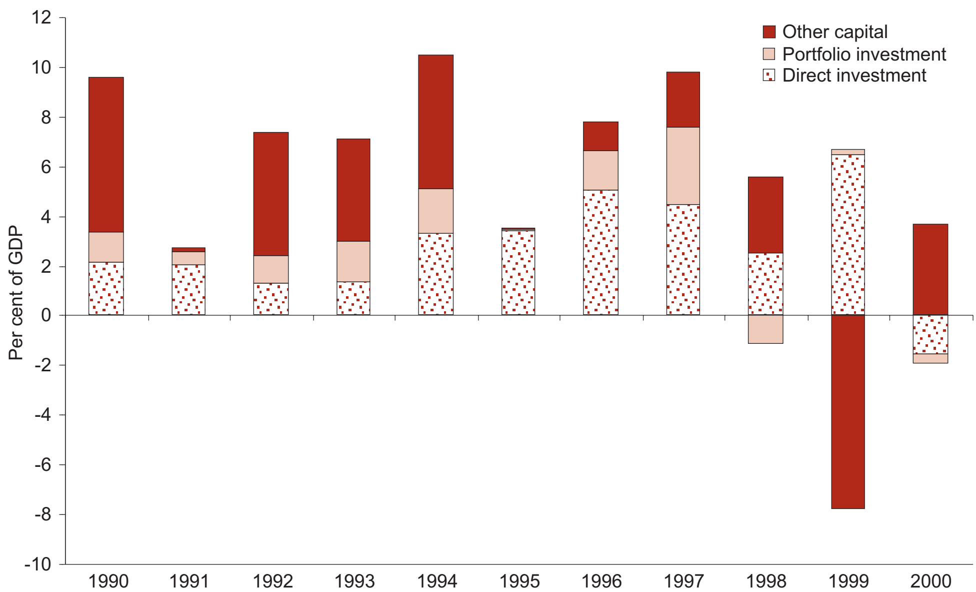
FDI is an important source of investment and current account deficit funding (Figure 9.3). FDI rose from US$0.7 billion in 1990 to US$9.2 billion in 1999. However, FDI's contribution is less stable than in Brazil, Mexico or Argentina, reflecting the lumpiness of FDI in Chile's small, resource oriented and privatising economy. (See Chapter 10 - *Chilean Business Opportunities* for a full discussion of FDI policies, trends and opportunities.) Indeed, during the 1990s, other capital flows, particularly bank lending, often exceeded Chilean FDI inflows (Figure 9.4).

Large, short term capital inflows create policy challenges for Chile. Major capital inflows between 1990 and 1997 appreciated Chile's real exchange rate by 30 per cent although in an effort to reduce the level and volatility of capital inflows, the central bank introduced implicit and explicit taxes on capital inflows.[9] Strong productivity and terms of trade growth accompanied the strengthening peso (Figure 9.5).

Figure 9.4

FDI and Bank Lending Dominate Capital Flows

Capital Flows by Type, Per cent of GDP



Note: Other capital largely consists of bank lending.

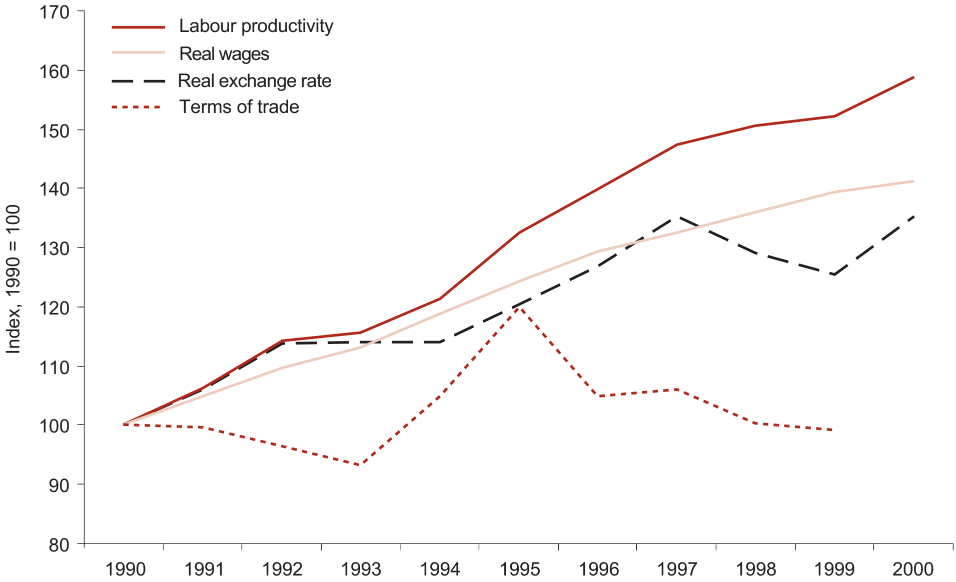
Source: Central Bank of Chile, 2001.

[9] Measures introduced in June 1991 included requiring interest free deposits with the central bank and a 1.2 per cent tax on capital inflows maturing in less than a year. In May 1992, the deposit rate was raised to 30 per cent of capital and extended to fixed period foreign currency banking deposits. In 1995, the deposit requirement was extended to stocks foreign residents acquired.

Figure 9.5

Productivity, Exports and Exchange Rate All Strong before 1997

Indices of Terms of Trade, Real Exchange Rate, Labour Productivity and Real Wages



Source: Central Bank of Chile, 2001.

Capital flow restrictions, low current account deficits and a strong banking system helped shield Chile from the contagion effects of the Mexican crisis (International Monetary Fund, 2001). However, as capital started to flow outwards in 1998 and 1999, due to the contagion effect from instability in Asia and Brazil, the Government reduced the requirement for an interest free deposit at the central bank from 30 per cent to 10 per cent, then finally abolished it altogether in 2000. Raising interest rates to stem these capital outflows (with falling commodity prices) contributed to Chile's recession in 1999. The whole episode underscored Chile's continuing vulnerability to capital flow volatility, despite all its progress.

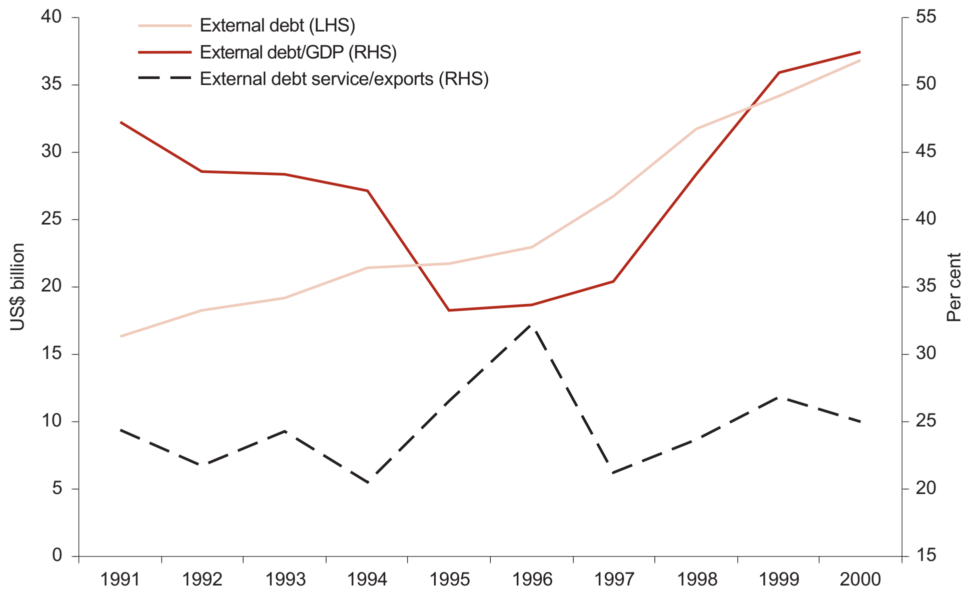
External Debt

Chile's foreign debt increased throughout the 1990s as a ratio to GDP, and more sharply after 1997; at 53 per cent in 2001 this ratio is similar to that of other Latin American economies. However, only 16 per cent of external debt is government debt, down from 44 per cent in 1990, indicating growing external debt was a private response to the greater availability of foreign credit in the 1990s. Also, Chile should not face any problems financing its payments; debt servicing only consumes around 25 per cent of goods and services export earnings (Figure 9.6).

Figure 9.6

Debt Rising as a Ratio of GDP

External Debt, US$ billion and Per cent



Note: 2000 figures are estimates.

Source: Central Bank of Chile, 2001; and Instituto Nacional de Estadisticas, 2001.

PUBLIC FINANCES REMAIN STRONG

A major strength of the Chilean economy compared to most other Latin American economies is the Government's avoidance of structural budget deficits. The central government ran budget surpluses through most of the 1990s, and although the budget went into deficit in the 1998 and 1999 recession, it returned to surplus in 2000 as the economy recovered.

Revenue

Major tax reforms in the 1990s raised government revenue from 14.5 per cent of GDP in 1990 to 22 per cent of GDP in 2000, allowing necessary increases in social spending and generating surpluses. Reforms did not change the basic tax structure but:

- increased the value added tax, VAT, rate from 16 per cent to 18 per cent
- increased the corporate tax rate from 10 per cent to 15 per cent and taxed reinvested profits
- increased the progressiveness of the personal income tax scale, including a top marginal rate of 45 per cent.

Total government revenue exceeds tax revenue because of privatisation receipts and the profits of CODELCO, Chile's publicly owned copper producer.

In March 2000, the Government announced it would tighten controls on tax evasion, currently estimated at 24 per cent of potential revenues, and make minor income tax adjustments. It also proposes to lower the maximum personal income tax rate from 45 per cent and raise the corporate tax rate from 15 per cent to 17 or 18 per cent of realised profits.

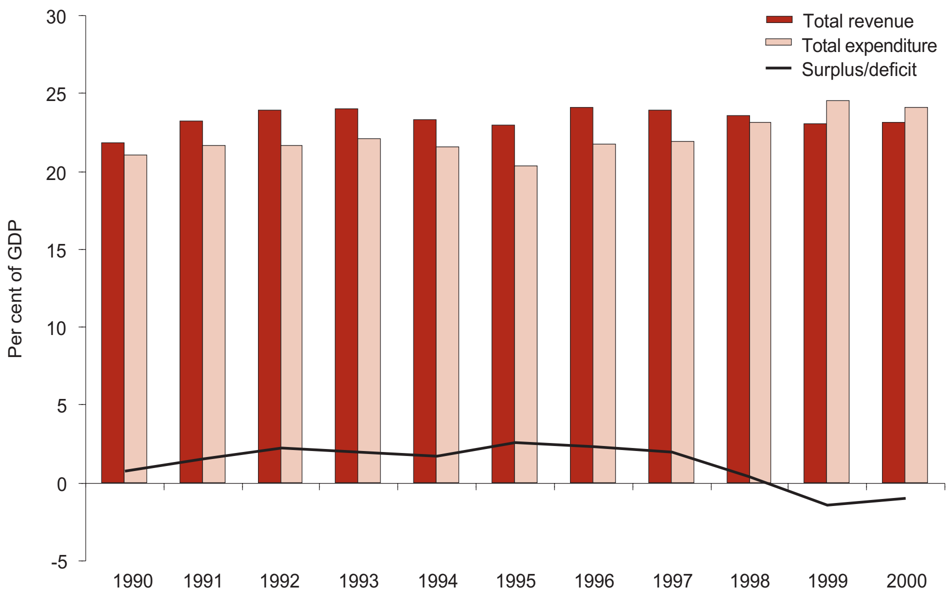
Expenditure

Tax reforms helped the Government expand social spending at an average annual real rate of 8.2 per cent between 1990 and 1994. Within social spending, the largest increases were in employment programs, education and health. However, as a share of GDP, government expenditure changed little. Expenditure expanded in 1998 and 1999, as the economy slowed and expenditure on unemployment relief rose but as the economy recovered in 2000, expenditure fell to 24 per cent of GDP (Figure 9.7).

Figure 9.7

Budget Surpluses in Most Years of 1990s

Revenue, Expenditure and Public Deficit, Per cent of GDP



Note: 2000 data is from the IMF.

Source: Ministry of Finance, 2001; and International Monetary Fund, 2001.

Budget Balance

In 1990, the surplus was equal to 3.6 per cent of GDP; it then remained stable until 1998 when the economic slowdown affected tax revenues and increased unemployment related spending (Figure 9.7). Data for 2000 show an estimated deficit of around 1 per cent of GDP.

PRIVATISATION AND INFRASTRUCTURE

After intense privatisation activity in the 1980s, this process halted temporarily in the first half of the 1990s as most traditional state enterprises were privatised. However, the Government then extended the sectors the private sector could enter.

Early Privatisation Efforts

Government enterprises now have limited involvement in the economy. The military government early on privatised agricultural, industrial and financial sector assets previously nationalised by Allende's socialist government. The debt crisis then forced the Government to re-nationalise many enterprises, assuming control of debts and assets. Between 1984 and 1985, these enterprises were financially rationalised and re-privatised. Most companies were sold directly to domestic and foreign investors. The Government also used 'popular capitalism' to transfer limited numbers of subsidised shares in banks and some electricity and telecommunications businesses to individuals to widen the spread of ownership. However, enterprise licences were distributed non-transparently among the military prior to the debt crisis and, even now, the largest ten to 15 business families control 70 to 80 per cent of the economy, contributing to poor income distribution outcomes. The Government sold other assets directly to regional groups or foreign investors using debt conversion mechanisms.[10]

The approach to privatising large telecommunications and electricity monopolies was innovative.[11] The Government unbundled electricity generation, transmission and distribution, then divided each function into several affiliates and sold each separately. Workers and other public sector employees received shares through 'popular capitalism' and pension funds acquired other stocks. The Government sold a minority holding in Compañía de Teléfonos de Chile, CTC, to small shareholders and offered 51 per cent internationally. Bond Corporation acquired these shares in 1988, but sold the company to the Spanish telecommunications operator, Telefónica, in 1990, as financial difficulties and pressure from Chilean regulators increased.

10 This involved buying Chilean foreign debt at a discount in the international secondary market, then exchanging it at face value for Chilean pesos, thus allowing foreign investors to buy real assets in Chile at a discount. This was a very popular form of foreign direct investment until the secondary market value of Chile's foreign debt came close to its face value in the late 1980s.

11 The largest companies privatised were the electricity generator, Endesa, the electricity distributor, Chilectra, the long distance telecommunications company, Entel, and the basic local telephony operator, CTC.

Later Privatisation Efforts

In the late 1990s, privatisations resumed. A new government completed the sale of service companies left after an earlier privatisation drive, and started a major new program of letting 20 to 30 year infrastructure concessions to private companies.

The most important privatisations involved letting parts of the electricity generators, Colbun Machicura for US$405 million, and Tocopilla for US$175 million, to US and Spanish companies and, in 1999, letting 55 per cent of sanitary water company, ESVAL, to British and Spanish investors, for US$138 million. The concessions program raised US$4.6 billion, covering more than 20 projects, including major roads, sea and airports under build, operate and transfer arrangements (Gomez-Lobo and Hinojosa, 1999).

Future Privatisation Plans

Plans to open several waste disposal companies to private investment are well advanced. The Government may sell its remaining stakes in some smaller electricity generators, water supply and treatment companies, and sell the national petroleum company, ENAP. It also is likely to offer more concessions in roads and seaports. Also, the Government plans to transfer some water and sanitation company operations to the private sector under build, operate and transfer agreements, and transfer concessions to operate prisons and water reserves. These operations could raise US$3 billion in the next five years. However, in the medium term, the Government is unlikely to sell Banco del Estado de Chile, the country's development bank, or CODELCO, the world's largest copper producer.

FINANCIAL SECTOR AND CAPITAL MARKET DEVELOPMENTS

The Government developed and strengthened the banking system during the 1990s, introducing stronger financial sector regulation. Capital markets also are well regulated but remain small by international standards.

Early Reforms and Performance of the Financial Sector

When the Government renationalised about two thirds of the banking sector during the early 1980s debt crisis, it took control of important banking and productive assets and large parts of the private pension industry.[12] It sold these financial institutions in 1984 and 1985, but Chilean taxpayers had paid heavily for the bail out. This costly crisis demonstrated banking regulation needed improving. A 1986 banking law introduced stringent prudential controls, including minimum capital adequacy

[12] In the banking industry, it intervened in 14 of the 19 institutions privatised in the 1970s, including the two largest Chilean banks, the Banco de Chile and the Banco de Santiago. Some of the assets related to these institutions included large productive companies, such as Compañía de Petróleos de Chile, COPEC, Industrial Forestal SA, INFORSA, and private pension administrators, such as Provida and Santa María, which together hold almost 70 per cent of total funds in the new system (Hachette, 2000b).

requirements, a limited state guarantee on personal deposits, a requirement that banks regularly present detailed financial information to the regulator and the public, and stringent limits on loans to businesses related to banks' controlling groups (Reinstein and Rosende, 2000). These reforms, and their strong enforcement, produced banking sector resilience in the 1990s.

Financial Sector Performance and Reforms in the 1990s

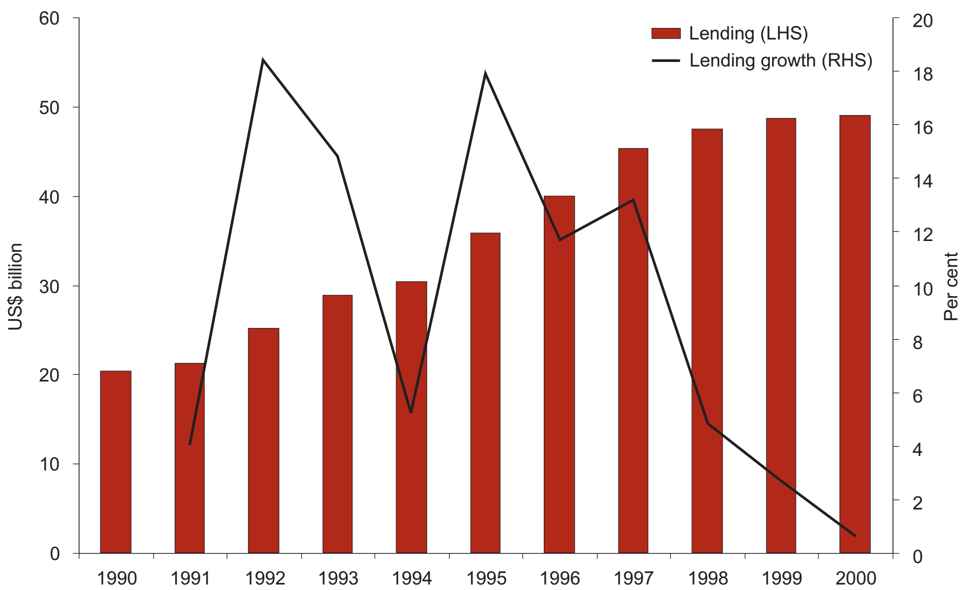
Unlike the Mexican and Argentinian banking sectors, the Chilean banking sector has maintained positive lending growth over the 1990s. However, new lending growth slowed markedly after 1996, reflecting falling confidence associated with the Asian, Brazilian and Argentinian crises and deteriorating terms of trade for Chile's commodity dominated exports (Figure 9.8).

Reflecting sharp inflation falls, particularly in the early 1990s, interest rates have fallen over the decade, as have bank spreads between lending and deposit rates (Figure 9.9). In 2001, interest rates fell from 2000 levels as the central bank lowered its reference rate in response to slowing economic activity, allowing Chile to rebound from the 1998-99 recession.

Figure 9.8

Bank Lending Supports Growth

Bank Lending, Level and Growth, US$ billion and Per cent

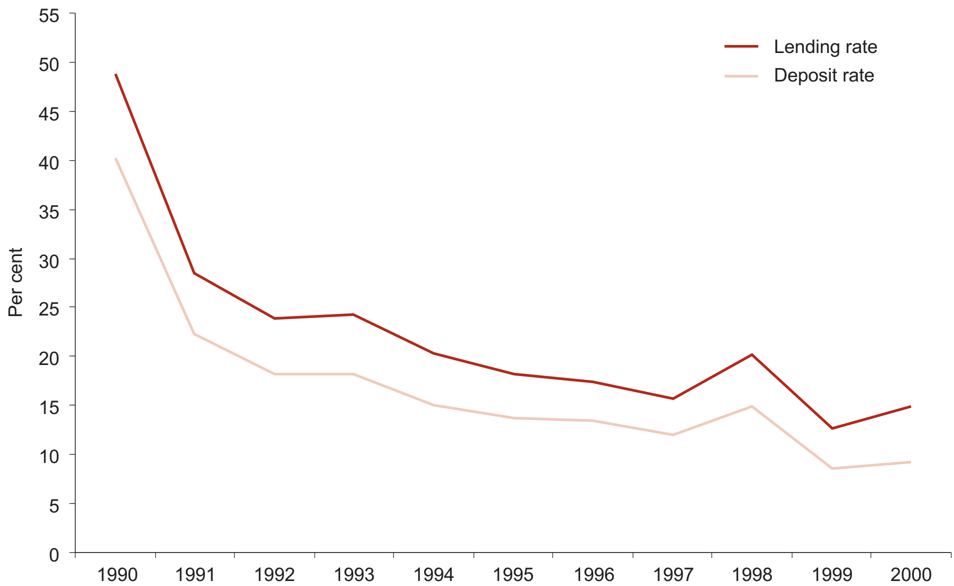


Source: Bank and Financial Services Supervisor, 2001.

Figure 9.9

Interest Rates Falling

Lending and Deposit Rates, 1990-2000, Per cent



Note: The deposit rate refers to rates offered to resident customers for demand, time or savings deposits.
The lending rate is the rate for short and medium term business financing needs.

Source: International Monetary Fund, 2001.

In 1997, further reforms to banking laws allowed banks to compete in new forms of intermediation, such as factoring and securitisation, and subscribe to initial public offerings up to 35 per cent of their capital and reserves. The 1997 reforms also allowed Chilean banks to undertake the same activities abroad as in Chile, standardised bank licence requirements and aligned capital adequacy regulation with Basle Accord ratios.

With the global financial industry evolving rapidly, competition from pension funds, insurance companies and mutual funds grew. Funds available from the national pension scheme allowed institutional investors, such as pension fund administrators, insurance companies and mutual funds, to increase the resources they manage from the equivalent of 28 per cent of deposits of the banking system in 1989, to the equivalent to 70 per cent of deposits in 1998 (Reinstein and Rosende, 2000).

Foreign financial institutions hold 54 per cent of all Chilean financial capital, up from 22 per cent in 1995, with Spanish and US banks having the largest presence. Foreign institutions introduced new technology and products, and improved customer services. However, the public is concerned a strong foreign presence and bank consolidation may reduce competition and the scope for spreads to fall further.

Growth of Pension Funds

Chile's 1980 social security reforms introduced a private, defined contribution scheme, which revolutionised pension funding and delivery. The scheme encourages participants to fully declare income, contribute throughout their working lives and carefully choose their funds. The annual real rate of return over the last two decades has averaged around 10 per cent, although returns in 2000 were 4.4 per cent, down from 16.4 per cent in 1999 (Monge, 2000). The pension scheme accelerated the adoption and development of new financial instruments and deepened local capital markets (Holzmann, 1996).

The number of workers in the pension system increased from 1.4 million in 1981 to 6 million in 1998, while funds managed expanded from just under US$10 billion, or 24 per cent of GDP, in 1990, to over US$36.9 billion, or over 45 per cent of GDP, in 2000 (Superintendencia de Administradoras de Fondos de Pensiones, 2001). In February 2001, almost 35 per cent of pension funds were invested in government debt, just over 35 per cent in private domestic financial instruments, 16 per cent in private companies' stocks and bonds, and 12 per cent overseas (Superintendencia de Administradoras de Fondos de Pensiones, 2001).

Investment limits on pension funds managers are a major issue; domestic industries want more funds to go into Chile's productive sectors, and pension funds and foreign investors want the pension funds to have greater freedom to invest offshore. Consequently, a proposal to extend the overall limit on overseas investment from 16 per cent to 30 per cent of funds is before Congress.[13]

Capital Markets

While Chile's corporate bond and stock markets are strong by regional standards, they are developing slowly, despite Chile's pension fund pool. In December 2000, only 44 companies had outstanding bond placements in the local bond market, totalling US$3.9 billion, or 5.5 per cent of GDP.[14]

While, by Latin American standards, equity market capitalisation is high as a share of GDP, only large companies can access the stock market. (See Figure 5.13 in Chapter 5 - *Mexico's Economy.*) In 2000, 111 companies were listed and, at US$6.9 billion, turnover was extremely low compared to, for example, Australia with US$198 billion turnover in 2000 (Federation of International Stock Exchanges, 2001).

In 2001, measures to strengthen capital markets include eliminating the capital gains tax on highly traded stocks; creating an emerging companies segment on the stock market and exempting these stocks from capital gains tax for three years; and protecting minority shareholders. However, new financial instruments are needed to intermediate between productive sectors and pension funds, for example extending the range of securitisable assets beyond bank mortgages.

[13] In March 2001, the Administradoras de Fondos de Pensiones could invest up to 16 per cent of their funds overseas in government backed debt in a selected list of countries; stocks traded in the New York, London, Paris, Frankfurt and Tokyo exchanges; and AAA bonds of listed companies.

[14] In December 1994, 45 companies had outstanding bond placements for a total of $2.36 billion; thus, not much happened in this market in the second half of the 1990s.

OTHER KEY ISSUES FOR FUTURE PERFORMANCE

To support strong Chilean economic performance in the 2000s, major priorities are to improve income distribution, reduce reliance on copper exports, and boost the electricity supply.

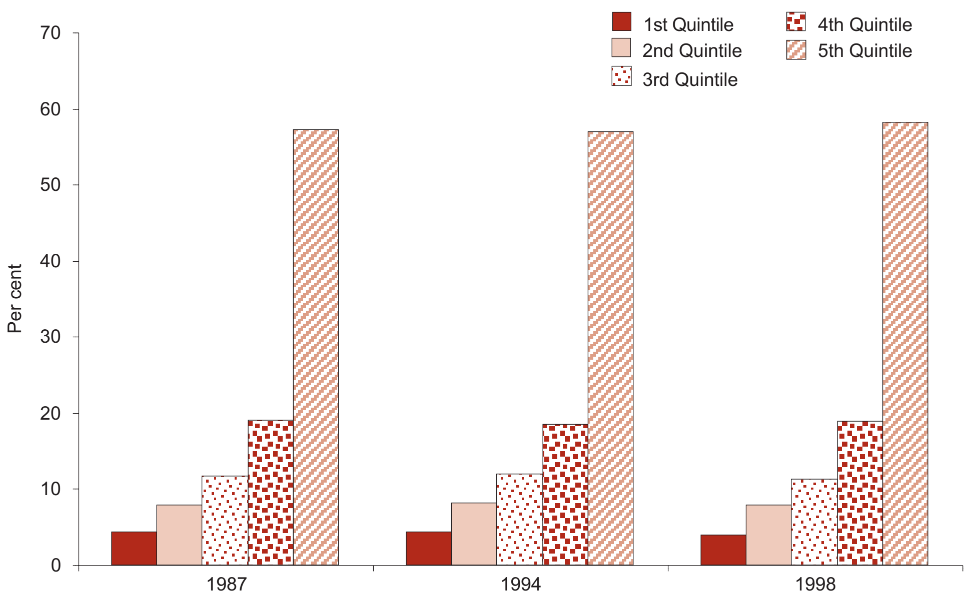
Poverty and Income Distribution

Poverty alleviation focuses on increasing education and literacy standards. Between 1990 and 1999, the Government increased real education spending by 142 per cent (Marcel, 2000). In addition, rapid economic growth kept unemployment down, and real wages increased at an annual average rate of 3.4 per cent. Consequently, the proportion of the population under the poverty line fell from 45 per cent in 1987 to 22 per cent in 1998 (Ffrench Davis, 1999). Nonetheless, income distribution remains highly unequal, and inequality even increased slightly in the 1990s (Figure 9.10).

Figure 9.10

Inequality Threatens Reform

Distribution of Monetary Income by Quintiles, Per cent



Source: Ministry of Planning, 2001; and Ffrench Davis, 1999.

Ensuring Electricity Supply

Like Brazil, California and South Australia, Chile faces an urgent need for extra electricity generating capacity. The network is running close to capacity and failing to meet annual demand growth of around 8 per cent. Moreover, heavy rains delayed work on a new hydroelectric dam by up to nine months, raising the prospect of energy shortages in 2002-03 (Economist Intelligence Unit, 2001). Private investment in electricity dried up as prices fell below economic levels, and 1999 regulatory changes, which fined generators for interruptions to supply, regardless of the cause.

ACHIEVEMENTS AND PROSPECTS

Chile's rich natural resources, strong human resources and sound economic policies support a solid banking sector, strong fiscal position, robust export sector, and efficient local and international corporate sector. High economic growth in the 1990s lifted Chile's income per capita from US$1 550 in 1987 to around US$5 000 in 1998, making it a middle income country.

After the December 2001 congressional elections, the ruling coalition is likely to focus on strengthening Chile's investor friendly policies. The macroeconomic outlook should be supportive, with forecast GDP growth in the 4 to 5 per cent range through to 2004, and inflation within the target range of 2 to 4 per cent (Economist Intelligence Unit, 2001). In 2001, inflation should remain subdued due to moderately growing domestic demand, gradually falling oil prices and intense competition making it hard for companies to pass on cost increases (Economist Intelligence Unit, 2001). Chile's high reliance on neighbouring economies for trade may make it somewhat vulnerable to any regional downturn caused by the crisis in Argentina. Also, with larger Latin American economies (except Argentina) all performing strongly and undertaking substantial market opening and liberalisation, Chile needs to remain a reform and innovation leader to attract the investment flows needed to sustain rapid growth.

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TRADE AND INVESTMENT OPPORTUNITIES IN CHILE

KEY POINTS

- **Chile is by far the most open economy in Latin America, and one of the most open in the world. Its flat 8 per cent tariff will fall to 6 per cent by 2003, and it has no significant non-tariff barriers. While Australian exports to Chile currently are falling, due to reduced coal demand and preferential access for other suppliers, manufactured exports are more prospective.**

- **Chile's foreign direct investment, FDI, regime is extremely liberal and FDI is a key driver of Chile's economy, rapidly expanding natural resource exports, and rejuvenating infrastructure and service sectors. GDP and FDI inflows are recovering from the Brazilian crisis.**

- **Chile's mining sector continues to attract considerable Australian FDI. Other prospective areas for investment include the wine industry, infrastructure, construction and financial services.**

Far reaching structural reforms in the 1970s and 1980s created an economy very open to international trade and financial flows; this drove strong economic growth in the 1990s. Chile's exports, imports and foreign direct investment, FDI, inflows all rose strongly. This chapter examines major features of Chile's trade and foreign investment regime and direction, particularly its trade and investment relations with Australia. It highlights major Chilean trade and investment opportunities for Australian business.

CHILEAN TRADE POLICY

In the 1990s, trade policy followed three complementary paths:

- continuing unilateral market opening
- participating in multilateral trade negotiations
- negotiating bilateral and regional market opening deals through free trade agreements, FTAs.

Unilateral Liberalisation

In the early 1970s, Chile eliminated all quantitative restrictions on international trade, and significantly reduced and standardised all external tariffs (Agosín and Ffrench Davis, 1998). In the 1990s, this process deepened, with the flat rate tariff falling from 15 per cent in 1990 to 8 per cent in 2001; it will fall to 6 per cent by 2003.

Preferential trade agreements and some zero rated imports reduced the average effective tariff to only 6.5 per cent in 2000.

Participating in Multilateral Trade Negotiations

Chile is a WTO member and a signatory to most WTO codes, and participates with Australia in the Cairns group and the Asia-Pacific Economic Cooperation, APEC, where it supports rapidly eliminating trade barriers.

Negotiated Market Opening

In the 1990s, Chile sought to widen its export markets, particularly for manufactures, and liberalise faster than the multilateral trade system through numerous bilateral and regional complementarity agreements (Hachette, 2000). Consequently, Chile signed bilateral agreements with seven countries and three regional bocks (Table 10.1). Chile is the most advanced country in South America in its activism in bilateral and regional trading arrangements.

The agreements with Canada (1997) and Mexico (1999) are full free trade agreements, covering goods and services, and including a wide range of investment and service trade issues and rules (Silva, 2001). Other agreements seek to build free trade zones, and trade and trade related issues coverage varies. The Chilean Government also seeks a free trade agreement with the United States; negotiations commenced in early 2001. As well, it is negotiating free trade agreements with the Republic of Korea, the EU and European Free Trade Association, and has completed a scoping study for an FTA with Japan. Chile also participates in negotiations within the Latin American Integration Area and APEC, and strongly supports negotiations for the Free Trade Area of the Americas, FTAA. It is an associate member of Mercosur; negotiations to join this grouping halted in 2000, and are likely to stay in abeyance if US negotiations proceed.

Table 10.1

Chile an Active FTA Negotiator

Chile's Bilateral and Regional Trade Agreements

Country or block	Coverage	Situation	Entry
Bolivia	Agreement with partial coverage including a specific number of products (IPPA, 1999)		1993
Venezuela	Trade in goods (IPPA, 1994)	Trade in goods 99 per cent free in 2000	1993
Colombia	Trade in goods	Tariff reduction program concluded in 1999; negotiations included services and investment	1994
Ecuador	Trade in goods, providing for extension to trade in services (IPPA, 1996)	Tariff reduction program concluded in 2000	1995
Canada	Trade in goods, services and investment	Tariff reduction program underway, to be concluded in 2014; free trade area for goods in 2003	1997
Peru	Trade in goods		1998
Mexico[a]	Trade in goods, services and investment, sanitary and phytosanitary measures, intellectual property and conflict resolution	Tariff reduction program concluded, but with a list of exceptions; new negotiations to begin in financial services and anti-dumping	1998
Mercosur[b]	Goods trade. IPPA with Argentina (1995), Paraguay (1997) and Uruguay (1999)	Free trade area scheduled for 2004	1996
Central American Common Market	Trade in goods, services and investment; IPPA with El Salvador (1999)	Tariff negotiations concluded with Costa Rica, El Salvador and Nicaragua	1999
EU	Trade in goods, services and investment	Trade liberalisation negotiations being prepared	1999
United States	Trade in goods, services and investment	Discussions underway on whether to commence negotiations	2001

Note: IPPA means Investment Protection and Promotion Agreement.

a This replaced the Economic Complementarity Agreement signed with Mexico in 1991.

b This replaced the Economic Complementarity Agreement signed with Argentina in 1991.

Source: Directorate of International Economic Relations, 2001; Silva, 2001; and Hachette, 2000.

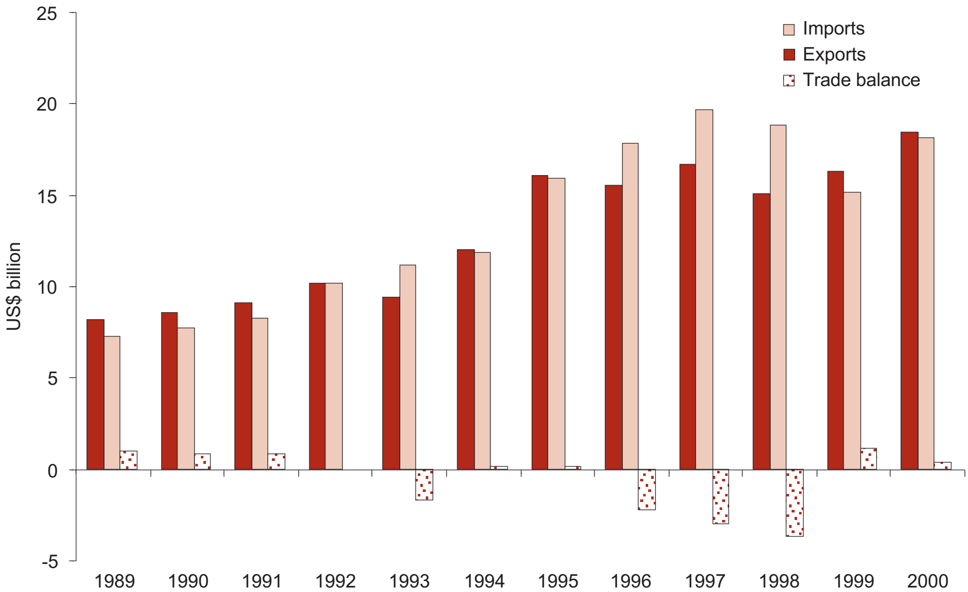
EXPORT AND IMPORT GROWTH PATTERNS

Chilean imports and exports grew strongly in the 1990s, and the current account was usually in surplus, although trade growth was volatile (Figures 10.1 and 10.2). Between 1990 and 2000, Chilean imports averaged an annual growth rate of 10 per cent compared to 8 per cent for exports. Dependence on a few major commodities made exports volatile and GDP swung due to various regional crises, contributing to import fluctuations (Figure 10.2).

Figure 10.1

Exports and Imports Grew Strongly in 1990s

Exports, Imports and Balance of Trade, 1990-2000, Per cent



Source: Banco Central de Chile, 2001a.

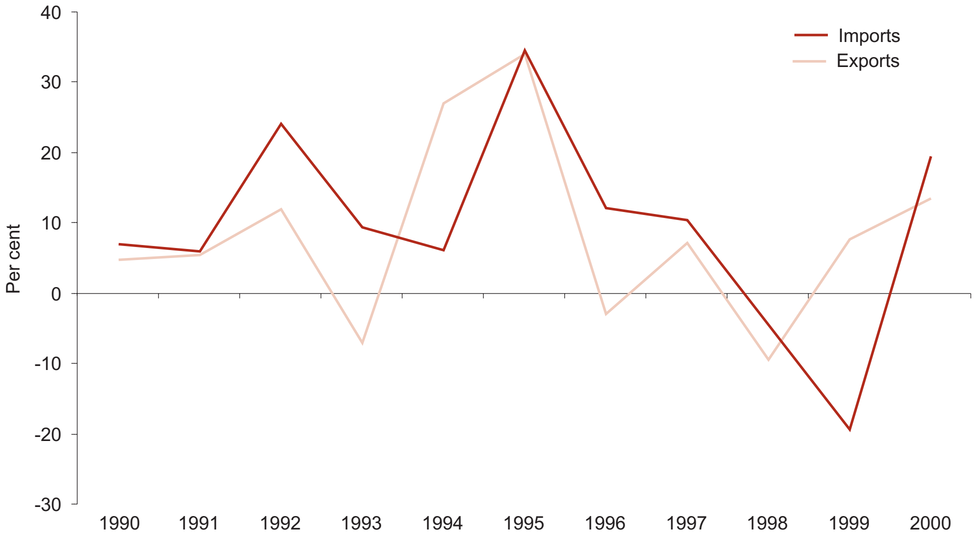
Exports

Copper dominates Chile's exports, accounting for 40 per cent of exports in 2000, slightly down from 45 per cent in 1990. However, Chile is trying to diversify its exports, with important non-copper exports including other minerals, fish and fresh fruit, and resource based manufactures, including wine, methanol and cellulose (Figure 10.3).

Figure 10.2

Export and Import Growth Volatile

Growth Trends in Chile's Exports and Imports, 1990-2000, Per cent

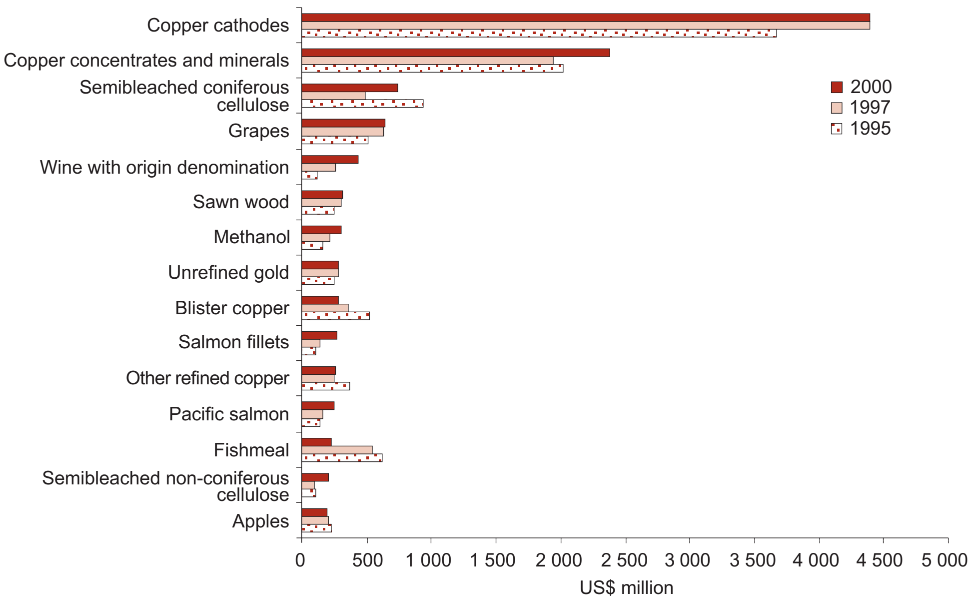


Source: Banco Central de Chile, 2001a.

Figure 10.3

Exports More Diverse but Still Resource Based

Chile's Top Exports, 1995, 1997 and 2000



Source: Bank of Chile, 2001b.

KEY DRIVERS OF IMPORT TRENDS

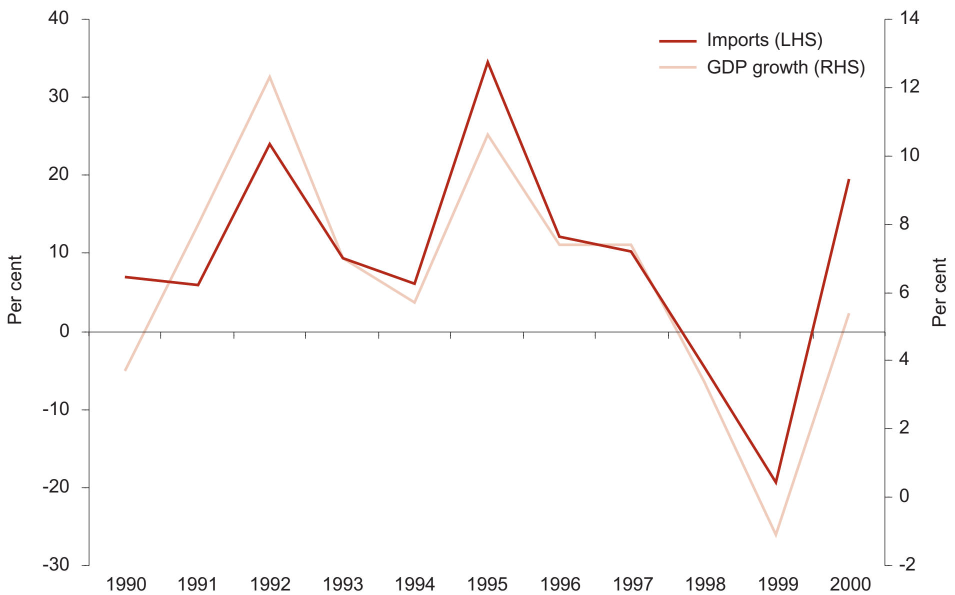
In the 1990s, with the uniform tariff for all goods and services fixed at 11 per cent until 1998, Chile's economic growth and exchange rate movements, rather than bilateral, regional or multilateral trade agreements, mainly drove import growth. In particular, imports closely followed GDP growth, growing strongly throughout most of the 1990s but plunging in 1998 and 1999, as GDP contracted (Figure 10.4). From 1990 to 1997, the real exchange rate appreciated steadily, contributing to import growth, but it depreciated in 1998 and 1999, reinforcing import contraction.

Bilateral and regional agreements negotiated in the 1990s barely affected trade flows, with the possible exception of trade with Argentina. Chile's imports from Argentina rose significantly, from 7 per cent of total imports in 1990 to 16 per cent in 2000, probably due partly to Chile's associate membership of Mercosur from 1996 which involved a concessional tariff of 2.8 per cent in March 2001 (Table 10.2). Despite comprehensive free trade agreements with Canada and Mexico, imports from these countries did not expand significantly.[1]

Figure 10.4

Import Growth Closely Follows GDP Trends

Import Growth and GDP Growth, 1990-2000



Source: Banco Central de Chile, 2001a.

[1] In 1997, Canada supplied 2.4 per cent of Chile's imports; by 2000, this share had expanded only to 2.8 per cent. In 1998, Mexico supplied 4.9 per cent of Chile's imports; by 2000, this share had fallen to 3.4 per cent.

The United States is Chile's biggest export market, with exports of agricultural products expanding. Therefore Chile hopes an FTA with the United States will improve significantly access for its agricultural produce and promote bilateral trade ahead of its South American competitors.

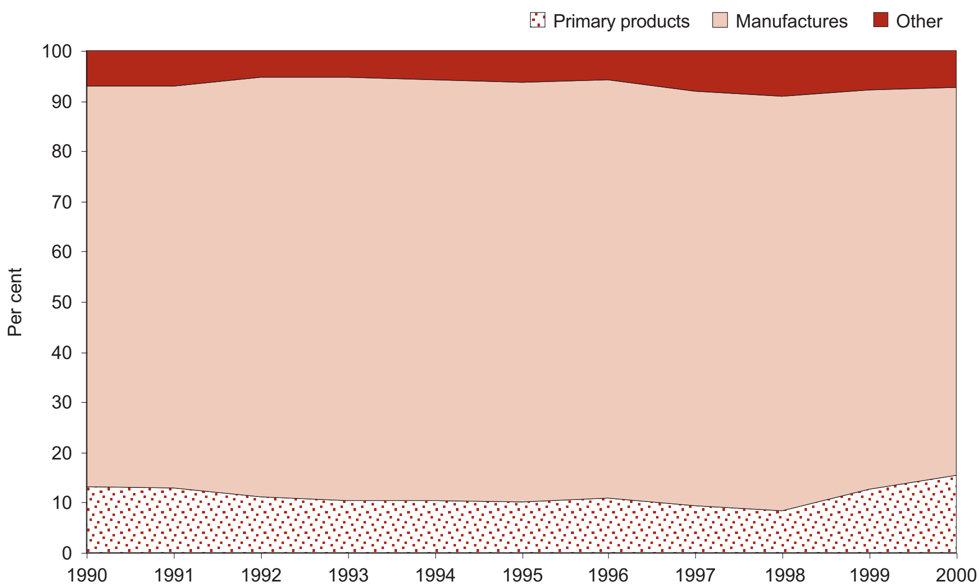
IMPORT STRUCTURE AND SOURCES

Manufactures dominate Chile's imports; their share changed little during the 1990s (Figure 10.5). By end use, most imports are intermediate or capital goods. However, throughout the 1990s, as incomes grew and tariffs fell, the share of imported consumer goods jumped sharply, from 11 per cent to 19 per cent. In 1997, as the exchange rate appreciated, consumer goods imports peaked. After falling during the recession, they rebounded a strong 19 per cent in 2000 (Figure 10.6).

Figure 10.5

Manufactures Dominate Imports

Chile's Imports by Sector



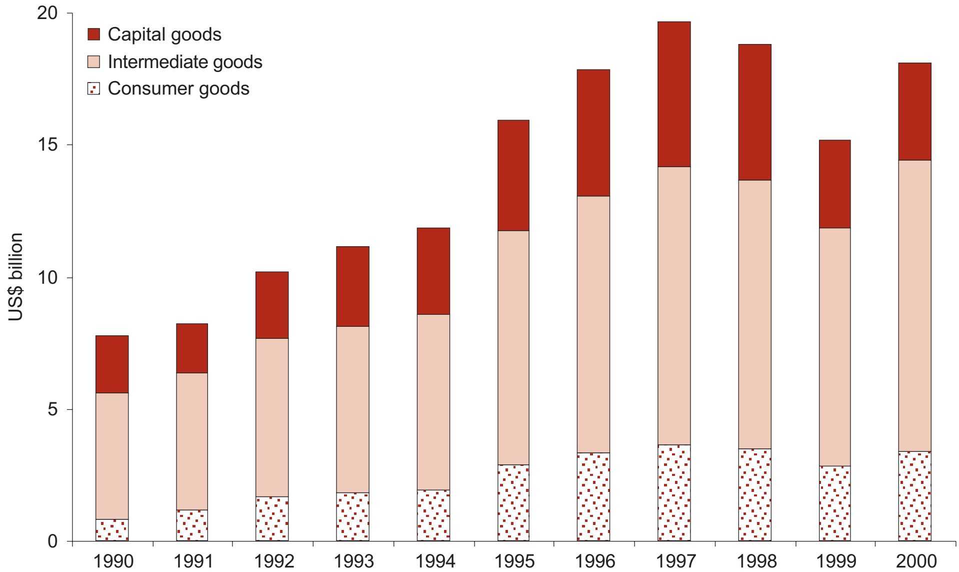
Note: Other includes free trade zone imports.

Source: Banco Central de Chile, 2001b.

Figure 10.6

Consumer Imports Rising

Chile's Imports by End Use, 1990-2000



Source: Banco Central de Chile, 2001b.

Major Merchandise Imports

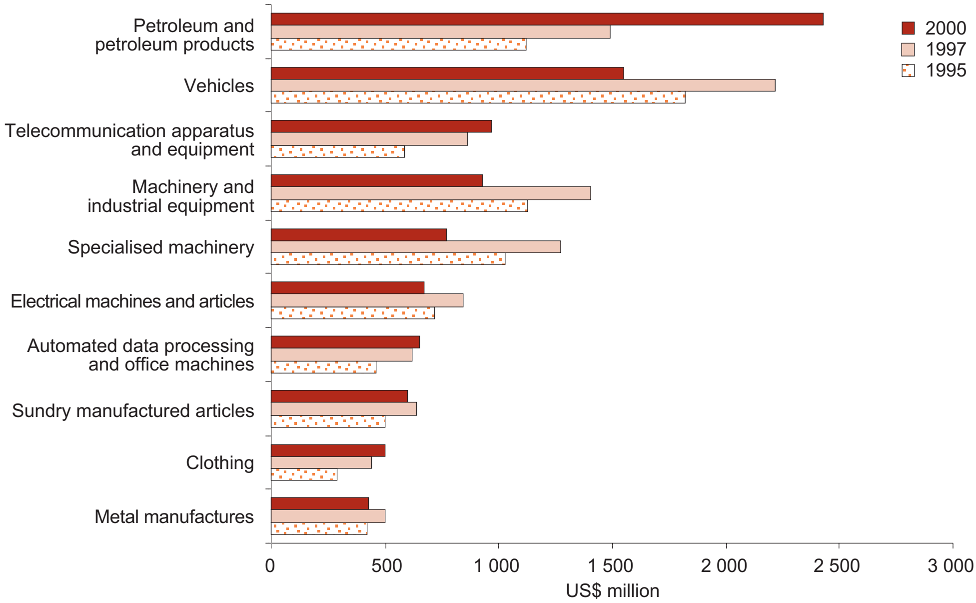
Petroleum products, cars, electronics, machinery and electricity industry supplies dominate Chile's imports (Figure 10.7). Capital goods imports, including vehicles, machinery, industrial equipment and specialised machinery, were growing strongly before the 1998-99 recession; while they plunged due to weak economic activity and investment in 1998 and 1999, they should rebound strongly in 2001 and beyond. In 2000, among the top ten imports, only petroleum products, telecommunications equipment, computers and clothing exceeded 1997 levels.

Between 1998 and 2000, the most rapidly growing imports, excluding petroleum products, were capital goods, including off road transport vehicles, agricultural machinery, radio and television equipment, software and digital equipment (Table 10.2). With economic growth strengthening, imports of capital goods and durable consumables are likely to strengthen.

Figure 10.7

Recession Hits Major Capital Good Imports

Chile's Top Ten Imports, 1995, 1997 and 2000, US$ million



Source: Banco Central de Chile, 2001b.

Table 10.2

Capital Goods Growing Rapidly

Chile's High Growth Import Items 1998-2000

Item	Average annual rate (per cent)	2000 Import value (US$ million)
Off road transport vehicles	165.7	102.0
Vegetable oils	133.7	62.5
Furniture and wood working machinery	127.3	24.0
Agricultural machinery	73.5	25.0
Communications equipment	43.3	35.0
Swaddling cloth, towels and hygienic cloth	37.8	50.0
Semiconductors	31.5	67.0
Chocolates	28.1	21.4
Software	22.0	67.0
Digital equipment	16.4	107.0

Source: Bank of Chile, 2001b.

MAIN SOURCES OF IMPORTS

In 2000, Chile's imports came mainly from Latin America (33 per cent), then North America (21 per cent), the EU (17 per cent) and Asia (18 per cent) (Table 10.3). At the country level, Chile's imports came mainly from the United States (19 per cent) and Argentina (16 per cent).

During the 1990s, Argentina and China became more important import sources while Japan diminished (Table 10.3); Australia doubled its import share, but by 2000, this still represented only 0.6 per cent of Chilean imports.

Table 10.3

Imports from Argentina and China Growing

Chile's Import Suppliers 1990, 1995 and 2000, Per cent

Market	1990	1995	2000
Latin America	**23.9**	**26.7**	**32.7**
Argentina	6.9	9.0	15.7
Brazil	7.7	7.7	7.3
Mexico	1.4	4.0	3.4
North America	**21.9**	**26.7**	**21.3**
United States	18.8	24.7	18.5
EU	**20.8**	**20.5**	**16.7**
Germany	7.1	5.1	3.4
France	4.0	2.8	2.5
Asia	**12.8**	**16.9**	**15.8**
China	0.7	2.5	5.2
Japan	7.8	6.6	3.9
Africa	**7.7**	**2.0**	**2.8**
Other[a]	**12.6**	**6.5**	**10.1**
Australia	0.3	0.7	0.6

Note: a includes free zone imports.

Source: Banco Central de Chile, 2001b.

AUSTRALIAN EXPORTS TO CHILE

Between 1990 and 1998, Australian exports to Chile grew rapidly at an annual average rate of 28 per cent, from A$32 million to A$235 million; coal and elaborately transformed manufactures, ETMs, exports largely drove this growth, averaging annual rates of 29 per cent and 31 per cent respectively. However, in 1999 and 2000, these same items led the export decline (Figure 10.8).

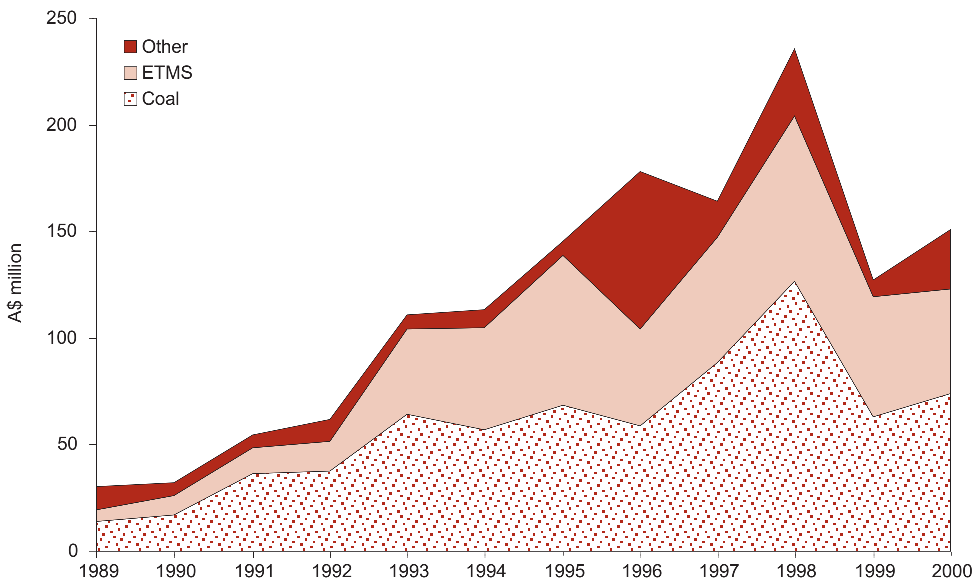
Coal Export Trends

While coal still accounted for around half of Australia's exports to Chile in 2000, the fall from 1998 levels is set to continue over the medium term, despite renewed Chilean economic growth. Chile's electricity generators are switching from thermal coal to natural gas. In addition, Australian coal faces a tariff of 8 per cent and must compete with tariff free coal from Canada and Columbia. This tariff differential was a significant barrier in the weak late 1990s coal market when margins were low. In the current strong market, Australia tends to withhold coal from Chile and other small markets to supply its main Asian customers.

Figure 10.8

Coal and ETMs Drive Export Growth

Australian Exports to Chile, 1990-2000, A$ million



Source: Department of Foreign Affairs and Trade, 2001.

ETM Export Trends

In 2000, Australian ETM exports to Chile totalled A$49 million, with the largest exports coated flat rolled steel (A$8.4 million), civil engineering equipment (A$5.7 million), liquid pumps (A$3.7 million), pharmaceuticals (A$3.1 million) and motor vehicle parts (A$2.9 million). Of these, only motor vehicle parts and pharmaceuticals exports grew steadily through the recession (Figure 10.9).

As GDP should continue to grow in 2001 and 2002, prospects for Australian ETM exports should strengthen. However, as no ETM has a significant market presence, Australian producers are vulnerable to fluctuating demand.

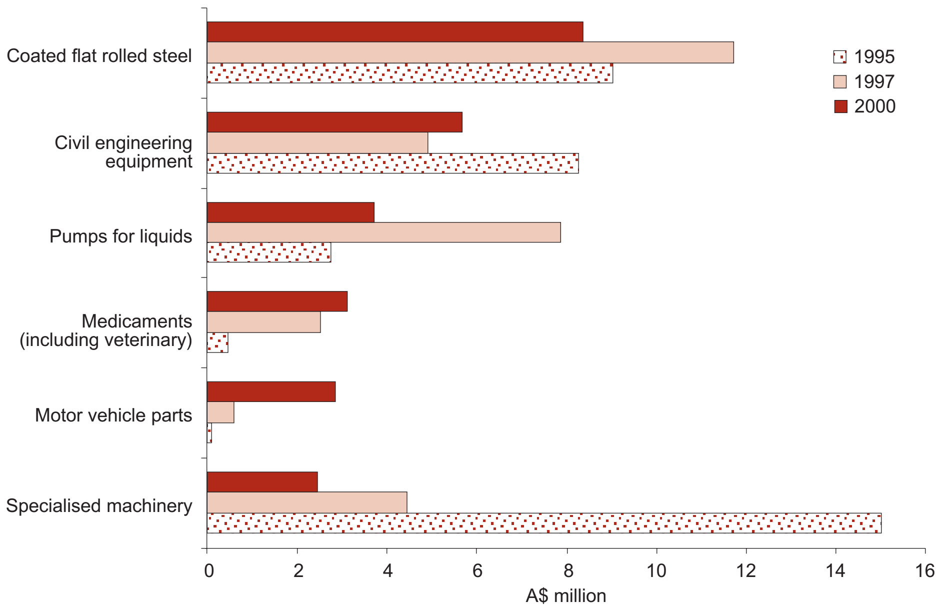
Trends in Other Exports

Excluding coal, other Australian primary production exports are negligible; they totalled only A$8.5 million in 2000.[2] Chile and other American economies are competitive commodity producers, and transport costs from Australia to Chile are high. Consequently, Australian exports of primary commodities are unlikely to expand dramatically in the medium term.

Figure 10.9

Recession Hits ETM Exports

Australia's Top Six ETM Exports to Chile, 1995, 1997 and 2000, A$ million



Source: Department of Foreign Affairs and Trade, 2001.

2 Australia's two largest other mineral and food based exports are refined petroleum (A$3.0 million) and milk and cream (A$2.1 million).

Although they are small, exports of simply transformed manufactures, STMs, grew strongly from A$2.1 million in 1996 to A$17.2 million in 2000; flat rolled alloy steel (A$8.3 million), metallic and peroxy salts (A$3.4 million), paper and paperboard (A$2.5 million), and inorganic chemicals (A$2.2 million) performed well. With Chile's resource based manufacturing industry expanding, markets for these and other basic industrial inputs should continue to grow.

AUSTRALIAN EXPORT OPPORTUNITIES

Apart from coal, major Australian export opportunities lie in ETMs and STMs. Chile is not a major commodity importer and closer countries mainly supply these imports (Figure 10.5).[3] Many have preferential access to the Chilean market.

ETMs

With Chile consolidating economic recovery, consumer imports rising and the economy diversifying, new ETM export opportunities should emerge. Australia's best opportunities lie in providing niche consumer goods for Chile's large, state-of-the-art supermarkets and capital equipment for Chile's rapidly expanding mining, wine and salmon farming industries.

Australia's significant presence in Chile's large mining sector generates many opportunities for mining service and supplies companies. Many already have an investment presence.

Suppliers already successful in the wine and aquaculture industries include:

- spray applicator, Enviromist, used by wine producers to spray grape vines close to the ground with minimal drift
- Australian-made plastic self adhesive wine labels, sold through an agent
- a computerised fish feeding system, Aquasmart, used by Chile's rapidly growing aquaculture industry.

STMs

Chile's diversification from commodity production to resource based manufacturing industry is increasing demand for basic industrial inputs; supplying these industries should support further growth in Australian STM exports. However, many inputs are bulky and low in value, often requiring direct investment to compete effectively and build a significant presence. For example, Burns Philp decided to develop a regional yeast producing plant to supply the local baking industry.

3 In 1999, these included bovine meat (US$172 million), sugar (US$68 million), wheat (US$65 million) and cotton (US$35 million).

CHILE'S FDI

Chile's liberal FDI policies attracted large inflows from the mid 1990s (Figure 10.10). These invigorated export-oriented commodity industries and upgraded manufacturing and service sector competitiveness.

FDI Policies and Trends

In the 1970s, Chile liberalised FDI across the board, allowing full foreign ownership in virtually all sectors, absolute freedom to repatriate earnings and national treatment for foreign investors, including in tax.[4]

Consequently, FDI's importance to Chile's economy grew over the decade, as its share in total fixed investment rose from 11 per cent in 1990 to 25 per cent by 1998. Apart from FDI friendly regulations, strong growth performance, Chile's 1990 return to democracy and ensuing political stability, the efficient and stable legal and business environment, and good country risk perceptions drove these inflows.

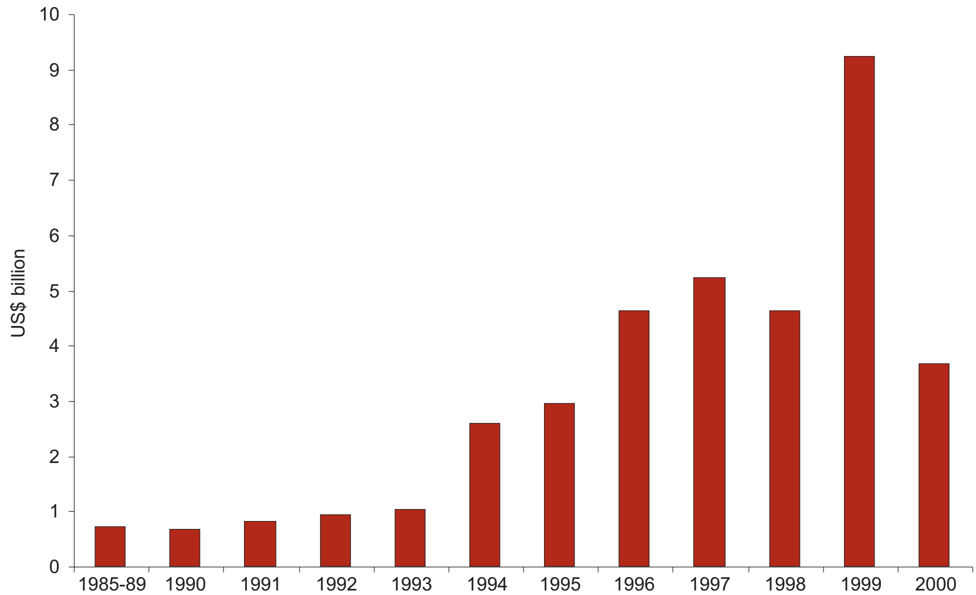
Composition of FDI

Between 1990 and 1995, mining attracted most FDI, with 58 per cent of inflows (Figure 10.11); most came from the United States (40 per cent) and Canada (22 per cent).

Figure 10.10

FDI Inflows Surge in 1990s

FDI Inflows, US$ billion



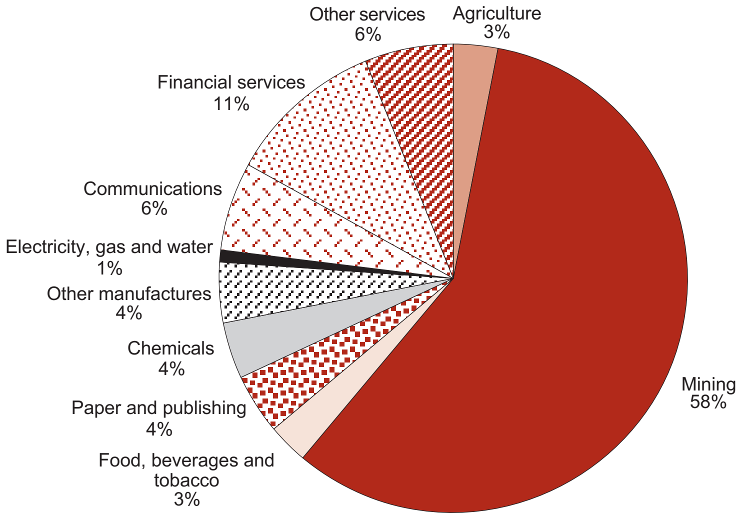
Source: Banco Central de Chile, 2001a.

4 FDI is banned only in the non-existent nuclear industry. Full foreign ownership is allowed in radio, but a station's two main managers must be Chilean.

Figure 10.11

Mining Dominates FDI Inflows in Early 1990s

Sectoral Distribution of FDI Inflows, Per cent, 1990-95



Source: Foreign Investment Committee, 2001.

Between 1996 and 2000, ongoing privatisation and infrastructure deregulation focused FDI flows on service sectors, particularly electricity, water and gas, financial services and communications (Figure 10.12). EU firms were major investors, supplying 45 per cent of FDI inflows; Spain alone accounted for 30 per cent, mainly in banking and telecommunications. Australian firms invested over US$1.2 billion, or around 3 per cent of FDI over the 1990s, mostly in mining.

FDI Drivers, Effects and Main Players

Foreign investment has reinvigorated many sectors in Chile. Most investors responded to sector specific attractors and remain important in these markets.

Mining

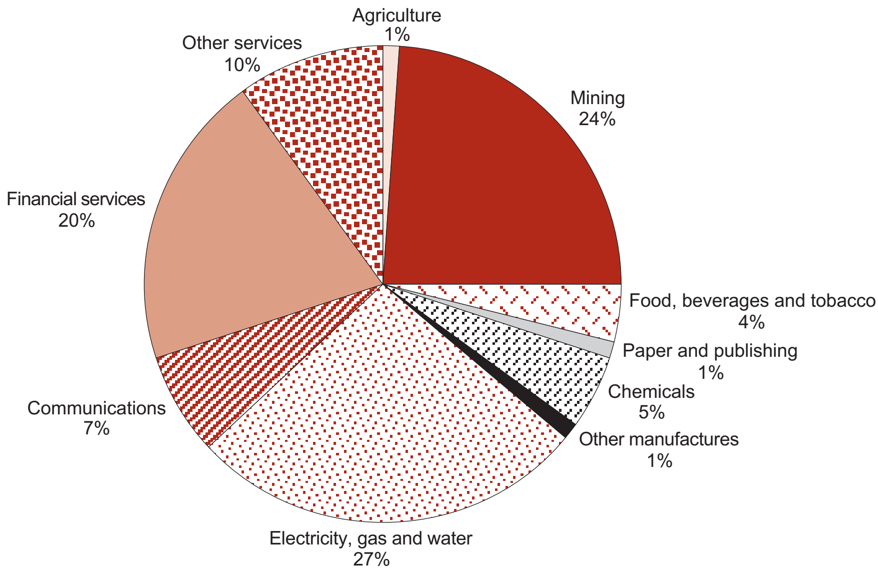
The 1986-1991 copper boom, coupled with Chile's strong prospectivity and attractive regulatory framework, drove robust international investor interest in Chilean mining.[5] Between 1990 and 1995, major mining companies investing in Chile included BHP Billiton (then BHP), Phelps and Dodge Corporation (United States), Rio Tinto (United Kingdom and Australia), Anglo American (United Kingdom) and Placer Dome, Falconbridge and Rio Algom (Canada). Investments concentrated on copper, driving Chile's share of world copper production from 18 per cent in 1990 to 30 per cent by 2000, and despite weakening prices, copper exports rose from US$3.9 billion to US$6.1 billion.

5 Chile's 1983 mining legislation places mining concessions under private law, guaranteeing them as an indefinite right. Mining firms also can defer tax on earnings until financial and tax earnings converge, and opt to accelerate depreciation of fixed assets.

Figure 10.12

Service Sector the Key Destination for Late 1990s FDI

Sectoral Distribution of FDI Inflows, 1996-2000, Per cent



Source: Foreign Investment Committee, 2001.

Fishing, agricultural and forestry sectors

During the 1990s, FDI in the fishing, agricultural and forestry sectors only totalled US$540 million or 2 per cent of FDI. However, these resources are world class, offering scope for export expansion. The fast growing, high value salmon farming industry attracts investors with booming world demand, a suitable climate and good feed stocks. Salmon exports more than doubled from US$248 million in 1995 to US$525 million in 2000; the main investors are Norwegian, Canadian and Dutch companies.

The wine industry benefits from foreign capital, mainly from French, Spanish, US and Australian companies. Most investors form alliances with local firms to produce quality wines for export markets (Agosín et al 2000). Again, driven partly by FDI, exports expanded from US$123 million in 1995 to US$434 million in 2000. Foreign companies including US giants Dole and Chiquita, as well as New Zealand and Italian firms supply almost 33 per cent of fresh fruit exports (Austrade, 2001).

US and New Zealand companies invested in forestry largely in the second half of the 1980s, attracted by Chile's abundant forestry resources and attractive investment incentives.[6] Investors generally formed alliances with local conglomerates, mainly Matte and Angelini, who faced financial pressures.

6 For example, Simpson Paper Co, Scott Paper Co, Carter Hold Harvey and Fletcher Challenge all invested, mostly in existing assets.

As investments matured, production and exports of wood and chemical wood paste products grew. However, many foreign investors ultimately withdrew due to poor prices and consolidation among domestic forestry sector groups as their financial position improved. Also, the Chilean forestry industry faces land claims by indigenous groups.

Infrastructure

Privatisations, liberal regulatory arrangements, concessions and strong profits all drove FDI in infrastructure, particularly in the late 1990s. Chilean groups dominated the initial 1989 privatisations of the electricity sector, but foreign companies invested significantly in the late 1990s. For example, Endesa España of Spain acquired Enersis and Endesa in 1999 for over US$3.5 billion, and AES Corporation bought generating company, Gener, for around US$1.3 billion in 2000. In addition, Tractebel (Belgium), Iberdrola (Spain), Southern Energy (United States) and Endesa acquired both electricity and gas assets, while Australia's AGL made a US$26.3 million investment in gas distribution in Valparaiso, Chile.

In the late 1990s, Chilean authorities also opened infrastructure, including roads, ports, airports, and sanitation, to private investment and established regulatory frameworks. (See Chapter 9 - *Chile's Economy*.) To boost investment in roads the Government has offered concessions since the early 1990s. Similarly, in sanitation, 1997 legislation allows privatisation and concessions.[7]

Banking

Acquisitions and the desire to expand market share drive FDI in banking. Foreign banks' share of loans rose from 14 per cent in 1995 to 44 per cent by 2000 as foreign banks' presence deepened. Spanish owned Banco Santander Central Hispano, BSCH, acquired Banco Santiago, and Banco Bilbao Vizcaya Argentina gradually bought into Banco Hipotecario de Fomento. Other foreign banks in Chile include Citicorp (United States), Chase Manhattan Bank (United States), Bank Boston (United States), Bank of Novia Scotia (Canada) and ABN Amro (Netherlands).

Telecommunications

Reflecting its early, far reaching liberalisation, Chile attracted significant telecommunications FDI in the late 1980s. Australia's Bond Corporation acquired the former state monopoly, Compañía de Teléfonos de Chile, CTC, in a 1988 privatisation; however, Bond Corporation's financial problems subsequently forced a quick sale to Telefónica España (Spain).

[7] Foreign companies currently submitting infrastructure tenders include Sacyr (Spain), Tribasa (Mexico), ACS (Spain), Cintra (Spain) and Groupe GTM (France), while Thames Water (United Kingdom), Anglican Water (United Kingdom), Aguas Barcelona (Spain) and Suez (France) are involved in sanitary concessions with annual investment targets.

In the 1990s, the telecommunications boom and liberal access attracted FDI into local, mobile and long distance services. International operators currently control the sector's two largest companies, with Empresa Nacional de Telecomunicaciones, ENTEL, controlled by Telecom Italia and Compañia de Teléfonos de Chile (now known as Telefónica CTC Chile) by Telefónica España. BellSouth, Endesa España and National Grid (United Kingdom) also have large Chilean telecommunication investments. These companies are upgrading services, driving up telecommunication equipment imports, which Australian companies help supply.

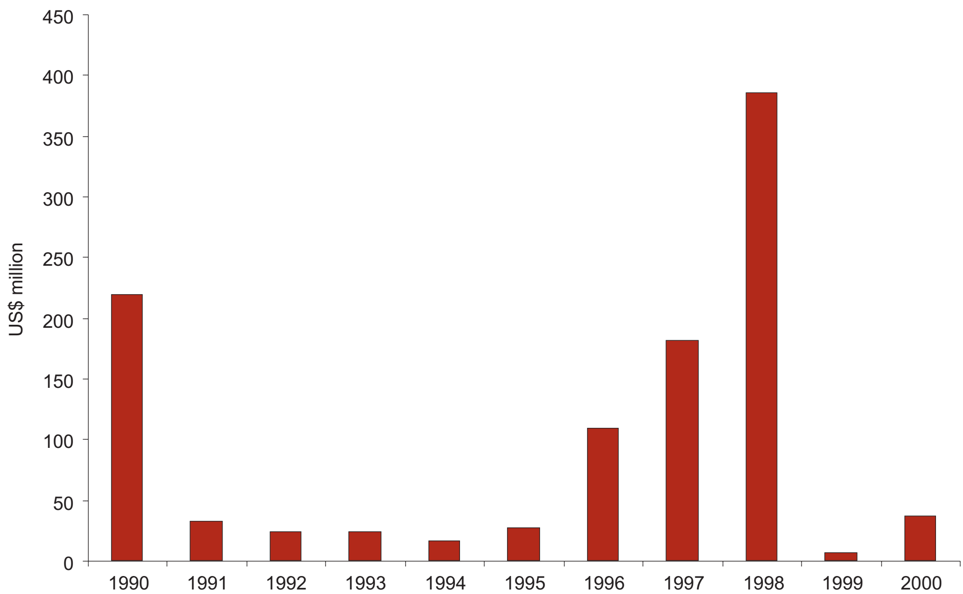
AUSTRALIAN DIRECT INVESTMENT IN CHILE

Australian direct investment in Chile totalled over US$1.2 billion during the 1990s, with volatility due to peaks in individual projects (Figure 10.13). Mining accounted for 90 per cent of Australian direct investments between 1990 and 1999 (Figure 10.14). BHP Billiton is the largest investor with a US$1 billion, 57.5 per cent share in Minera La Escondida Ltd. The next biggest mining investors are Western Mining Corporation, Eltin, Newcrest and AMP (Table 10.4).

Figure 10.13

Australian Investment Volatile

Australian Direct Investment in Chile, 1990-2000, US$ million



Source: Foreign Investment Committee, 2001.

BHP BILLITON IN CHILE

BHP Billiton has two major copper mining and processing operations in Chile, Escondida, in the Atacama desert in northern Chile, and the smaller Cerro Colorado mine.

BHP Billiton is Escondida's majority owner (57.5 per cent) and operator; other owners are Rio Tinto, a Japanese consortium and the International Finance Corporation. Escondida is the world's largest copper mine; each year its 2 200 workers produce almost 917 000 tonnes of copper in concentrate and cathodes. It also is Chile's largest private exporting company and a major contributor to the economy. In 1998, both directly and indirectly, it generated 25 per cent of the Atacama region's GDP and over 2 per cent of national GDP.

The original concentrating plant, commissioned in 1990, has been expanded four times and an oxide leach plant was commissioned in 1998. Total investment to date is around US$2.8 billion and annual production capacity is 950 000 tonnes of copper. A major expansion will provide new production facilities operating from September 2002, costing US$1.05 billion in additional investment.

Escondida is a responsible corporate citizen and is committed to community development through the Minera Escondida Foundation, a non-profit organisation that contributes significantly to education, health and social development in the mine's region.

As water is vital for operations and the Atacama desert is one of the world's driest places, Minera Escondida works with organisations to develop long term safeguards for wetland ecosystems adjacent to Escondida, including artificially recharging water systems, and incubating and feeding flamingo chicks.

BHP Billiton will continue making significant contributions to the Chilean economy and community through investment, jobs and taxes, and also through using advanced technology and setting high standards in employee relations, safety performance, housing, industrial facilities and environmental protection. Escondida already provides industry and the investment community with a model of successful development in a favourable investment climate. Future developments centre on Escondida expansions and a full feasibility study of the Spence copper project.

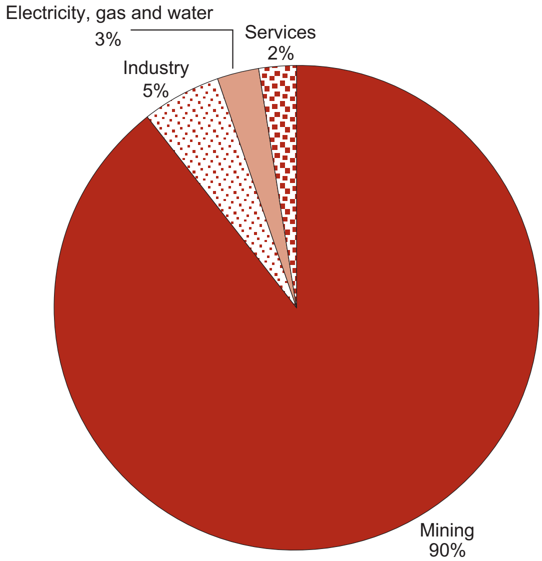
Source: BHP Billiton, 2001.

Other major Australian investments include AGL's investment in a retail gas distribution network, Orica's US$19 million investment in explosives manufacturing, AMP's US$10 million real estate holding and Burns Philp's US$6 million investment in yeast production (Table 10.4).

Figure 10.14

Mining Dominates Australian Investment

Sectoral Distribution of Australian Investment in Chile, 1990-99, Per cent



Source: Foreign Investment Committee, 2001.

Table 10.4

Many Australian Companies Investing in Chile

Australian Main Companies In Chile, 1974-1999, US$ million

Investor	Local company	Investment (US$ million)	Sector
BHP Escondida Inc	Minera Escondida Ltda	1 051.7	Mining
AGL International	Inversiones AGL Chile Ltda	26.3	Electricity, gas and water
WMC Resources International Pty Ltd	WMC Chile SA	20.8	Mining
Orica Explosives Holdings Pty Ltd	ICI Chile SA	18.9	Explosives
Eltin South America Ltd/Eltin Overseas Ltd	Eltin (Chile) SA	16.6	Mining
Newcrest International Pty Ltd/ Newcrest Mining Ltd	Minera Newcrest Chile Ltda	10.5	Mining
AMP Life Ltd	CB Inmobiliaria SA	10.0	Real Estate
North Broken Hill Peko Ltd	Inversiones North Ltda	9.3	Mining

Table 10.4 (continued)

Investor	Local company	Investment (US$ million)	Sector
P&O Catering and Services Pty Ltd/ Cook Freeze Pty Ltd	P&O Catering y Servicios Chile Ltda	8.9	Tourism
Eltin Ltd	Eltin (Chile) Ltda	8.4	Mining
AMP Life Ltd	AMP Chile Holdings Ltda	6.3	Mining
Mauri Fermentation Chile Pty Ltd	Burns Philp Chile Inversiones Ltda	6.1	Food
Australian Laboratory Services Pty Ltd	ALS Geolab SA	3.6	Services
Ausdrill Pty Ltd	Perforaciones Ausdrill (Chile) Ltda	1.7	Mining
AGL Finance Pty Ltd	Inversiones AGL Chile Ltda	1.5	Chemicals
Chile Minera NL/ Gearhart Australia Ltd	Minera Metalsearch Chile Ltda	1.4	Mining
AMP Life Ltd	AMP Investments Chile Ltda	1.4	Financial services
Ani Products Overseas Ltd	Ani Chile Ingeniería Ltda	1.3	Services
Central Inca Gold NL	Central Inca Gold NL (Agencia)	1.2	Mining
TNT Ltd	TNT Ltd y Compañía Ltda (Inversiones)	1.1	Transport
Mount Isa Pacific Pty Ltd	Minera Mount Isa Chile SA	1.0	Mining
Comalco Ltd/Comalco Aluminium Ltd	Comalco Estudios Ltda	0.7	Metal
BHP Engineering Pty Ltd	BHP Ingeniería (Agencia)	0.6	Services
Henry Walker Group Ltd	Henry Walker Contracting Pty Ltd y Compañía Ltda	0.4	Services
MTJ Quigg	MTJ Quigg	0.3	Tourism
Minerva Holdings Pty Ltd	Inversiones Minerva Ltda	0.3	Finance
Brambles Industries Ltd	System Pallets SA	0.2	Transport
Asarco Australia Ltd	Exploraciones Mineras Pacífico Austral SA	0.2	Mining
Otraco (International) Pty Ltd	Otraco Servicios Chile SA	0.2	Chemicals
Peko Wallsend Ltd	Warman International (Chile) SA	0.2	Metal working
SMC Pneumatics Pty Ltd	SMC Pneumatics Chile SA	0.2	Metal working

Source: Foreign Investment Committee, 2001.

ORICA'S LATIN AMERICAN PRESENCE

Orica, the world's leading supplier of industrial explosives, is expanding rapidly its explosives markets in Latin America, building on its global recognition and track record.

Among Orica's Latin American explosives markets, Chile is the largest (US$150 million per year), followed by Brazil and Mexico (US$50 million each), then Argentina (US$20 million). Orica Explosives is a newcomer to the previously 'closed' Venezuelan market, but recent investments in new bulk emulsion and packaged plants (US$3 million) aim to capture growth in the booming local market (US$50 million by 2005). Orica Explosives' Latin American headquarters is in Santiago, Chile.

Orica Explosives initially entered Latin America in Chile in 1989, purchasing a small company which held 20 per cent market share. During the next few years, volumes in that market increased five fold to current levels.

In Brazil, Orica Explosives supplies one of the country's most important energy projects. The Machadinho hydro-electric plant should supply energy for 600 000 residential consumers, contributing 1.14 megawatts of installed capacity to the national energy supply. The US$3 million contract involves excavating 7 million cubic metres of rock, using two dedicated mobile manufacturing units in open pit blasting and underground works.

In Venezuela, Orica Explosives aims to double its workforce to 30 people in 2001; its success is due to the strategic alliance partnerships it has with local companies in Venezuela.

Source: Orica, 2001.

AUSTRALIAN INVESTMENT OPPORTUNITIES

Australian and Chilean export-oriented mining and agricultural sectors enjoy many synergies, creating potentially profitable investment opportunities. In addition, Chile's liberal FDI rules and private infrastructure programs create opportunities in service and infrastructure sectors.

Mining and Mining Services

Australia's presence in Chile's mining sector is strong. Current developments include BHP Billiton's expansion at Escondida and AMP Investment's share in El Tesoro, a new open-pit copper mine. Opportunities also may exist for Australian mining companies in gold, silver and molybdenum production.

Opportunities also are good for Australian companies producing mining supplies and services, particularly differentiated and high technology products where local competition tends to be weaker.

MINCOM: A GROWING PRESENCE IN LATIN AMERICA

Mincom is an Australian owned software developer. MIMS, its major product, is world class enterprise asset management software, covering financial, maintenance, purchasing and human resource functions for capital intensive industries such as mining, transport, defence and utilities. Mincom rebranded the web and eBusiness enabled version of MIMS as Ellipse. Since its global launch in March 2001, the program has attracted strong interest, including in Latin America, with many customers using this product for business to business e-commerce.

As in other overseas markets, Mincom used its expertise and customer base in the mining industry to break into Latin America. Its first contract was with Exxon's large coal mine in Colombia; later it installed MIMS at Exxon's Disputada copper mine in Chile. As Chile is the region's mining centre, in 1992, Mincom established its Latin American headquarters in Santiago. From this base, Mincom became the leading supplier of integrated asset management software to Latin America's mining industry. It now also has offices in Antofagasta (Chile's mining capital), Belo Horizonte (Brazil's capital for general mining), Lima and Mexico City. Mincom then expanded into other selected markets, with regional clients in defence, transport, utilities, and oil and gas.

Mincom employs 75 staff, with no Australian expatriates based in the region. In the year to 30 June 2000, it generated sales of US$10.5 million, with revenue hit by weak commodity prices and the Y2K slowdown. In 2001-02, revenue should grow by over 20 per cent, more typical of Mincom's recent performance.

Mincom recently adopted a strategy of partnering with major multinationals, including Caterpillar and PricewaterhouseCoopers, to penetrate markets faster than incremental growth achieves. Mincom believes this will be particularly important in Brazil, where the country's size, combined with language and other special factors, can stretch the resources of even the largest organisation.

Source: Mincom, 2001.

Wine

Chile's wine industry increasingly is export focused and seeks to raise quality in a consolidating world industry. This creates opportunities for Australian wine companies with strong skills in marketing, infrastructure, production of quality, mass produced 'new world' wines, and profitable management of winery consolidation via mergers, acquisitions or alliances. To date, Australian wine companies like Mildara Blass and BRL Hardy are active in Chile, using alliances as their preferred entry method. Wine industry services and supplies and, as the Chilean wine industry modernises and faces rising wages, labour saving devices should produce other good export opportunities.

MILDARA BLASS-VIÑA SANTA CAROLINA STRATEGIC ALLIANCE

In 1998, Mildara Blass (since acquired by Fosters) and Viña Santa Carolina SA formed an alliance to create a new wine brand, Dallas Conte. Both companies own the brand, with Mildara Blass exercising exclusive US marketing rights.

The Dallas Conte brand successfully exports merlot, cabernet and chardonnay wines. In April 2000, the influential US wine magazine, *The Wine Spectator*, awarded the merlot and the cabernet 88 points out of 100, ranking it as a very good quality wine. Chile's excellent climatic conditions and a skilled Australian winemaker combined to produce this excellent result.

Source: Viña Santa Carolina, 2001; and Australian Embassy, Santiago, 2001.

Other Processed Foods

Other active processed food export sectors include fish, dried fruit and vegetables, frozen fruit, tomato products, canned fruit, pasta, fruit preserves and confectionery. Dairy is an important domestically focused processed food sector. This diversity creates a range of investment opportunities for Australian companies.

Infrastructure

With electricity and telecommunication privatisation largely complete, future opportunities include supplying equipment and services to privatised companies seeking efficiency increases via outsourcing and new technology. Mincom is targetting this market. Companies also can enter the market via joint ventures or acquisitions, as AGL did in retail gas distribution.

Sanitation offers new privatisation opportunities; seven of Chile's 13 sanitary companies are yet to be privatised. In the four privatised sanitation companies, concession holders must supply and distribute clean water, collect, treat and dispose of waste water, and provide adequate sewerage treatment under tight performance agreements (US Department of State, 2001). With only 18 per cent of Chile's water receiving any treatment (3 per cent in Santiago), these requirements should create significant opportunities for related service suppliers.

Construction

In the seven years leading up to the 1999 recession, Chile's fastest growing sector was construction. The recession should be only a temporary setback. In 2000, around US$1.5 billion of new high rise office buildings, 20 000 government funded housing units, and a public works concession program worth US$8.5 billion between 2001 and 2006, were underway or in prospect (US State Department, 2001).

Australian building materials producer, James Hardie acquired a fibre cement factory as its base in Chile. Other investment opportunities exist for products suited to framed housing, and export opportunities exist in construction equipment.

JAMES HARDIE: ESTABLISHING A CHILEAN PRESENCE

James Hardie, an Australian specialist in cement fibre and gypsum products, is expanding throughout the Americas. In December 2000, it acquired 100 per cent of Chilean producer Fibrocementos Ecológicos Limitada, including its new fibre cement manufacturing plant, for US$6.9 million. A further planned US$2.3 million investment will increase plant efficiency and bring products into line with company standards. The company's decision to enter the Chilean market marks the first step to potential wider involvement in South American markets; it subsequently entered into a strategic alliance with the Chilean firm, Ceramicas Santiago, to expand its operations into Brazil and Argentina.

James Hardie made the Chilean acquisition because of the positive outlook for economic and construction sector growth, the shift from masonry construction systems to lower cost, framed construction methods based on cement fibre and the reduced use of asbestos products.

Source: James Hardie, 2001.

Financial Services

Chile's strong financial sector may offer opportunities for Australian funds managers and suppliers of innovative products to the pension funds sector. In particular, products with acceptable risk-return profiles for pension fund investments to finance growth of export-oriented natural resource industries, would be well received. If Australian equity markets were allowable international investments, this could boost Australian equity market turnover, and pension funds could diversify their mining and wine portfolios to access global leaders in these sectors.

Chile as a Regional Headquarters

Another source of trade and investment opportunity is to use Chile as a port of entry or a regional headquarters for the wider regional market, as BHP Billiton, Mincom and Orica do. Chile has the region's lowest and simplest tariff regime, most liberal FDI rules, best business environment and best network of trade agreements, giving producers access to a market of 470 million people. These advantages mean around 45 Australian companies have a presence in Chile, more than in any other Latin American economy.

STRATEGIC ALLIANCE IN EDUCATION

Latin America's ambitious educational programs encourage private sector involvement. Many of Chile's 50 or more privately funded tertiary institutions undertake collaborations and exchanges with universities throughout the world.

Partnerships with overseas institutions help in developing a more competitive edge. Australians are native English speakers; the currency is highly competitive making tuition fees very affordable; the population is culturally aware; and Australian educational institutions have a good reputation. Thus, Australian educational institutions are desirable strategic partners.

University of Western Sydney's activities in Latin America include student exchanges with two Chilean universities and an agreement with Arcis University to train 20 English teachers in Chile who, in turn, will teach English Proficiency to all 4 000 students at the university. University of Western Sydney is responsible for quality assurance and certification of students. This acts as a lead into further education in Australia for students and staff seeking higher degrees or further development.

Source: Castillo, 2001.

FUTURE TRENDS

Chile's liberal trade and investment regimes create many opportunities for Australia to increase its market profile as a trader and investor. A range of commodity and manufactured exporters have entered the Chilean market, but considerable potential for expansion clearly remains in the manufacturing sector. Low external tariffs mean Australian exporters generally face less discriminatory treatment from Chile's many free trade agreements than in other major Latin American markets.

Australian mining investment in Chile is likely to continue rising, in turn assisting Australian mining service and supplies producers and exporters. Wine is clearly another major export-oriented sector with significant investment potential for Australian companies. Wine industry services and supplies also should produce good export opportunities. Supplying goods and services to the diversifying manufacturing and primary producer sectors also should generate good export and investment opportunities as Chile continues its robust growth.

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LATIN AMERICAN BUSINESS ENVIRONMENT

KEY POINTS

- Over the last two to three decades, the business environments in Brazil, Mexico, Argentina and Chile have changed considerably and further reforms to increase efficiency are underway.
- Most of these governments have simplified requirements for establishing businesses and strengthened bankruptcy laws, intellectual property rights, competition policy and corporate governance; however, in many areas, more needs to be done.
- Except for Chile, business people consider that court systems, bureaucracies and taxation systems need to improve efficiency and transparency; the regulatory burden means that businesses should engage good lawyers, accountants and consultants.
- Labour markets are generally inflexible, with many mandatory benefits, including for employment termination, adding to the costs of doing business in these economies; as a result, many workers remain without benefits and are untaxed in the informal sector, but foreign firms cannot operate there.
- Skilled labour is generally quite expensive, particularly once benefits and taxes are added. However, unskilled labour remains cheaper than in developed economies and generally is quite productive.
- The Latin American economies generally have complex and inefficient tax systems, constraining investment, savings, employment and exports. Compliance costs are high.
- Although the economies have deregulated and privatised considerably, many restraints on competition remain, except in Chile. Intellectual property right protection often is difficult.
- As personal relationships are key to doing business in Latin America, an on-the-ground presence often is essential for Australian firms attempting to gain market profile. Traders can do well using good local distributors and agents.

Trade liberalisation, privatisation, elimination of many foreign investment restrictions, and complementary reforms have transformed the economies and business environments of Mexico, Argentina, Brazil and Chile, hereafter called the four Latin American economies. Today, these economies offer various opportunities, particularly for those businesses with medium to long term perspectives. Nevertheless, doing business in these economies is different from doing business in more developed countries, and successful foreign businesses in these markets understand the business culture, laws and regulations. As in any market, it takes time to establish a solid presence.

This chapter briefly outlines the effect of history on business culture; then it examines the legal environment in the four Latin American economies, including business forms available to investors, corporate governance standards, bankruptcy laws, the efficiency and impartiality of the courts, intellectual property right protection and dispute resolution. It highlights features of the four taxation regimes and labour markets, and warns of bureaucratic frustrations and time consuming processing. It assesses moves to reduce corruption, then examines ways to enter the market, comparing the use of intermediaries and an on-the-ground presence. It highlights the value of due diligence assessments and careful selection of legal representatives. Finally, it indicates how the business environment is changing and modernising, making it easier for traders and investors to do business in these economies.

THE IMPACT OF HISTORY AND CULTURE ON THE BUSINESS ENVIRONMENT

Latin America is a huge, ethnically, culturally and historically diverse region; its constituent countries have at least as many differences as similarities.

Historical and Ethnic Diversity

The four Latin American economies have a common history of Spanish and Portuguese colonisation, and post colonial regimes which moved between autocratic and democratic rule, but their pre-colonisation civilisations had marked differences. For example, for over 3 000 years, at the centre of the Aztec empire, Mexico had highly developed, autocratic, centralised and stratified economic, political and social systems. Peru, Bolivia, Paraguay, Ecuador and northern Chile were home to the Incas, the major pre-colonial South American civilisation. Today, Indians and Mestizos, people of mixed European and Indian descent, comprise at least 85 per cent of the population of Mexico and these South American countries.

On the other hand, Indians of Brazil, Argentina and southern Chile were dispersed and less able to survive colonisation. Today, 85 per cent of Argentines are of European descent, with most of the remainder Mestizo; only 1.5 per cent of the population is Indian.[1] Brazil had a long history of African slavery and around 50 per cent of its population are of African descent, with the remainder of European

1 Between the 1850s and 1940s, more than 3.5 million immigrants arrived in Argentina; about 45 per cent were from Italy and 32 per cent were from Spain. Before the 1960s, substantial numbers also came from Britain, Germany, France, Switzerland, Denmark, Poland, Russia, the Middle East, and Japan.

and Mestizo descent; less than 1 per cent of the population is Indian. Most Chileans also have European and Mestizo heritages, and like Argentina and Mexico, Chile has no African tradition.

Spain colonised all of Latin America, except Brazil; Spanish is the official language of Mexico, Argentina and Chile. Portugal colonised Brazil; Portuguese is its official language. Most Latin American populations are nominally Roman Catholic, although a lesser proportion actively practise their religion.

State Led Development Models

From the 1930s, in response to their history of foreign powers' intervention, the Depression's severe impact, and UN regional agencies' push for import substitution policies, the four Latin American economies pursued inward looking, state led development strategies. These models lasted until the 1970s and 1980s. The state directly intervened in all productive activities and, with extraordinary regulatory capabilities, it bolstered and inhibited industry and service sectors with protectionist and promotional schemes. Consequently, industries lacked competitiveness and initiative; the system encouraged low productivity; state owned enterprises had overstaffed workforces; and collusion between business leaders and government officials was common.

While recent reforms have reduced this legacy, it still influences the business culture. New foreign entrants doing business with government, such as bidding for large privatising state assets, still need considerable inside knowledge and connections to succeed (Stoffel, 2001). Because connections are so important, a well known local businessman heading offices of a foreign business can boost the business' market profile and share (Barker, 2001).

Cultural Attitudes

In the last two decades, three in the case of Chile, the four Latin American economies' economic structures and social and business attitudes have changed dramatically, but their histories continue to influence business arrangements. Understanding their traditions, attitudes and social norms greatly improves foreign companies' chances of business success.

Attitudes towards foreigners and cultural allegiances vary. For example, Mexicans, proud of their rich and diverse multicultural heritage, typically are intensely nationalistic. Their attitudes towards foreigners are mixed; currently, interest in foreign knowledge, products and services is high but historical grievances remain. Foreigners who fail to appreciate Mexican history and culture perpetuate negative attitudes. Brazilians retain hierarchical work structures but, with their cultural mix and love of sport, are less formal than many other people in the four Latin American economies; Australians generally find Brazilians easy to do business with. Brazilians also have a strong interest in foreigners and things foreign but are strongly nationalistic. Chilean and Argentine business cultures and social interactions tend to be more formal and hierarchical. Argentines are quite nationalistic, although their broader cultural allegiance, to Latin America or Europe, may appear unclear.

Traditionally, personal relationships based on trust and respect were the key to doing business in the four Latin American economies. Relationships, rather than merit, service or price considerations, often determined promotions and contracts. While this tendency is changing, respect for authority and status are stronger than in Australia. Consequently, junior employees may be less inclined to solve problems and show initiative; usually, very senior staff, as well as technical people, decide on goods or services purchases, for example (Barker, 2001). However, some businesses are adopting western management styles, encouraging delegation and independent decision making.

The workforces in the four Latin American economies are well motivated and generally work very hard, but tend to value a balanced lifestyle. Traditionally, women did not participate in the workforce, and some discrimination against women's promotion still exists. However, more professional women now are in the workforce and foreign women can conduct business successfully in the four Latin American economies.

THE LEGAL ENVIRONMENT FOR BUSINESS

Although some challenges remain, the legal environment for foreign businesses, particularly in Chile, has improved over the last decade. However, foreign investors should use professional legal advisers, particularly for business incorporation, contract development, staff dismissal, taxation compliance and other formal undertakings. Investors should choose their solicitors and use them carefully. For example, Mexicans are not accustomed to aggressive negotiations in which solicitors take the lead. Because the relationship between potential partners is valued, investors, not solicitors, should do most of the talking (Pikoff, 2001).

In addition to many other reforms, the four Latin American economies' governments generally have simplified requirements for establishing a business, and strengthened bankruptcy laws, intellectual property rights and corporate governance. However, the slow court systems can be a problem.

Business Forms

Commercial and civil codes offer foreign investors various options for establishing a business. In Mexico, fixed and variable capital limited liability corporations, limited liability partnerships, general partnerships and joint ventures are possible. Foreigners may partially or wholly own corporations and partnerships.[2] Foreign nationals can conduct business as representatives of foreign based firms.

2 Mexico's fixed capital, limited liability corporation is the Sociedad Anónima, SA. Most foreign corporate investors use Mexico's variable capital limited liability corporation, Sociedad Anónima de Capital Variable, SA de CV; it has the advantage that changes in capital can be approved internally; whereas, an SA requires authorisation from the Ministry of Foreign Relations. The limited liability partnership is known as the Sociedad de Responsibilidad Limitada, SRL. The general partnership, sociedad en nombre colectiva is used infrequently as partners assume unlimited liability toward third parties. The joint venture agreement, asociación en participación, frequently is used by small and medium foreign investors. Mexican law also provides for the establishment of franchises and branch offices; while branch offices may have certain tax advantages, because they are not separate legal entities, the parent company can be held liable for branch office actions. Bringing a foreign franchise to Mexico can be very profitable. However, the foreign firm should expect a high business failure rate because of local management problems (Purcell, 2001).

Mexico's FM3 business visa allows unlimited visits to Mexico for one year; this can be renewed up to four times, for five years. However, if foreign nationals spend more than 183 days in Mexico, they are considered residents, subject to national taxation.

In Argentina, most foreign investors establish as a stock corporation, or SA, or branch offices. Incorporating a subsidiary stock corporation limits a foreign owner's liability for the subsidiary. A branch office could expose a foreign owner's assets outside of Argentina to liability; however, forming a branch in Argentina is usually less costly than incorporating.[3] The most common joint venture vehicle is the Union Transitoria de Empresas, UTE, governed by the Companies Law.[4] The Commercial Companies Law generally regulates business entities, while the Foreign Investment Law also regulates foreign investors establishing Argentine businesses.

Brazil offers many business forms. Foreign businesses usually establish subsidiaries as either a limitada, limited liability company, a cross between a partnership and a company, or sociedade anonima, a publicly listed corporation; the latter is Brazil's most common business structure (Department of Foreign Affairs and Trade, 2001).

Chile also offers many business forms. Foreign investors usually use stock corporations, SAs, limited partnerships and branches of foreign corporations (PricewaterhouseCoopers, 1999).[5] Incorporating in Chile is inexpensive and not time consuming.

Corporate Governance Standards

Control of most large, publicly traded firms in the four Latin American economies, apart from privatised former state enterprises and foreign companies, usually rests with a single person or family. Generally, they treat minority shareholders poorly. While corporate governance and accounting standards are quite good in large professionally managed, privatised companies, especially those listed on the New York Stock Exchange, standards are weaker in family controlled companies.

However, government support for better corporate governance is increasing. For example, in June 1999, Mexican private sector organisations, representatives of the Central Bank, Ministry of Finance and National Banking and Securities Commission developed and introduced a voluntary Corporate

3 SAs must be registered with the Public Registry of Commerce of the jurisdiction of incorporation. The directors and even the president of the company may be foreigners; however, a majority of board of directors members must be Argentine residents. The Companies' Law also provides for the Sociedad de Responsabilidad Limitada, SRL, which frequently is used as an investment vehicle; SRLs are subject to income tax in the same manner as SAs and branches. Argentine companies are subject to supervision from two different sources: the Public Registry of Commerce (Inspección General de Justicia) and from controllers or supervisors (Comision Fiscalizadora-Sindicos) appointed by shareholders.

4 A non-resident corporation may be a member of an Argentine UTE if it complies with the same kind of registration proceedings with the Public Registry of Commerce as foreign company branches. A UTE is best used for temporary associations such as developing specific works or services. UTEs are not treated as independent legal entities, although they are for certain purposes including labour laws, social security contributions and value added and turnover tax. The members pay income tax and the tax on assets. Members of the UTE are not subject to joint or several liability unless otherwise provided for by the UTE agreement.

5 Others include general partnership, silent partnership, joint venture and sole proprietorship.

Governance Code for Mexico to increase company competitiveness and attract investment through more transparent management. The code establishes guidelines on the board of directors, evaluation of and compensation for directors, audits, finance and planning, and stockholder information. While compliance with the code is voluntary, publicly traded firms must report their level of compliance to the National Banking and Securities Commission and to capital markets.

To further improve Argentine corporate governance rules, including minority shareholding rights, the Government may draft a new law (Díaz and Sanchez, 2001). Argentine law currently protects minority stockholders and outside investors from wealth expropriation by insiders and hostile takeovers (Apreda, 2000). In recent years, many foreign corporates and investment funds have taken over big domestic conglomerates, improving Argentine corporate governance standards. Unlike traditional family owned and managed companies, most foreign invested corporates have large, active stockholders, holding blocks of shares, allowing more activism and demanding managers respond to their concerns (Apreda, 2000).

Brazilian family owned firms generally have weak transparency and public disclosure, and poor treatment of minority shareholders (Conolly and Simoes, 2001). To address this, the Government increased minority shareholders' voting rights and recently, with International Finance Corporation's help, established a second tier of the stock exchange to list firms committed to more stringent corporate governance and US accounting standards. This bourse is operational, but not very active yet (Bertelsmeier, 2001).

In Chile, financial authorities are extremely vigilant, requiring audits and yearly financial statements, so large and medium companies tend to operate only one set of books (Jeria and Barraga, 2000). However, minority shareholder rights are problematic. If passed, a new law will require, through public tendering, all shareholders to receive the same offer during takeovers or floats, and minority shareholders will be able to liquidate their holdings if ownership changes substantially. Foreign institutional investors badly burnt in joint ventures with major Chilean family owned companies, pushed for this law.

Bankruptcy Laws

As in Asia in 1997, the Mexican and Brazilian crises of 1994 and 1999, revealed weaknesses in bankruptcy regimes of Latin American economies; this weakened creditors' capacity to secure collateral and undermined financial institutions' capacity to intermediate savings.

Mexico's new bankruptcy law, effective since December 2000, replaces legislation passed in 1943. As the courts still are processing cases under this law, mid 2001 is too soon to evaluate its impact on investment and lending. However, the new law eliminates the old law's pro-debtor bias, shortens proceedings and increases investor/creditor security.[6] Debtors used to extend proceedings for years,

[6] Under the new law, debtors will find avoiding payment much more difficult, and the higher likelihood of liquidation serves as a disincentive to manipulating the system. Federal district courts, considered more professional and less prone to interference, now have jurisdiction for bankruptcy cases, and can appoint specialists to evaluate business solvency. The 18 month maximum period for determining the status of business in bankruptcy cases means assets still will have some value if liquidated. These changes should foster increased lending.

blocking creditors' efforts to realise collateral and avoiding debt payment by declaring bankruptcy. In addition, the lack of judges trained in bankruptcy created uncertainty and opened the system to manipulation.

The Argentine Bankruptcy Law, amended in 1995 after the Mexican crisis sharply increased non-performing loans, provides for corporate restructuring, bankruptcy proper and out of court arrangements between all or some creditors and the debtor.[7] The law generally functions well, enabling creditors to secure their collateral or payments owed; however, the court system slows this process. Small and medium businesses' credit costs are high, partly because of bank caution in lending to this sector since the Mexican crisis but mainly because, in the current recession, most Argentine small and medium firms find it difficult to collect payment from clients. This raises the risk of financing this sector (Iribarne, 2001).

Brazil's bankruptcy laws remain weak. For eight years, Congress has considered a bill to reform them; President Cardoso has pledged to make its passage a priority (Bunce, 2001). The present law has a pro-debtor bias, including allowing insolvent companies to continue operating. By declaring bankruptcy, shareholders/owners can avoid debt payments for two years.[8] This gives debtors a major incentive to initiate bankruptcy proceedings; this in turn reduces the availability and increases the cost of finance for small and medium businesses.

Chile's bankruptcy laws are modelled on those of the United States, and courts implement them reasonably effectively and consistently. Importantly, a creditor can seek a bankruptcy judgment against a creditor solely on grounds of failure to make a single loan payment; the judgment does not need to be based on financial insolvency (US Department of State, 2000b).

Efficiency and Impartiality of the Courts

Except in Chile, court systems in these major Latin American economies lack transparency and are relatively inefficient. While Mexico's judicial system has become more efficient and impartial, decisions can be slow and corruption may occur at lower judicial levels. Corruption at appellate levels is uncommon, and businesses may overturn corrupt decisions on appeal (Pikoff, 2001). However, Mexico's civil code can be unclear and court rulings are not published. Moreover, the judicial system favours defendants and various mechanisms can delay proceedings.[9] In Mexico, some commercial disputes can be treated as criminal cases; for example, failure to pay for services received is considered as fraud. Securing good legal representation is very important in Mexico.

7 The law was modified to facilitate mergers and acquisitions, and avoid local firms disappearing as structural reforms occurred.

8 The insolvent firm then only pays a modest 12 per cent per year interest on outstanding debt compared to the going rate for most small and medium businesses of 40 to 50 per cent. If a bankrupt firm repays its debts after two years, the bankruptcy order is dissolved, and the owner can continue running the business (Bunce, 2001). Furthermore, even after two years, to be declared bankrupt, firms must convince the courts that shareholders set out to defraud creditors, not just that shareholders cannot repay them.

9 The *ley de amparo*, equivalent to a stay or injunction, is commonly used. Other tactics include challenging the identity of the other party or one's own competence to stand trial.

Despite some important reforms, Argentina lacks an efficient, expedient and impartial judiciary system, and the existing system needs serious renewal (Berensztein, 2001).[10] Delays and uncertainty in Argentine court processes result in most companies seeking to avoid litigation by building safeguards into contracts. Both foreign and local firms usually do due diligence checks before signing contracts with unknown parties. If litigation eventuates, to avoid frustration and distress, both foreign and major local corporations use influential and reputable solicitors. In the provinces, lawyers with good local connections are used. Personal connections and networks often are crucial to expedite cases and achieve appropriate outcomes.

Lenient rights of appeal also burden Brazil's rather complex judicial system; consequently, civil cases can take two to six years, and bankruptcy cases can take ten to 12 years (Department of Foreign Affairs and Trade, 2001). In bankruptcies, litigation costs and preferred creditors' claims, including workers, usually obliterate the value of collateral (Bunce, 2001). As in Mexico and Argentina, businesses do not take court action for smaller sums. Lower level Brazilian provincial courts also may be less transparent than federal courts.

Chile's judicial system is well defined and independent. The Government is very unlikely to become involved in dispute adjudication. However, businesses should secure good legal representation before starting operations in any of the four Latin American economies.

Intellectual Property Rights Protection

While the four Latin American economies are strengthening intellectual property rights, except in Chile, the protective legislation is implemented poorly. Since the mid 1990s, to comply with North American Free Trade Agreement, NAFTA, patent and trademark standards, Mexico has strengthened its legislation and increased enforcement.[11] Nonetheless, infringement continues to threaten the competitiveness and profits of both national and foreign companies. Businesses operating in Mexico or with Mexicans should register all trademarks, patents, and copyrights locally. When business observes local registration laws, the chances of winning an infringement case are good (Pikoff, 2001).

Despite Argentina's comprehensive legislation, including in the Constitution, to protect intellectual property rights in scientific, literary, artistic and educational works, regardless of the means of reproduction, software piracy remains quite widespread.[12] Increasing illegal imports and domestic copies along with difficulty in getting the Goverment to enforce the law, threaten the software industry.

10 Reforms to date include establishing a Judiciary Council (Consejo de la Magistratura) in the 1994 Constitution to replace the Senate in appointing and removing judges; creating tax courts for a more efficient way to solve tax disputes; and, in December 1999, establishing the Anticorruption Agency, designed to combat bribery and investigate sudden increases in public officials' assets.

11 In 1994, Mexico reformed the Industrial Property Law and created the Mexican Institute of Industrial Property, IMPI, to manage the administration and protection of property rights. A new federal Copyright Law extended the definition of copyrightable materials and in 1998, the Government funded enforcement activities and initiated an anti-piracy campaign. In 1999, it imposed stricter penalties for piracy.

12 Article 17 of the Constitution protects intellectual property and since 1966, Argentina has been party to the Paris Convention. Furthermore, Argentina approved the Trade Related Aspects of Intellectual Property Rights, TRIPS, provisions of the General Agreement on Tariffs andTrade, GATT.

Since 1999, a prominent sector of the Argentine software industry has led an aggressive campaign to secure intellectual property rights. (See www.softwarelegal.org.ar.) This campaign identified public agencies, some of the worst offenders, private firms, and non-government organisations violating the law, forcing them to cease these practices. After declaring a moratorium until October 2000, the industry returned to the courts and enjoyed some small but important victories. Consequently, software and databases now are expressly included within the scope of legislation and, in future, Argentine courts should apply criminal sanctions to illegal software copying.

While Brazil has legislation protecting intellectual property rights and patents, counterfeiting and technology pirating problems remain serious.[13] Also, as Paraguay does not observe intellectual property laws, smuggling of counterfeit goods from there into Brazil is widespread. Consequently, the United States argues Brazil does not comply with trade related intellectual property rights, TRIPs, issues.

Chile has good intellectual property legislation and the government enforces it (Silva, 2001). Chile belongs to the World Intellectual Property Organisation, and patents, trademarkes, industrial designs, models and copyrights are protected by the provisions of the International Convention for the Protection of Industrial Property (the Paris Convention). In 1992, Congress approved legislation that expands copyright protection from 30 to 50 years; however, copyright infringements, generally by small and medium companies, still cost foreign firms much money (US Department of State, 2000b).

SOFTWARE PIRACY

The Business Software Alliance, an industry group, estimates that software piracy in Latin America resulted in US$1 128 million in lost sales in 1999. Annual retail losses remain heavy as the region's software market continues to grow. While still high, piracy rates fell slightly in 1999, due to new laws, better enforcement and increased public awareness (Table 11.1). Generic computers with all basic software installed continue to be readily available in most Latin American markets.

Table 11.1

Software Piracy High in Latin America

Software Piracy in Latin America, Per cent and US$ millions

Country	Piracy rate (per cent)	Retail losses (US$ millions)
Argentina	62	192
Brazil	58	392
Chile	51	59
Mexico	56	134

Source: Economist Intelligence Unit, 2001.

13 For example, one Australian business in São Paulo took out product patents for its products, but found they were not enforceable. Its products have been copied quite frequently, including mould numbers and the logo, usually by backyard operators (Robinson, 2001).

Dispute Resolution Including Arbitration

In most of the four Latin American economies, businesses should litigate commercial disputes only as a last resort, and contracts should include clear terms for private dispute resolution. In Mexico, while most disputes are settled privately and informally, alternative dispute resolution, including arbitration is available. Both Mexico's Commercial Code and International Conventions provide for dispute resolution outside the court system, but this avenue is not used frequently (Pikoff, 2001). This is possibly because, while the arbitration is legally binding, the court process to recognise and enforce arbitrated disputes can be slow.

Argentina's 1998 arbitration law requires businesses to attempt civil and commercial negotiations before filing suits in the courts. The law allows for international arbitration, but a judge also may require the litigants to use a local arbitrator before filing suit.[14] This new law helps curb the number of lawsuits and facilitates more economical and consensual solutions. However, arbitration still has a few problems, such as some randomly selected arbitrators' inexperience.

Brazil's 1996 arbitration law ensures arbitration clauses can be enforced; although the law's constitutionality is being challenged, the law is expected to be upheld. The law allows parties to choose the jurisdiction of law applicable to them, and location of arbitration, including outside Brazil. However, the Brazilian Supreme Court must confirm foreign rulings (Department of Foreign Affairs and Trade, 2001).

Chile allows local and foreign arbitration, is a signatory to international arbitration agreements and local courts enforce foreign arbitration rulings, although the arbitration process is somewhat complex. Information on arbitration is available from the Santiago Chamber of Commerce (see www.camsatiago.com).

LABOUR LAWS AND MARKETS

In all four Latin American economies, unskilled labour remains cheaper than in the United States, even given lower productivity, but skilled labour, especially foreign educated employees, is relatively expensive. The general minimum wage in Mexico currently ranges from around US$3.70 to US$4.15 per day, depending on the region.[15] Argentine unskilled industrial workers earn US$15 per day, while Brazilian factory workers wages are US$10 per day and the minimum wage in Chile is US$10 per day. In most of the four Latin American economies, high quality managerial personnel are available, although salaries and conditions may exceed Australian levels. Local managers head most foreign firms. Information technology personnel often are in short supply but, except in Mexico, other skilled labour generally is available.

[14] The law requires a specially trained negotiator, chosen either randomly or by agreement of all parties, to conduct meetings to exhaust all available ways of reaching an agreement, thus avoiding a trial. The law also establishes incentives to keep the parties engaged during the arbitration process, including fines for non-attendance. If for any reason arbitration fails, the negotiator only notifies the court of the outcome, without mentioning the cases' causes and circumstances, thus preserving information disclosed during the bargaining process.

[15] This compares to the US hourly minimum wage rate of US$5.15.

Except in Chile, dismissing labour in these economies can be very difficult and expensive. In Brazil, investors buying companies should secure lawyers to quantify their likely legal liabilities from labour disputes and severance packages, to include in negotiations. For example, a privatising state enterprise could have very expensive redundancies, about double the annual salary of dismissed employees. If investors need to downsize the workforce or dismiss unproductive employees, the employees probably will seek litigation (da Costa e Silvia, 2001). Brazilian labour courts favour local employees, and if decisions are made against them, they can appeal endlessly. Hence such disputes can take five years to resolve, compared to half that time elsewhere. To avoid this, companies consult with unions to set up a voluntary redundancy program; courts then must approve it (da Costa e Silvia, 2001).

Again except for Chile, other labour laws in the four Latin American economies also are rather rigid. Even Chile is re-regulating its less regulated labour markets. Regardless of their nationality, companies operating in Mexico, Brazil and Argentina assume significant and potentially costly employee obligations. In these three economies, rigid labour laws have caused the development of huge informal labour markets where workers usually receive no compulsory benefits and pay no tax.

The Mexican Federal Labour Law sets out a long list of mandatory benefits and strict guidelines for employment termination. While foreign companies should understand all employer obligations, employee termination conditions particularly are important.[16] Employers must comply with a significant list of employment conditions and mandatory benefits related to hours of work, paid holidays, Christmas bonuses, paid maternity leave, mandatory profit sharing, employer's housing, social security and pension contributions, and training requirements. Minimum mandatory benefits alone increase employee salaries by roughly 37 per cent. Businesses also may need additional voluntary benefits to minimise personnel turnover and attract senior staff, particularly in the tight, skilled labour market. Altogether, the real cost of a Mexican employee is from 37 to 100 per cent above the nominal salary (Economist Intelligence Unit, 1997).

Argentina's formal labour markets are similar; labour laws add considerably to the cost of employing labour. Businesses find it very difficult to terminate employment contracts for under-performance; in practice, employers only can dismiss personnel in the case of force majeure or an involuntary reduction of the employer's operations. Collective bargaining agreements have delivered mandatory benefits which include an annual bonus, equal to a month's wage, employer contributions for social security, family allowances, medical services, pension and unemployment benefits, and compulsory union dues; these all add around 50 per cent to the nominal wage (Alexander, 2001). Employers must pay severance pay equal to a month's salary for each year worked.

16 Mexican Federal Labour Law generally requires employers who dismiss a worker to pay severance equal to three months salary, plus an additional 20 days of salary for every year of service. Employees with more than 15 years' tenure receive a seniority payment of 12 days of salary per year of service, even when they leave the firm voluntarily. Although Mexican regulations do provide for 'just cause dismissal', which releases employers from paying costly severance packages, 'just cause' can be difficult to prove in practice. Mexican companies generally prefer offering a severance package to risking a protracted and expensive court battle.

In 2000, the Argentine Government introduced some labour law amendments, which somewhat reduced the burden of redundancy obligations, but most analysts consider changes were cosmetic. These have not reduced foreign and local business community concerns about labour law rigidity, overall labour costs and the difficulty of dealing with unions (Iribarne, 2001).

Brazil's formal labour market also is rigid, complex and bureaucratic, and considered in need of a major overhaul (Flôres, 2001; and Bertelsmeier, 2001). Compulsory obligations can add up to 70 per cent to the base wage of Brazilian employees (Goncalves, 2001; and Flôres, 2001). Voluntary benefits to attract and keep skilled staff, including health, dental and life insurance and study assistance can add another 30 per cent to base salaries (Barker, 2001).

Chile's labour laws and market are more flexible and Chile has enjoyed calm labour relations since returning to democracy. Labour contracts are negotiated at the company level; there is no sectoral bargaining. The Government is negotiating to update the labour laws. However, with unions now legal and stronger labour legislation, some analysts see Chile as heading towards a European style labour market (Reus, 2000; and Silva, 2000).

The Informal Sector

Except for Chile, the four Latin American economies have an extensive informal sector, creating unfair competition for legally registered firms. The informal sector produces roughly 30 per cent of Mexico's GDP and provides as much as 70 per cent of employment (Economic Development Associates, 2001). In Argentina, 45 per cent of workers operate in the informal sector (Alexander, 2001). During the Argentine recession, unemployment increased but not dramatically because informal sector wages fell significantly, although formal sector wages fell only marginally, if at all (Alexander, 2001). Brazil also has an extensive informal sector; less than 10 per cent of the population pay tax. In the four Latin American economies, foreign firms cannot operate in the informal sector.

Mexico hopes its ongoing efforts to simplify business regulations will lower the time and cost of compliance, thereby encouraging informal firms to join the formal sector. In Argentina and Brazil, rigid labour regulations and costly labour taxes continue to encourage informal sector growth.

TAXATION REGIMES

Again except for Chile, the four Latin American economies generally have complex and inefficient taxation regimes, with many cascading and overlapping taxes, which constrain investment, saving, employment and exports. Local business compliance, especially by small and medium firms, often is poor. However, foreign companies face stiff penalties from taxation authorities if they fail to comply. Hence, foreign investors should employ a competent accountant, preferably from one of the big five international accounting firms, to ensure they meet all taxation requirements (Stoffel, 2001).

As part of the ongoing institutional reform associated with NAFTA membership, Mexico has significantly reformed its taxation system in recent years. Mexican tax law does not distinguish between foreign and domestic businesses; tax is assessed on residency and income source criteria. Individuals and companies are classified as either resident individuals and companies, foreign residents with a permanent establishment or fixed base in Mexico, or non-residents without a permanent establishment or fixed base in Mexico.[17] Mexican federal authorities levy six principal taxes: corporate and personal income tax, fixed and financial assets tax, royalty taxes, interest taxes, value added tax, VAT, and payroll taxes. Repatriated profits are not taxed. Most states also levy payroll taxes, property taxes, and taxes on property purchases. Both federal and sub-national governments offer tax related investment incentives. Accelerated depreciation is the most important federal incentive; state level incentives include reduced property and payroll taxes.

The Argentine taxation system is archaic and complex with over 200, often inefficient, taxes. Consequently, evasion is high and revenue collection is low (Druck and Fernández, 2000). VAT accounts for almost half of all tax revenue. Corporate and personal income taxes only account for around 21 per cent of total revenue, and social security taxes account for 18 per cent. The provinces also levy taxes, including turnover taxes. The Government combined the taxation and customs administrations to reduce costs and increase efficiency, but collection costs remain high, and transparency and efficiency issues remain unresolved (International Monetary Fund, 2001).

Table 11.2

Taxation Regimes in Latin America

Selected Comparative Corporate Tax Rates in Latin America, Per cent

Country	Income tax	Withholding tax on dividends	Withholding tax on interest	Tax on branch profits	Depreciation allowance	VAT or sales tax
Argentina	35	0	15 or 35	0	2, 20, 10, 33	21
Brazil	34	0-15	15	0	4, 20, 10-20, 20	ICMS 7.25, ISS up to 5, IPI 10-15
Chile	15	20	4 or 35	20	1-4, 10-14, 5-20	18
Mexico	35	7.69	4.9, 10, 15, 21 or 40	7.69	5, 25 or 71, 30, 5-25	15

Note: Depreciation allowance rates apply to buildings, vehicles, machinery and computers respectively; Chile has no depreciation allowance for computers.
ICMS is Brazil's federal sales tax; ISS and IPI are state and local sales taxes.
The Chilean Government submitted a tax reform bill to Congress which seeks to raise corporate income tax to 17 per cent.

Source: Economist Intelligence Unit, 2001.

17 Resident individuals and companies are subject to taxation on their worldwide earnings. Residents need only live in Mexico for 183 days or more in a year. Resident companies are companies incorporated in Mexico. Foreign residents with a permanent establishment or fixed base in Mexico pay taxes derived from activities related to these. Finally, non-residents without a permanent establishment or fixed base in Mexico are subject to taxation on Mexican-source income only. For example, if a foreign firm's employee is sent to Mexico for three months to work with a local distributor, the income earned during those three months is subject to Mexican taxation.

The Argentine Government attempted some incremental tax reforms in the 1990s, and the new Minister for the Economy, Domingo Cavallo, currently plans significant taxation reforms. Most business people and analysts agree significant reform is needed to create an efficient, predictable, and non-distortionary taxation regime (Berensztein, 2001). At present, the Government tends to use tax policy as its major fiscal adjustment and distributional tool; but for local and foreign investors, the frequent tax changes create uncertainty.[18] However, the current administration has promised not to change the tax system again after enacting reforms currently under consideration. Local and foreign companies pay the same tax rates, and Argentina's tax treaties with many countries, including Australia, seek to avoid double taxation. For example, if the recipient is an Australian resident, the maximum tax rate in Argentina is 12 per cent on interest, 15 per cent on dividends and 15 per cent on royalties.

Brazil's taxation system also is very complex, inefficient and obsolete; tax rates are very high and many are cumulative. Business faces 14 taxes at three levels of government.[19] State and municipal tax collections lack transparency. The taxation system reduces certainty for business, makes forward planning difficult and reduces incentives to invest. Many foreign investors find taxes too high, so they use local lawyers and accountants to minimise tax legally (Conolly and Simoes, 2001). As a result of the high tax burden, local business compliance is low; many large and most small local companies operate in the informal sector and pay no tax. The Government allowed moratoriums on tax evaders during late 1990s recession, further undermining incentives to comply. States compete for investments by providing tax exemptions and incentives, reducing tax revenue but providing some relief to foreign investors (Goncalves, 2001).

Brazil's President Cardoso has attempted ambitious taxation reforms, including of indirect taxation and federal state transfers, over the last four to five years, to reduce so called Brazil Cost, or *Custa Brasil*. However, many interests, including provincial governments, opposed his packages, and Congress rejected most of them. Now Congress may be unwilling to reform taxes because elections are looming (Saraiva et al, 2001). While it will be very difficult to gain Congressional approval for tax reform, the Government nevertheless has been pushing ahead with tax reform proposals, announcing a package at the end of June 2001.

To stimulate tax compliance and encourage domestic and international investment, Chile significantly reformed its taxation system. Consequently, its system functions well (Davis, 2000). Complying with company tax is easy, and although the Government levies some withholding taxes, the burden is minimal (Barraga and Jeria, 2000). Capital gains tax for foreign investors was abolished in late 2000 (Venkataraman, 2000).

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18 For example, the Government recently increased nominal social security tax rates, extended the VAT base to include previously excepted goods and services, and increased the financial transactions tax to 0.6 per cent of all bank deposit deposits and withdrawals.

19 The average corporate tax rate is 30 to 33 per cent, and the top tax rate is 35 per cent; dividends do not attract tax; personal tax rates are 15 per cent (for incomes from R$900 to R$1 800 per month) and 27.55 per cent (for incomes over R$1 800 per month). State and federal government indirect consumption taxes are 24.5 per cent, industrial products tax is about 10 per cent and cities tax services from 2 to 12 per cent.

Nevertheless, evasion remains a problem, and the Chilean Government currently has legislation before Congress designed to increase compliance. Potential changes to major tax rates include reducing the top marginal income tax rate of 45 per cent to narrow the gap with the company tax rate of 15 per cent (Beros, 2000) and increasing the VAT rate, currently 18 per cent. The tax base is being broadened but some business people consider the tax net still is mainly capturing the same people (Pau and Monge, 2000). Australia does not yet have a double taxation agreement with Chile.

Most foreign investors bring capital into Chile under Decree Law 600, thereby entering a contract with the Chilean Government, protecting them from dramatic change in the tax regimes. Investors can elect to go with the current tax system, but if the system changes, they can revert to a system that guarantees a maximum total tax burden of 42 per cent. However, this option requires a minimum investment of US$1 million, with at least 30 per cent in equity; the remainder can be in debt.

COMPETITION AND DEREGULATION

In recent decades, the four Latin American economies have deregulated considerably, and are introducing competition policy legislation, but implementation varies in its effectiveness. In the mid 1980s, after decades of state intervention in the economy which drastically limited competition, Mexico undertook wide ranging reforms. Aggressive market liberalisation, including liberalising trade and privatising and eliminating price controls, laid the groundwork for increasing competition.[20] In 1993, to address private sector anti-competitive behaviour and ensure competition in non-tradeable sectors, Mexico introduced the Federal Law of Economic Competition, or Ley Federal de Competencia Económica. This established competition law and a commission to promote efficiency and ban horizontal agreements, such as price fixing and market division. It also created or strengthened sectoral regulatory agencies. Hence, Mexico has deregulated completely entry, exit and pricing in most export and import competing sectors, while making important advances in service sectors (OECD, 1999).

The 1994 Argentine Constitution establishes protection against market distortion and monopolies.[21] Under the Antitrust Law, businesses cannot limit, restrict, falsify or distort competition in producing and exchanging goods and services, or abuse a dominant market position. Prohibited restrictive practices include fixing prices, coordinating bids in public tenders, and excluding, impeding or hindering one or more competitors from accessing a market. A crucial case involving the postal service, soon will test how well Argentina's new competition law works. In 2000, a huge oil and energy company, Repsol-YPF (which in 1999 was privatised), was forced to sell service stations owned by a subsidiary

[20] For example, in the mid 1980s, the Government began removing domestic price guarantees on basic crops, replacing costly untargeted consumer subsidies with direct transfers, and eliminating official import prices. It continued price liberalisation throughout the 1990s.

[21] Under the recent Antitrust Law, certain transactions resulting in economic concentrations require the prior approval by the Committee for the Defence of Competition.

to avoid a quasi-monopoly in the retail market. This suggests that the competition authority has the ability and resources to apply the law. Whether it regularly will administer the law fairly and properly remains untested. In other industries, competition varies according to the sector.[22]

The Minister for the Economy sees increased competition as a substitute for devaluation, and wants business costs to come down 30 to 40 per cent. However, Argentine companies work with very high margins, particularly in the financial sector, and foreign banks appear to have followed suit (Vexina, 2001). Foreign corporations have succeeded in consumer goods, agribusiness, and construction, where competition is high.[23] Nevertheless, managers of foreign businesses report collusive behaviour, including on price, is a significant problem among major Argentine business sectors and chambers of commerce. Such chambers also can lobby government for protection against foreign investors and trade.

The Brazilian Government's new competition policy and a consumer code protects consumers, and a well regarded unit, the Conselho Administrativo de Defesa Econômica, CADE, operating under the Justice Department, implements competition policy. In the early 1990s, the Government also removed price controls, giving firms incentives to increase production, while trade liberalisation gives firms incentives to increase quality (Bahia Guimarães, 2001).

Chile is very open and competition is the norm; foreign businesses are able to participate freely in most sectors.

DEALING WITH THE BUREAUCRACY

Bureaucracies in the four Latin American economies, based on the Iberian model and moulded by the tradition of state intervention, can be quite hierarchical, often are overstaffed and inefficient, and lower levels can lack transparency. This can create tedious and costly work for businesses. To help deal with all these regulations, foreign businesses should employ good local lawyers, accountants and consultants familiar with the local bureaucracy and international investor needs.

This particularly helps with state and municipal bureaucracies, where businesses, regardless of ownership, are more likely to encounter red tape and corruption. Local governments control numerous business formalities including zoning, environmental regulations and operating licences. While federal governments usually encourage deregulating these requirements, provincial and municipal government responses vary.

[22] For instance, ownership in the steel and cement industries is highly concentrated. However, other non-tradeable sectors, such as insurance and banking, have opened enormously. Hence, primarily European institutions (Grupo Santander-Hispano, BBVA, ING and HSBC), and some American ones (Citibank and BankBoston) now dominate in a sector Argentine institutions previously controlled.

[23] Procter and Gamble, and Unilever grew substantially during the 1990s; Nestlé and Gillette established their Argentine businesses decades ago; Cargill and Nidera are traditional players in the strong, export-oriented, agri-industry sector; and finally, Chilean companies invested during the 1990s economic reforms.

The Mexican Government has attempted to simplify bureaucratic procedures related to business. Between 1996 and 2000, the Federal Regulatory Improvement Commission eliminated almost 50 per cent of business formalities, including information, registration, and permit requirements, imposed by 11 federal ministries, and simplified 90 per cent of remaining ones (Comisión Federal de Mejora Regulatoria, 2000). Transparency and speed of administrative decision making at the federal level have improved, with established limits governing the maximum processing time for federal formalities, such as incorporation permit requests. However, despite recent improvements, many problems remain. Corruption may cost companies up to 5 per cent of their total expenditures (Jiménez, 2000). Further reducing corruption may take time, but President Fox plans to establish a committee to fight federal employee corruption.

The Argentine bureaucracy also hampers business efficiency, and transparency issues exist at all levels of government. Countless procedures, arbitrary regulations and lack of transparency increase transaction costs. At Argentine federal and state levels, foreign businesses confront problems including frequent changes in personnel, as party political appointees fill many bureaucratic positions and turnover can be very high; ill informed personnel and low salaries and morale provide an incentive for corruption. Inefficiency arises from the weak career civil service; duplicated responsibilities and transactions; lack of willingness to disseminate public information; arbitrary office hours interrupted by strikes; longer delays during summer when personnel take holidays; and agencies rarely meeting deadlines (Berensztein, 2001). Some politicians recognise Argentina needs a sustainable, practical, and aggressive policy of reinventing the state at the federal, provincial and local level. However, few will confront the powerful interests entrenched in the bureaucracy (Berensztein, 2001).

Chile's regulatory systems are transparent; regulators have little discretion. However, rule making processes are not transparent and do not generally include provision for public hearing or comment (US Department of State, 2000b). Corruption exists in Chile, but is very limited; in 1999, Chile ranked nineteenth on Transparency International's corruption index (the United States ranked eighteenth).

BUREAUCRATIC ABSURDITY IN ARGENTINA

The following anecdote highlights Argentine preoccupation with process. An American family moving to Argentina wanted to bring their cat. Officials told them that to enter the country, the cat required a 'passport', with photo. The family visited the vet, the US Department of Agriculture and Federal Express, and sent the proper documentation and seals for verification by the Argentine Consulate. At the airport, airline staff diligently checked for any special regulations, and sent a telex to Ezeiza International Airport to advise them of the incoming animal, since it required a special veterinary surgeon be on call. Despite all this processing, the family found the cat alone at the luggage carousel; no vet was present; and Customs did not even check the cat's substantial immigration file.

Source: Berensztein, 2001.

Brazil's top two to three levels of bureaucracy generally are quite good (Bertelsmeier, 2001). However, more junior levels are poorly paid and the quality of bureaucrats declines, slowing processing times. Transparency issues can arise, especially at state and municipal levels; however, corrupt approaches should be resisted (Bahia Guimarães, 2001).

Chile's bureaucracy also is generally efficient and transparent at more senior levels, but the same problems can arise at more junior levels (Pau and Monge, 2000).

MARKET ENTRY STRATEGIES

Various factors, including the product or service and desired level of control over marketing strategies, determine market entry strategies in the four Latin American economies. However, most businesses recommend a step-by-step approach. Setting up a local office, distributorship or factory is costly in time and money. Hence, exporters may want to develop a market presence, and learn more about the commercial environment before taking this step. For example, foreign companies could ship an order or two through a local distributor to see if the product sells, before establishing a long term commitment with that distributor. They may continue selling their products through distributors until the market readily accepts these products. Then they may consider establishing a direct market presence. In Mexico, businesses should incorporate locally only if the investor devotes the time necessary to understand and comply with all relevant laws and regulations (Pickoff, 2001).

Selling directly to end users eliminates the costs of intermediaries and allows suppliers to determine client needs through direct contact. However, it requires knowledge of the local business environment and incurs costs of developing market strategies, advertising and cultivating clients. Reliance on local distributors or wholesalers avoids many of these problems, and lessens the supplier's risk. Also a distributor's reputation may enhance or diminish the reputation of the product; however, in some sectors or regions, few, if any, distributors or wholesalers may be available. Most foreign firms find the use of local distributors invaluable, as it avoids the payment collection and taxation compliance issues prevalent at the small enterprise level in many the four Latin American economies (Robinson, 2001; and Stoffel, 2001).

Many companies prefer to employ agents, either companies or independent sales representatives, particularly if their product has technical elements or requires considerable customer service (Brickhouse, 2001). This can be cost effective in reaching smaller cities and more remote locations (US Department of State, 2000a). While suppliers retain responsibility for completing sales and bear the associated credit risk, they maintain greater control over sales strategies.

In Mexico, increasingly joint ventures are a common entry method for foreign investors, especially among small and medium businesses (Smurr, 2001). Local partners may offer local knowledge, contacts and infrastructure, while foreign partners offer technology or technical know how and capital. Time invested in selecting joint venture partners is critical. Fortunately, credit information for due diligence assessments is more readily available these days, although the level of disclosure varies (Smurr, 2001).

NEWPORT SCIENTIFIC PTY LTD: SELLING SCIENTIFIC EQUIPMENT IN LATIN AMERICA

Australian company, Newport Scientific Pty Ltd manufactures and distributes a small range of high technology scientific instruments for the analysis of starch, cereals and foods. Worldwide, even in the biggest of markets, sales opportunities are small and niche. Newport Scientific prefers to operate through a network of distributors because it finds other methods of gaining market entry (such as joint venture or own operations) are too capital and time intensive for a small enterprise to establish and support.

Newport Scientific has a network of exclusive and non-exclusive (commission basis) distributors worldwide, including exclusive distributors in Latin America. Exclusivity prevents price wars against its product, vital in maintaining profitability, and offers security to distributors who need to invest in marketing, often for lead times of several years, before being rewarded with market success.

In Mexico, in many cases, buying decisions are made by a US head office on behalf of its Mexican office, or purchasing may be done centrally in the United States. Newport Scientific therefore decided that sales and support should be handled by its US distributor which already was represented in Mexico. Use of the US distributor capitalises on its experience, competency and resources. The remaining market can be segmented in many ways, but Newport chose the technical application of its instruments as its basis.

Newport's marketing strategies vary in the four Latin American economies. As wheat is very important for the Argentine economy, Newport appointed an exclusive distributor in Argentina who can invest in becoming an expert in wheat research and applications. An exclusive distributor in Brazil services the Brazilian market directly and other markets indirectly, with a common focus on sub-tropical and manufactured food and feed applications. A good relationship exists between Newport's Brazilian and Argentine distributors, enabling an exchange of ideas and resources, enhancing both businesses.

Identifying the size of each potential market, segmenting the territory in a practical way, and maintaining a few exclusive distributors is important for Newport's Latin American business. It tries to ensure it has only as many distributors as it can properly support with the resources of its small business, offering them exclusivity and continuity to support profitablity.

Source: Elliott, 2001.

Careful selection of distributors and agents also is critical. Firms should conduct diligence assessments before signing agreements. Government agencies, trade associations and industry experts can help suppliers find reliable local representatives. Firms should consider the agent's or distributor's experience with foreign products and specific knowledge of the product and sales region. To market successfully through distributors and agents, firms usually need to provide adequate training and technical support. Foreign suppliers to the four Latin American economies should consider starting with small orders or short term projects to test the relationship with their distributor, and consider using different representatives in different cities.

In Mexico, businesses should not grant exclusive, national agreements to a distributor (US Department of State, 2000). In most of the four Latin American economies, businesses transferring technology to partners should consider doing this in stages, as partners meet performance criteria. Technology theft by local partners is not uncommon and legal redress is weak (Robinson, 2001). Foreign nationals should be aware that Mexican, Argentine and Brazilian companies, particularly small and medium ones, have little access to financing. This may affect their marketing and advertising budgets, and timely payment of merchandise.

When investors want a strong local presence, they may consider opening a local branch, distributorship or store, establishing a franchise, or building a local factory. This is essential in Brazil; service exporters particularly find it very important to establish a local presence to promote their profile (Barker, 2001; and Department of foreign Affairs and Trade, 2001). Franchising may be an interesting option; less complicated than a joint agreement, this type of business has been growing rapidly in the four Latin American economies since the early 1990s (US Department of State, 2001c).[24]

K-TECH, INC: INVESTIGATING LOCAL INVESTMENT PARTNERS IS KEY

US export company K-Tech, Inc in Mexico provides an extreme example of the importance of conducting diligence assessments on potential agents and investment partners, and highlights the importance of employing your own, trusted legal counsel. Without conducting an extensive background assessment, K-Tech recruited the brother of a respected local colleague to handle its Mexican sales. Instead of setting up an agent relationship, K-Tech followed its new representative's advice and set up a local company, giving the representative an ownership share. The local representative employed a local solicitor to handle the incorporation. While everything appeared to be moving forward, K-Tech discovered the representative had defrauded it and set up the company in his and a friend's name only.

However, the marketing manager for K-Tech stresses this is the only bad experience he has had in 15 years of doing business in Mexico. Today, the company has a new agent, exports successfully to Mexico and plans to expand operations in the region.

Source: Brickhouse, 2001.

[24] Of more than 450 franchises operating in Mexico, 40 per cent are foreign. Services franchises comprise 24 per cent of the market, including business service firms, advertising agencies, financial consulting, printing and publishing, temporary job services, training centres and automotive services.

Relationships with Local Partners

Effective relationships with local investment partners start with careful research; strong personal and business relationships start with understanding local customs and patience. Getting to know potential partners may be time consuming, but it is well worth the effort. Trust and respect are essential in effective relationships.

The first step is to recognise that nationals of the four Latin American economies generally are more formal than Australians. Use titles and formal language to address local colleagues until they indicate otherwise. Demonstrating a real interest in individuals, their family and culture is important. The four Latin American economies' nationals generally expect and appreciate small talk before talking business; at a dinner, business often is not discussed until dessert. Image and generosity are similarly important in the four cultures.

The Mexican concept of time often frustrates foreigners. Meetings often start late or are cancelled suddenly. This may seem disrespectful, but rarely is it meant to be. Demonstrations of impatience simply risk alienating potential partners. Similarly, deadlines are often fluid; in many cases, they express good intentions, rather than firm commitments. This is changing, however, as modern business attitudes influence local customs. Again, demonstrations of frustration are likely to be met by shock, rather than understanding.

Argentine business dealings are intrinsically linked with cultural practices. Traditionally, Argentines feel most comfortable doing business with people they already know. This makes the small talk at the beginning of business relationships and meetings very important. It often takes several meetings to come to an agreement; this may frustrate investors. However, more internationally oriented firms have begun to adopt more modern approaches. Argentine firms are more patriarchal than their European and US counterparts. Few women or minorities fill high level managerial positions. Indeed, employment advertisements often list gender, age and appearance requirements. Personal relationships spill over into professional life, and family members often are in key positions in the same firm. This does not necessarily imply such people are unqualified, but reinforces the concept that trust is considered essential to doing business. Thus, Argentine firms interested in joint ventures probably will spend a considerable time getting to know any potential international partners.

However, a new generation of business leaders with MBAs and/or international experience are helping modernise traditional Argentine business practices; the banking industry, one of the most globalised sectors of the economy, is leading this process. Major Argentine firms like IMPSA and Perez Companc also have very skilled, internationalised management. The presence of international consulting firms like McKinseys, and PricewaterhouseCoopers and major law firm recruits with US degrees, also helps lift business practices in Argentina. Moreover, demand for graduate business education is growing.

Security Issues

Except for Chile, the four Latin American economies have experienced higher crime rates in the last decade, particularly in major urban areas such as São Paulo, Rio de Janeiro, Mexico City and Buenos Aires. Kidnapping and violent street crime are not uncommon in Mexico and Brazil and, with the recession, street crime is rising in Argentina. Law enforcement agencies are far from efficient and reliable; provincial police corruption, budget constraints and misallocation of resources undermine effectiveness. Security problems and local police service failure have triggered the development of a new, profitable private security industry with local and international security agencies.

CONCLUSION

Increasingly, the business environment in the four Latin American economies is conducive to foreign trade and investment. Except for Argentina, these economies currently have solid economic fundamentals; most have eliminated restrictions on foreign investment and the legal environment governing business generally is improving, although several challenges remain. Investors must take time to understand attitudes and customs of these economies; although they may seem similar at first, they are quite different. Dealing with the bureaucracy can be frustrating and time consuming. Corruption, although generally decreasing in the four economies, is still an issue except in Chile. Labour markets remain rigid. However, the commitment to ongoing reform appears strong. Given the lack of religious, ethnic and cultural divides, the creativity and proficiency of the working population, and the abundance of natural resources, the four Latin American economies offer significant investment opportunities to the investor willing to take the time to understand these markets.

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REGIONAL ECONOMIC INTEGRATION

KEY POINTS

- The huge number of regional economic integration schemes in the Americas include several with ambitious agendas to increase trade, investment, institutional convergence and economic policy cooperation between western hemisphere countries.

- All have external tariffs which discriminate against non-members and some also give members investment preferences.

- This web of arrangements may constrain Australian and other non-partner countries' trade and investment opportunities in Latin America. Australian exporters and investors need to be aware of the planned direction of existing agreements and new initiatives underway, so they can factor this into trade and investment decisions in Latin America.

- For example, the planned Free Trade Area of the Americas, FTAA, seeks to create free trade and investment between all countries in the western hemisphere, except Cuba. While negotiations will be fraught with difficulties, if it does eventuate, the FTAA could reduce opportunities for Australian exporters in some significant Latin and North American markets.

- Thus, the Australian Government will be carefully monitoring developments in this area. Several alternative approaches to maintaining and expanding Australia's market access range from signing Trade and Investment Promotion Agreements with key markets, to negotiating free trade agreements, FTAs. Already the Australian Government is actively considering negotiating an FTA with the United States.

Unlike East Asia, Latin America has made many attempts at trade integration since the Second World War. Only a few have succeeded in influencing trade flows. However, now governments in the Americas are intensifying efforts to integrate North and Latin America, in several cases as an alternative to multilateral most favoured nation, MFN, liberalisation. The most important of these agreements are influencing trade and investment flows, and discriminate against non-partners. Hence, these schemes have significant implications for Australia's future trade and investment strategies in the region.

This chapter identifies the five regional groupings that form the basis for integration in Latin America, and briefly describes all major preferential trade agreements and integrated groupings in force in Latin America. It then focuses on the America's two most significant agreements the North American Free Trade Agreement, NAFTA, and the Common Market of the South, or Mercosur, which will most affect Australian exporters' and investors' opportunities in the region. It analyses recent developments regarding Free Trade Area of the Americas, FTAA, negotiations, discussing the likely nature of this agreement if it eventuates, and highlights its potential effect on Australian investment and trade opportunities. Finally it draws implications for the region from these integration schemes and for Australian interests in Latin America.

Rationale for Latin American Integration

Latin American economies have significant ethnic, historical and economic differences. Not surprisingly, member countries' political, strategic and cultural objectives often are as important as their economic interests in determining the rationale, sustainability and future development of most regional integration agreements (World Bank, 2000).

Latin America can be divided into five distinct regions, based on common historical, geographical, ethnic and economic structures. Countries in these groupings have significant commonality, making them natural groupings in regional integration schemes already underway or being proposed:

- Mexico, with an extension into Guatemala and Belize[1]
- Central America and the Caribbean Basin, comprising mostly small, fragmented nations and islands[2]
- Andean America (Peru, Ecuador and Bolivia, and to a lesser extent, Paraguay and northern Chile)[3]
- the Southern Cone (Argentina, Uruguay, most of Paraguay and Chile, and southern Brazil)[4]
- Brazil, the former Portuguese colony, with roughly half the land area, output and population of South America.

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1 These countries are distinct, historically they were home to the Mayan civilisation and today at least 75 per cent of their populations remain part Indian. Mexico shares a long land border with the United States.

2 A high proportion of this grouping's populations are of African origin, and traditionally, the United States interacted closely with these nations.

3 These nations cover significant original American civilisations; their populations are predominantly Indian and *Mestizo*, with no African influence, and their economies are based on mining rather than agriculture.

4 These countries comprise populations with a strong European heritage, with little or no Indian and African influence, and traditionally their economies were based on agriculture.

OVERVIEW OF REGIONAL PREFERENTIAL TRADING AND INTEGRATION AGREEMENTS

Latin American regional integration was not a priority, nor even feasible until the late twentieth century, because the United States and former European powers were dominant trading partners, economies relied on import substitution policies and in several economies, inflation was spiralling. Governments alternated between democracy and military rule. Nevertheless, from 1947 to 1990, eight regional integration agreements developed involving Latin American countries, including the Andean Group and the Latin American Integration Association, LAIA. The LAIA did not achieve significant gains and Mercosur partially superseded it.[5]

The Andean Group attempted to establish a customs union from 1969; despite comprehensive legal and bureaucratic structures, this did not eventuate. In 1976, Chile unilaterally reduced its tariffs and left the pact. However, by 1997, Bolivia, Colombia, Ecuador, Venezuela and Peru had created the Andean Community, which was not a full free trade area, FTA. In June 2000, the five members adopted directives to establish a common market by 2005.

During the 1990s, major new trade initiatives reinvigorated Latin American integration. In 1991, Brazil, Argentina, Paraguay and Uruguay established Mercosur, aiming to create a common market. In 1994, Mexico joined the 1988 Canada-United States Agreement creating NAFTA.

As Latin American countries reformed and opened their economies to international trade and investment, many signed north-south free trade agreements including between the United States and Mexico, and the EU and Mexico, Mercosur and the Central American Common Market. Meanwhile, Chile actively sought bilateral agreements around the world. (See Chapter 10 - *Chilean Business Opportunities*.) Finally, from 1990, the United States reaffirmed its interest in establishing the FTAA and Mexico signed several free trade agreements in Latin America. The main regional initiatives are summarised in Table 12.1.

5 The Latin American Integration Association superseded the Latin American Free Trade Agreement, which, by the late 1970s had failed, due to a confusing strategy to allocate different industrial sectors to specific countries. Although the association was to liberalise only selected products, membership was diverse, problems were numerous and viewpoints diverged, making negotiations tiring and unproductive. However, the association still exists with a General Secretariat in Uruguay, and claims its members will liberalise trade but will not create a free trade area by 2005-06. Its main role is to compile statistics, finance studies and support general purpose committees; it has helped maintain links among the Andean Group and Mercosur in a forum where Mexico and Chile also are present.

Table 12.1

Regional Integration Accelerates

Main Regional Integration Initiatives in Latin America, 1980-2005[a]

Agreement	Objectives	Year of entry into force
Intra-regional		
Latin American Integration Association, LAIA; ALADI in Spanish (Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela). It superseded the Latin American Free Trade Association, formed in 1960	Lower intra-regional trade barriers and greater industrial cooperation. It incorporated regional and sub-regional mechanisms to foster trade, including tariff reductions on a range of LAIA-sourced goods. However, it is now largely defunct, except as a source of statistics.	1980
Andean Community (Bolivia, Colombia, Ecuador, Peru and Venezuela) (formerly the Andean Pact)	A common market among Andean states. Disagreements between members undermined progress. It was relaunched in 1996 to create a directly elected parliament and a customs union by 2001. Its common external tariff of 5 to 20 per cent took effect in February 1995. Agreed to establish a common market by 2005. In 1998, governments agreed to create an FTA with Mercosur.	1990[c]
Mercosur (Argentina, Brazil, Paraguay and Uruguay)	A customs union aiming eventually at freely circulating goods, services, capital and labour. Members also aim to coordinate macroeconomic policy and harmonise legislation. It has eliminated tariffs on 90 to 95 per cent of merchandise trade between members and applies a common external tariff of 0 to 20 per cent to non-member imports.[b]	1991
Central American Common Market, CACM (Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua)	A customs union including agreements on trade practices, rules of origin and a schedule to reduce tariffs on intra-regional trade to 5 to 20 per cent on about 5 000 products. It also established a bank to finance industry and infrastructure.	1991[c]
Group of 3 (Colombia, Mexico and Venezuela)	An FTA to eliminate trade barriers by 2005; includes removing tariff and non-tariff barriers, unifying customs procedures and cooperation accords in several non-trade areas.	1995
North American Free Trade Agreement, NAFTA (Mexico, Canada and United States)	To eliminate most economic barriers, except workforce movements, over 5 to 15 years. Includes financial services and intellectual property, but not government procurement or energy. It incorporates side agreements on labour, agriculture and the environment.	1994

Table 12.1 (continued)

Agreement	Objectives	Year of entry into force
Mexico, El Salvador, Guatemala, Honduras	Partial FTA, liberalising around half the trade between the four countries and around 76 per cent of tariff lines.	2001
Free Trade Area of the Americas, FTAA (being negotiated between 34 countries; all countries within the western hemisphere except Cuba)	Governments have established working groups on trade access and investment harmonisation issues.	2005 (planned)
Extra-regional		
Mexico-EU	Liberalises over 96 per cent of EU-Mexico trade by 2007 at the latest; fully liberalises industrial products by 2003 for the EU and 2007 for Mexico with negotiations on tariff phase-out of agricultural items deferred until 2003; includes rules on intellectual property and dispute resolution, and provides EU access to the Mexican procurement and services markets, similar to NAFTA.	2000
Mexico-EFTA (European Free Trade Association)	An FTA whereby Mexico gets full market access for all its industrial goods and EFTA countries face a gradual tariff elimination for industrial exports to Mexico to 2007; Mexico gets preferential access for various agricultural products; agreement on rules of origin, services, investment, intellectual property and dispute settlement.	2001
Mercosur-EU	Framework agreement entered into force in 1999; negotiations on non-tariff elements began immediately and negotiations on tariffs and services began on 1 July 2001.	2005 (indicative)
Chile-EU ('association negotiations')	Governments began negotiating an FTA in 2000; agreed to start market access negotiations on tariffs and services as from 1 July 2001.	–
Chile-EFTA	Beginning in 2000, negotiating on trade in goods, services and investment, government procurement, competition, and legal and institutional aspects.	–
Mercosur-South Africa	Governments signed a framework agreement, setting out commitment to negotiate an FTA.	No deadline

Note: a In addition to these initiatives, extra-regional discussions on trade and investment arrangements have been underway, involving Japan, the Republic of Korea, Singapore, Chile and Mexico.

b In 2001, Argentina was given an exemption and has set the external tariff on consumer goods at 27 per cent and lowered tariffs on most capital goods to zero.

c Date of reactivating trade agreement after the arrangement had fallen into disuse.

Source: Economist Intelligence Unit, 2001b; European Commission, 2001; European Free Trade Association Secretariat, 2001; Mission of Mexico to the EU, 2001; and European Commission, 2000.

In addition to these major regional groupings, bilateral initiatives include Chile-Venezuela (1993), Bolivia-Chile (1993), Colombia-Chile (1994), Chile-Ecuador (1995), Costa Rica-Mexico (1995), Bolivia-Mexico (1995), Canada-Chile (1997), Chile-Peru (1998), Mexico-Nicaragua (1998), Chile-Mexico (1999), Mexico-Israel (2000) and CACM-Chile (2001).[6] Chile also is negotiating an FTA with the United States.

Some of these integration efforts have increased intra-Latin American trade (Table 12.2). While NAFTA, and to a lesser extent Mercosur, encourage strong and growing internal trade flows, the other major Latin American FTAs generate more modest internal trade growth. Over the 1990s, regional integration

Table 12.2

NAFTA and Mercosur Promoting Major Integration

Internal Trade Flows of Major Western Hemisphere FTAs, US$ billion

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Latin America										
Global exports	136	135	145	155	183	220	249	277	267	282
Intra-Latin American exports	17	20	25	29	35	42	46	53	52	44
Intra/total (per cent)	12	15	17	19	19	19	19	19	20	16
Central American Common Market										
Global exports	4	4	5	5	6	7	8	8	10	11
Intra-Central American Common Market exports	0.6	0.8	1.0	1.1	1.2	1.5	1.6	1.8	2.2	2.3
Intra/total (per cent)	16	18	23	23	22	21	20	22	21	21
Andean Community										
Global exports	32	29	28	29	34	38	46	48	39	43
Intra-Andean exports	1	2	2	3	3	5	5	6	5	4
Intra/total (per cent)	4	6	8	10	10	12	10	12	14	9
Mercosur										
Global exports	46	46	50	54	62	70	75	82	81	74
Intra-Mercosur exports	4	5	7	10	12	14	17	20	20	15
Intra/total (per cent)	9	11	14	19	19	20	23	24	25	20
NAFTA										
Global exports	537	565	599	624	738	854	918	1 013	1 012	1 071
Intra-NAFTA exports	230	237	264	291	355	393	432	496	521	585
Intra/total (per cent)	43	42	44	47	48	46	47	49	52	55

Source: LAIA, 2000.

6 In 1995, soon after NAFTA, Mexico attempted to broaden trade ties by negotiating preferential trade arrangements, including with Colombia and Venezuela (which became the Group of 3), El Salvador, Guatemala and Honduras, and several bilateral initiatives with Costa Rica, Bolivia, Nicaragua and Chile. In 2001, Mexico continues to hold negotiations with Belize, Ecuador, Peru and Panama.

by these other groups only marginally increased overall intra-Latin American trade. As 1999 was a recession year in many major Latin American economies like Brazil, Argentina and Chile, the trade downturn in that year was temporary; total and intra-Latin American trade increased again in 2000.

NAFTA

NAFTA is not a unified agreement but three bilateral treaties between the United States, Canada and Mexico. NAFTA eventually will provide free trade in most goods; liberalise trade in services, foreign direct investment, FDI, labour and environmental standards; and establish supra-national enforcement institutions.

Trade in Goods

NAFTA will eliminate tariff and non-tariff barriers among members in stages over a maximum of 15 years from 1994, with ten year limits in some cases. NAFTA does not have a common external tariff; instead, rules of origin generate economic rents for members' industries (Krueger, 1995; and Simpson, 1994).[7]

MAIN NAFTA TRADE PROVISIONS AFFECTING MEXICO

Tariffs

By 2004, all tariffs will be eliminated on North American industrial products traded between Canada, Mexico and the United States. A few tariffs on US exports of agricultural products to Mexico will be phased out by 2009. On 1 January 1994, Mexico eliminated tariffs on nearly 50 per cent of all industrial goods imported from the United States, including machine tools, medical devices, semiconductors and computer equipment, and telecommunications and electronic equipment. By 1999, 65 per cent of all US exports of industrial products to Mexico entered Mexico tariff free, including light trucks, most car parts and paper products.

Non-tariff barriers

For NAFTA partners, Mexico will eliminate non-tariff barriers and other trade distorting restrictions, including most import licences, and local content, local production and export performance requirements.

Rules of origin

NAFTA reduces tariffs only for goods made in North America; tough rules of origin determine whether a good qualifies for preferential tariff treatment under NAFTA. The two rules of origin ensure substantial North American processing:

Tariff shift rule: all non-NAFTA inputs must be in a different tariff classification than the final product

Value content rule: a set percentage of the value of the goods must be North American.

Source: US Department of Commerce, 2001.

[7] Rules of origin set conditions where goods partially manufactured in a member country, with foreign parts or inputs, can be considered as domestic goods, and qualify for free (zero tariff) circulation within the area.

NAFTA opened the highly protected Mexican automotive market to Canada and the United States; consequently, Mexico must phase out intra-NAFTA automotive tariff and non-tariff barriers over five to ten years. To protect US and Canadian domestic markets from European and Asian automotive producers using Mexico as a gateway, NAFTA imposes complex rules of origin requiring a domestic value content of 62.5 per cent, forcing prospective new entrants to establish a strong local presence.

Canada and the United States practically abolished quotas on their imports of Mexican textiles and clothing, and tariffs will fall to zero by 2004. However, the corresponding rules of origin are very strict and discriminatory, requiring Mexican industries to use North American fibres in fabrics.[8]

Agriculture

Agricultural sector arrangements are even more complex. Both the United States and Canada have protected horticultural sectors but export grain, while Mexico has open horticultural sectors but imports grain. Moreover, the United States and Canada both import sugar and meat under very restrictive arrangements, and have high non-tariff barriers on livestock.

Mexico and the United States will not eliminate all barriers to agricultural trade until 2009. Meanwhile US-Canadian and Mexican-Canadian agricultural trade flows also remain significantly restricted. Agriculture will be a testing ground for a new approach to sanitary and phytosanitary standards, which significantly affect Mexico's agricultural exports to the United States. This approach uses the proximity of the two countries to identify 'safe areas, states, plants or farms'.

Trade in Services and FDI

NAFTA's services agreement goes beyond the WTO's General Agreement on Trade in Services, GATS, both in openness and methodology. Right of establishment and ownership rules govern services sector opening, in the same way rules of origin govern goods trade under preferential trading arrangements.[9] By harmonising truck and railway standards, the three countries almost fully liberalised cross-border operations by late 2000, and financial services liberalisation is progressing steadily. Mexico's telecommunications market was quickly opened to US and Canadian suppliers of value added services and equipment, offering them good investment opportunities. Furthermore, in 2000, Mexico practically abolished its financial sector entry and individual firm size restrictions within NAFTA. However, other foreign providers, including Australians and Europeans, even after the EU-Mexico agreement, continue to face entry barriers in these sectors, and cannot profit from the enlarged market.[10] Finally, NAFTA allows some, but not full, professional services mobility.[11]

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8 Studies confirm NAFTA's protectionist and rent seeking use of rules of origin across a range of sectors, particularly electronics, textiles and automotive sectors. As the difference between the Mexican and US MFN tariffs increases, the corresponding rules of origin become more restrictive (Estevadeordal, 1999).

9 These two concepts probably most affect foreign service providers' access.

10 Restrictions include a foreign provider's market share and business size.

11 The US-Canada Free Trade Agreement did not permit blue collar labour mobility. NAFTA allows intra-company transfers only if the employee has been with the company at least one year out of the past three. However, on top of the existing immigration ceiling, the United States allows only 5 500 more Mexican professionals to enter it each year.

NAFTA's services liberalisation is based on the more liberal negative list principle; members list protected sectors with their corresponding restrictions, but everything else is open to free trade. In contrast, under GATS, everything not listed is assumed to be restricted. Mexico has resisted NAFTA liberalisation of its energy sector. Its retail petroleum market is closed to US and Canadian providers, and it prohibits FDI in oil exploration, production or refining, even in risk sharing contracts. Mexico's liberalisation of petrochemicals, electricity and gas services also is very limited.

NAFTA members provide national treatment to FDI investors from other member countries and an 'internal' MFN clause ensures any member country investor must be treated at least as well as other foreign investors.[12] Also, the United States and Mexico agreed, in a side treaty, to reduce the statutory withholding tax rates charged on interest, dividends and royalties flowing in both directions.

New Institutions

NAFTA created a Free Trade Commission to supervise implementing the agreements, continuing liberalisation, resolving disputes and ongoing sectoral and issues work by eight committees and six working groups. To gain access to NAFTA dispute resolution procedures, Mexico must reform its legal and administrative procedures on trade disputes.[13]

The Commission on Environmental Cooperation and the Commission on Labour Cooperation monitor member countries' environmental and labour issues, check national laws and regulations are followed and settle new or specific disputes in these areas. They may form a precedent in future FTAA negotiations.

NAFTA Evaluation

Through NAFTA, the United States gains cheaper consumer goods and access to a larger market. Mexico, on the other hand, gains higher FDI from its NAFTA partners and access to the huge US market. A more detailed discussion of some of the more significant studies assessing the impact of NAFTA on its members and non-members is in Appendix 1.

Despite the 1994-95 crisis, since 1994 Mexico's yearly per capita income growth has remained 3 percentage points above pre-NAFTA levels and, since 1996, Mexico's average per capita GDP growth has been 3 percentage points higher than the combined average growth of Argentina, Chile and Brazil. Some of this improved performance can be attributed to NAFTA and related reforms, but these three economies also suffered recessions during this period.

[12] Although this does not violate in principle any WTO article, potentially it might conflict with some regulations, particularly those in GATS and Trade Related Investment Measures agreements.

[13] Under NAFTA dispute settlement procedures, disputes concerning the agreement's interpretation follow standard WTO methodology, being heard by a panel of experts whose decisions a governing body may review. However, for disputes related to anti-dumping and countervailing duties, panel decisions are binding.

The level of intra-NAFTA trade steadily increased over the 1990s, with a significant spike in 1994 (Figure 12.1). Over the decade, intra-NAFTA trade grew on average almost 11 per cent per year, while trade with the rest of the world grew by only 6 per cent per year. The share of intra-NAFTA trade in total NAFTA trade increased from 38 per cent to 47 per cent in this period.

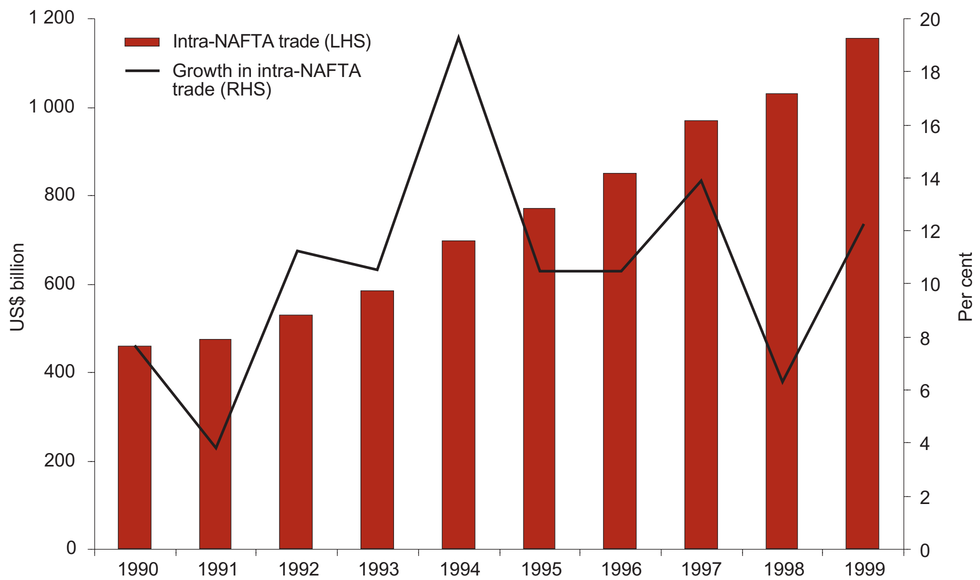
NAFTA expanded Mexico's bilateral trade with the United States from US$90 billion to US$226 billion between 1993 and 1999. Most additional trade is in intra-industry manufactures, and at least half is intra-firm trade in completed and intermediate goods. Rather than boosting agricultural production or domestic manufacturing in Mexico, NAFTA induced some US producers to move south to optimise production and distribution costs, accelerating a pre-NAFTA trend.

Trade and investment diversion adversely affected some Central American economies, and newly industrialised Asian economies, like the Republic of Korea, Taiwan, Hong Kong and Singapore. Many had wages roughly equivalent to Mexican levels but supplied higher quality products. Exports of electronics, automotives, clothing and light manufactures were most affected.

Figure 12.1

NAFTA Leads to Growth in Intra-regional Trade

Intra-NAFTA Trade and Growth, 1990-99, US$ billion and Per cent



Source: Inter-American Development Bank, 2000.

MERCOSUR

Mercosur is the third largest trading bloc in the world after the EU and NAFTA. This arrangement was created in 1991, after Argentina, Brazil, Paraguay and Uruguay signed the Asunción Treaty. It mainly developed as Argentina and Brazil renewed their trade and diplomatic ties after restoring their democracies in the late 1980s.[14] Mercosur is modelled on the EU, and aims to create a comprehensive common market with free movement of goods, services, capital and labour. As a first step, from 1995, members established an FTA trading 8 000 items or more than 95 per cent of the goods exchanged among the four members at zero tariffs. The main exceptions to the agreement were sugar, cars and information technology.

Intergovernmental bodies (Common Market Council, Common Market Group, Trade Commission, Joint Parliamentary Commission, Economic and Social Consultative Forum, and an Administrative Secretariat, located in Montevideo) manage Mercosur. It has not developed supranational institutions to date, although these may be needed, as small economies like Chile are reluctant to join without independent dispute resolution mechanisms (Flôres, 2001b).

Mercosur Achievements

Except for automotives and sugar, Mercosur's FTA agreement became fully effective on 1 January 2000. Temporary duties remain on labour intensive goods like footwear (by Argentina) and rice (by Uruguay) and some specific non-tariff barriers (Berlinski, 2000). Beyond trade related issues, the main source of difficulties has been external and internal macroeconomic events, including the Mexican and Asian crises, the strong US dollar, the Brazilian devaluation and the current Argentine crisis.

Introduced in January 1995, the common external tariff, covering 85 per cent of goods Mercosur imports, ranges from 0 to 20 per cent.[15] Using unweighted 1998 data, average common external tariffs ranged from 0 per cent for coal to 20.5 per cent for textiles (Table 12.3).

Argentina and Brazil planned to adopt a common external tariff of 14 per cent for capital goods by 2001, but they will not meet this target as exceptions remain and macroeconomic instability has caused rescheduling. Nonetheless, the overall trend is towards compliance, and members still may reach their 2006 target of a full customs union, with a 16 per cent tariff for most key information technology goods.

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14 In December 1994, members signed an encompassing protocol to establish the customs union, giving Mercosur an international legal status and consolidating its basic structure.

15 However, within this group it allows 232 exceptions for Argentina, 175 for Brazil, 210 for Paraguay and 212 for Uruguay.

Table 12.3

Manufactures Face High Common External Barriers

Common External Tariffs for Goods Traded Duty Free within Mercosur, 1998

	Simple average	Maximum	Import weighted average
Agriculture and hunting	9.6	19.0	8.6
Forestry	7.6	17.0	9.5
Fishing	12.0	13.0	8.2
Coal	0.0	0.0	0.0
Petroleum and gas	0.0	0.0	0.0
Metal ores	5.3	7.0	5.0
Other mining	6.5	13.0	7.6
Food, beverages and tobacco	15.1	23.0	18.0
Textiles	20.5	23.0	20.7
Wood	15.1	21.0	18.7
Paper	14.0	19.0	11.4
Chemicals	12.1	23.0	12.1
Pottery and glass	14.1	23.0	14.6
Iron and steel	13.2	21.0	13.7
Machinery and equipment	17.2	23.0	16.2
Other manufactures	20.3	23.0	21.0
All sectors	15.4	23.0	15.3

Note: 1998 is a good year for giving a reasonable picture of the common external tariff structure. After the 1999 Brazilian devaluation, exceptions and distortions increased, culminating recently with the Mercosur Council approved waiver to Argentina, allowing it to lower tariffs for capital goods to zero and raise duties on consumer goods to 27 per cent, until December 2002.

Source: Estevadeordal and Krivonos, 2000.

New Members?

Chile and Bolivia are associate Mercosur members; they belong to the FTA and participate in some technical groups on the customs union. Chile gives a preference to Mercosur imports, with a 2.7 per cent tariff compared to 8 per cent for non-Mercosur imports in 2001. Chile was to become a full member in late 2000, but this was postponed as Chile's negotiations for a free trade agreement with the United States resumed. In principle, all parties favour Chile fully joining Mercosur although considerable practical barriers remain.[16] Venezuela also is negotiating with Mercosur regarding membership; negotiations are set to conclude in 2001.

[16] Chile wanted Mercosur to reduce its common external tariff rate to Chile's MFN rate of 9 per cent at that time; increase macroeconomic stability; and acquire some supranational institutions. On the other hand, Mercosur members want Chile to cease negotiating bilateral free trade agreements.

Mercosur and Democracy

In Mercosur, as in the EU, all members and associates must be fully operating democracies. The 1996 San Luis Presidential Declaration on democratic commitment in Mercosur excluded any country where republican institutions were not fully in operation. In 1996, the clause helped prevent an attempted *coup d'état* in Paraguay.

Mercosur and Macroeconomic Cooperation

The 1999 Brazilian exchange rate crisis prompted Mercosur members to seek closer macroeconomic cooperation through a Macroeconomic Monitoring Group, which first met in October 2000. Mercosur's four members' central banks and other macroeconomic agents are progressing coordination and defined a preliminary set of five monitoring indicators; however, this initiative is delayed by Argentina's crisis and limited scope for deeper cooperation due to Brazil's free exchange rate versus Argentina's pegged exchange rate.

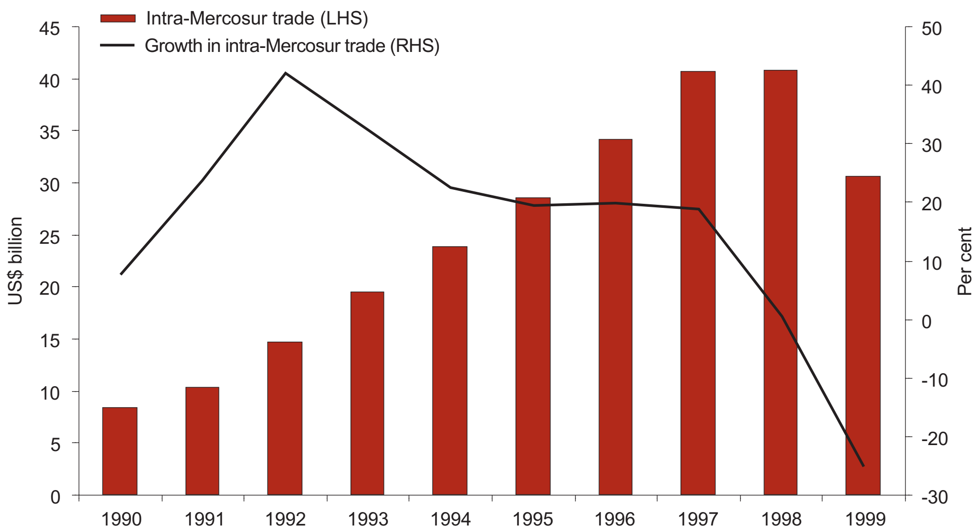
Mercosur Evaluation

Mercosur initially was successful in increasing intra-Mercosur trade, which grew rapidly between 1990 and 1997. While trade stagnated in 1998 and fell by 25 per cent in 1999, due to the depreciation of the Brazilian real and subsequent recession in Argentina, it should recover in 2000 (Figure 12.2). The annual average rate of intra-regional trade growth over the decade was 16 per cent; in contrast, Mercosur trade with the rest of the world grew by an annual average of only 7 per cent. Hence, the share of intra-Mercosur trade to members' total trade rose from 11 per cent in 1990 to 20 per cent in 1999.

Figure 12.2

Mercosur Spurs Growth in Intra-regional Trade until 1997

Intra-Mercosur Trade and Growth, 1990-99, US$ billion and Per cent



Source: Inter-American Development Bank, 2000.

Smaller members depend more on Mercosur, particularly for exports, than larger economies (Table 12.4). Although the latest available figures are for 1999, the Brazilian real's devaluation in that year seriously distorted trade flows.

Table 12.4

Smaller Members More Dependent on Mercosur

Members' Intra-Mercosur Trade, 1998, Per cent of Total Trade Flows

	Exports to Mercosur	Imports from Mercosur
Argentina	35.6	25.1
Brazil	17.4	16.2
Paraguay	52.4	45.8
Uruguay	55.4	43.2

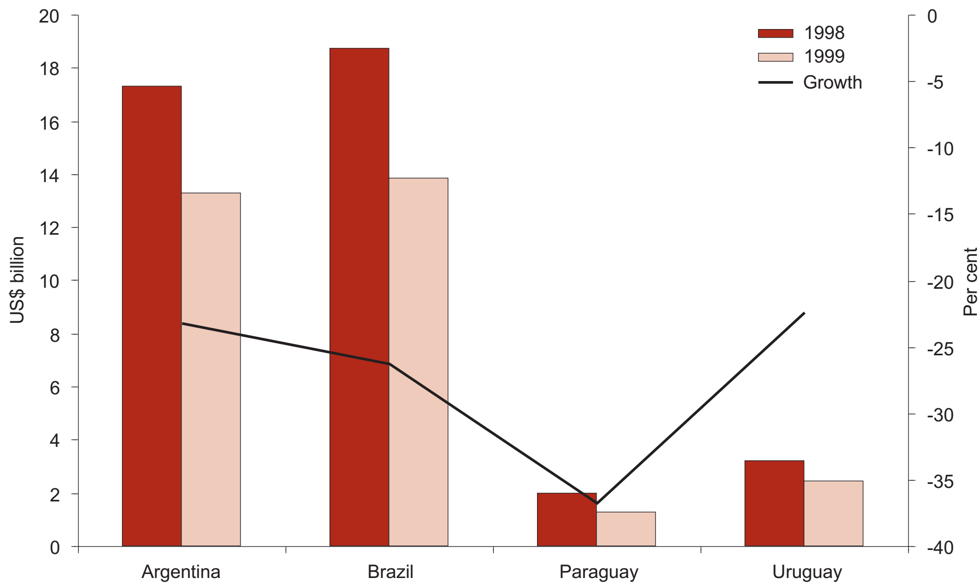
Source: Flôres, 2001a.

Due to their greater reliance on Mercosur markets, exports from Mercosur's smaller members were hit hardest by the recession in Brazil and Argentina (Figure 12.3).

Figure 12.3

Plunge in Intra-Mercosur Trade Hurts Smaller Members

Intra-Mercosur Trade and Growth, 1998-99, US$ billion and Per cent



Source: Inter-American Development Bank, 2000.

While encouraging intra-Mercosur trade, the agreement creates significant inefficiencies by diverting trade away from the cheapest source (Yates, 1998). Distortions are greatest in the automotive and parts sector, where Mercosur governments created a special regime to promote FDI, raising or maintaining barriers to protect local sectors (Nagarajan, 1998).

Mercosur's automotive regime is complex and controversial, but is liberalising slowly. The December 2000 Meeting of the Common Market Council approved a new version of the regime, setting 1 February 2006, as the target to create a totally free Mercosur automotive market. Most members set a new external tariff of 35 per cent for most vehicles, 14 per cent for specific items (mostly bulldozers and other machines for agricultural purposes), and an average of around 18 per cent for automotive parts; in this sector, common external tariffs should converge on 1 January 2007.

Prospective Mercosur Initiatives

Mercosur's most important initiative with a grouping outside the region is its planned agreement with the EU. The two groups plan to establish an FTA by 2005 and create a Cooperation Council, responsible for supervising the pace of the association. Negotiations have started, including on tariff reductions.

Several other initiatives are underway. In mid 2000, the Argentine private sector, through the Chamber of Exporters, put forward a proposal for the creation of an FTA between Mercosur, Closer Economic Relations (Australia-New Zealand FTA), CER, and South Africa. The proposal has not progressed to date due to competing priorities both within Mercosur and Australia. In 1996, Australia and New Zealand commenced discussions regarding negotiating a free trade agreement between CER and Mercosur. These discussions have not progressed, due to negotiation pressures facing Mercosur from its planned agreement with the EU and the FTAA. In December 2000, South Africa signed a framework agreement with Mercosur for free trade negotiations, although no timeframe has been set for their conclusion. Also, Mercosur entered an agreement to negotiate with the European Free Trade Association. Brazil also is entertaining closer relations with China which might lead to a preferential agreement in the medium term. Negotiations with the Andean Community are fairly well advanced; individual Mercosur members have signed preferential trade agreements with the community, as a preliminary step to a treaty to establish an FTA between the two groups in 2001.

THE FREE TRADE AREA OF THE AMERICAS PROPOSAL

In 1994, at the Miami Summit of the Americas, the United States re-launched the Bush initiative to establish a trade region in the Americas, and the 34 nations present proposed the FTAA. The plan was to create more than a free trade agreement; it seeks to achieve an open market for goods, services and capital, uniting the North and Latin American countries and providing a set of disciplines to protect investors and sellers. It aims to liberalise energy and telecommunications markets, and harmonise and advance competition and subsidies policies, government procurement and other similar WTO issues.

The Inter-American Development Bank, Organisation of American States, Economic Commission for Latin America and the Caribbean, and the United States helped establish working groups and a secretariat so negotiations could close by 2005. Since 1995, annual ministerial trade meetings discuss, evaluate and approve results. A Trade Negotiations Committee created in March 1998 established nine negotiating groups.[17] The FTAA has a rotating presidency and vice-presidency which, in the final negotiating period, becomes a co-presidency by Brazil and the United States.[18] Failure of the Seattle meeting of the WTO in 2000 to launch a new multilateral trade liberalisation round boosted support for the FTAA and, at the third summit of the Americas in Quebec City in April 2001, President George W. Bush and the Latin American countries reaffirmed their commitment.

Such a large FTA would offer members potential benefits; however, while it is being developed, the initiative distracts attention from other regional and multilateral negotiations and absorbs significant amounts of limited resources. The broad, tight and closely controlled negotiations, schedule makes it difficult even for richer economies like Brazil and Argentina to adequately staff the FTAA negotiations, Mercosur negotiations and WTO Millennium Round negotiations, as well as other minor integration efforts.

Despite real progress in some negotiating groups, it will be difficult for 34 negotiators to coordinate solutions and deepen content themes in the context of the FTAA. The possibility that NAFTA outcomes will apply to issues like rules of origin, casts serious doubts over the possibility of achieving the FTAA objective of 'developing an efficient and transparent system of rules of origin … without creating unnecessary obstacles to trade' (Annex II, San José de Costa Rica Declaration). Different interests and priorities already are apparent. Of nine negotiating groups, only two deal with trade access, the rest deal with competition policy, investment rules, dispute settlement and services trade issues. Most Latin American countries seek agricultural access and control over US and Canadian anti-dumping actions. On the other hand, the United States is more interested in competition policy, investment rules and intellectual property protection.

Brazil wants to deepen South American integration, particularly Mercosur, before negotiating the FTAA (Flôres, 2001b). Negotiations for the FTAA are so complex that the final agreement may have fewer disciplines than initially expected; thus it may not be a full FTA. For example, major developments on agricultural access may not eventuate but disciplines on international procurement may emerge (Taccone, 2001).

[17] These are for market access, agriculture, investments, subsidies, anti-dumping and countervailing duties, government procurement, intellectual property rights, services, competition policy and dispute settlement.

[18] The first meeting (Denver, June 1995) produced a balanced joint declaration, stating that the Free Trade Area of the Americas will be based on the 'existing sub-regional and bilateral agreements', in total compliance with WTO rules, noting the different development levels of the 34 countries involved and acknowledging recent developments in integration activities in Latin America. The third meeting (Belo Horizonte, Brazil, May 1997) produced two important statements: the principle of a single undertaking, which does not allow for different negotiating tracks, in terms of subject areas or sub-groups of countries; and 'the FTAA may co-exist with existing agreements, in so far as their respective rights and obligations are not covered by those of the FTAA, or when they go beyond them'. The latter placed the FTAA above existing integrations; however, this was counter-balanced by an item, largely due to Mercosur's efforts, that adherence to the FTAA may be either on a country or a bloc base, but a bloc must negotiate as a single unit.

Support for the FTAA varies. Chile and Uruguay are very keen; Argentina mainly is interested in strengthening US political links and upgrading institutions; and Brazil is less enthusiastic, wishing to consolidate South America's position to present a common front to the United States (Díaz and Sanchez, 2001). Many countries, particularly Chile, view a trade bloc as a counter to other blocs and as a political commitment to fostering democratisation and free market policies among trading partners. At Quebec, Venezuela signed on to the FTAA only very conditionally, and indicated it could quit negotiations at a later date.

Finally, US trade negotiating authority, formerly termed fast track, is controversial; the US Congress has not yet granted trade negotiating authority to the current Bush Administration, whether as a country specific or omnibus authorisation. Latin American countries have indicated they will not start negotiations until this authorisation is passed.

SPECIFIC ISSUES: FDI AND SERVICES

Regional integration attempts in Latin America often go far beyond free-trade-in-goods agreements and have implications for both FDI and the service sector.

FDI

To date, except for some NAFTA provisions, FDI liberalisation has occurred independently of the regional integration trend. That is, all foreign investors receive equal access to Latin American markets. Latin America and Australia have an interest in this situation continuing, as preferential treatment for partner investors could lock out non-partner investors, reducing the quality and quantity of FDI received, and opportunities for Australian investors.

Regional integration and competition increasingly impact on FDI. Many major US and European buyers are entering the market with a local or third Latin American country partner, and major Latin American economies are investing in each other. Moreover, key players' participation in Latin American markets, like Spanish company Telefónica's purchases of major privatising telecommunication companies in Brazil and Argentina, are based on the expectation of a more integrated, if not single, Latin American market in future. Competition for investment also is growing, as the 1990s letting of infrastructure concessions to attract FDI investment to Argentina and Brazil demonstrated.

Services

Building on NAFTA, the United States is pushing for WTO-plus agreements in the FTAA negotiations and in bilateral negotiations with Chile. These include developing further 'new themes' from the Uruguay Round; services are a prominent issue. With clear comparative advantage in sectors like telecommunications, utilities and financial services, the United States is interested in further opening services trade in Latin America. Mercosur, the Andean Community and the Central American Common Market also are tackling the issue of free movement of services within their markets. For example, Mercosur has progressed in opening up financial services, transport and energy supply.

IMPLICATIONS FOR AUSTRALIA

Growing preferential regional and international trade integration within Latin America, and between Latin America, the United States and EU pose significant challenges for Australia. Within Mercosur economies and Mexico, tariff differentials between MFN rates and FTA partners' rates are quite high, and Australian exporters face considerable discrimination. Even in Chile, which has relatively low, flat tariffs, Australia's coal export market was cut significantly after Chile signed bilateral FTAs with Canada and Columbia. Although Australia is discriminated against by NAFTA, wool exports to Mexico generally increased in the last half of the 1990s due to the concentration of NAFTA's textile industry within Mexico. However, Australia's overall wool exports to NAFTA have fallen by almost 10 per cent per year since 1996.

A comprehensive FTAA, including Latin American agricultural access to the United States, could occur. Even if the FTAA opened only particular agricultural markets to Latin American producers, this would be a major challenge for Australia, putting at risk many significant agricultural export markets in the United States; these were worth A$2.5 billion to Australia in 2000. Over and above the estimated economic benefits to Australia of a free trade agreement with the United States, estimated in preliminary studies to be worth up to A$19 billion over 20 years (Centre for International Economics, 2001), this threat makes Australia's strategy of seeking agreement to negotiate an FTA with the United States important.

Another challenge for Australia would be any expansion of Latin American arrangements covering investment and services that discriminated against non-partner economies. Such an expansion would constrain the potential to increase Australian investment in Latin America and explore mutually beneficial natural complementarities between Australian and Latin American sectors like mining, agribusiness, financial, telecommunications and information technology services.

Australia also is pursuing multilateral avenues to protect its trade and investment access. Most notably, along with the United States and many Latin American economies, Australia seeks the launch of a new round of WTO negotiations in November 2001, and pursues successful multilateral outcomes on agriculture, investment and other post-Uruguay issues. If the new round can be launched successfully at Qatar or soon after, this may reduce incentives for a comprehensive FTAA agreement.

Australia may be willing to engage in a dialogue, for example to resume the CER-Mercosur dialogue, presently dormant because of the Argentine crisis and the heavy burden of Mercosur's ongoing negotiations.[19] As Mercosur develops to include issues like competition, the practically oriented CER agreement also could offer Mercosur a useful alternative model to the EU rules based model (Tavares de Araujo and Tineo, 1998; and Flôres, 2001a).

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19 The Australia-New Zealand Closer Economic Relations, CER, is a WTO-consistent free trade area between Australia and New Zealand.

Additionally, Australia has negotiated an Investment Promotion and Protection Agreement and a Double Taxation Agreement with Argentina. It has an Investment Promotion and Protection Agreement with Chile, but a Double Taxation Agreement could be a useful addition, given the high level of Australian FDI in Chile. Australia also is negotiating an Investment Promotion and Protection Agreement and a Double Taxation Agreement with Mexico, with the latter close to being finalised.

FUTURE TRENDS

The likely future pattern of the rapidly expanding mesh of Latin American preferential trade agreements is difficult to forecast. Within Mercosur, Argentina's continuing economic crisis will obstruct the deepening of Mercosur, including plans to coordinate macroeconomic management, and Mercosur's negotiations with other groupings, including the CER.

Within NAFTA, closer integration of the US and Mexican economies will be critical to Mexico's future growth. Mexico's desire for greater integration should discipline its macroeconomic and investment policies and help upgrade legal and economic institutions. Improved institutions and growing integration within NAFTA should continue to drive growth. Ultimately, Mexico is aiming for a common market with free labour mobility; however, the United States may view this as a very long term plan. Australian trade on specific commodities could be harmed, but overall, exports to Mexico are increasing, benefitting Australia. However, future rules of origin and discriminatory service investment access arrangements will require close monitoring.

Latin America's evolving network of agreements contributes to US pressure for the FTAA. However, despite the 2005 deadline for finalising negotiations, the initiative's shape remains unclear. Most Latin American economies will be reluctant to sign on without significantly improved agricultural market access and some concessions on the US anti-dumping regime (Flôres, 2001b). As negotiations progress, the practical difficulties of dealing with 34 negotiating partners will intensify. Given the importance of the Brazilian economy in Latin America and its natural leadership role in South America, the final outcome may largely depend on the US-Brazil dialogue.

Brazil seeks deeper South American integration prior to negotiating and implementing an FTAA, so the United States cannot 'pick off' South American countries, one by one in bilateral negotiations (Flôres, 2001b). Several Andean Community and Mercosur countries sympathise with this position; however, deeper integration may only be feasible when Argentina overcomes its crisis. Finalising the EU-Mercosur agreement could boost prospects for South American integration and tentative openings to East Asia and Africa (through South Africa) also may add some momentum. In this context, a Mercosur-CER agreement also may play a role.

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APPENDIX 1

Evaluating the Integrations: a Deeper Look

The advent of applied, or computable, general equilibrium, AGE, or CGE models improved evaluations of free trade agreements, based on assessing trade diversion and creation. All sectors/goods can be simultaneously considered and their impact on welfare, measured by expected impact on gross domestic product, GDP, calculated.

However, CGE models are limited in their usefulness in assessing the benefits of trade liberalisation because they do not include productivity gains from trade opening, and usually assume perfect competition. Moreover, a crucial target of modern integrations is services trade, which also is difficult to model. Thus, analysing ventures like the FTAA using a static, perfect competition, single services sector CGE model reduces the relative gains of countries competitive in services, like the United States, while inflating the relative gains of countries less competitive in services.

Many models have been developed to determine the effects of regional trading arrangements in Latin America. Some major results are outlined (Appendix Table 1). Most show these regional agreements create some welfare benefits for members. However, they generally do not model the costs these arrangements impose on non-members, nor compare these gains with the benefits of full multilateral trade liberalisation in the countries concerned.

Appendix Table 1

Most Agreements Produce Some Welfare Gains

Main CGE Models Analysing Latin America Free Trade Agreements

Model(s)/Agreement(s)	Static model?/ Uses imperfect competition?	Main Results
1. Papers in Francois and Shiels (1994) / NAFTA	Yes (and dynamic as well) / Yes	Welfare gains (measured by equivalent variation, from 1985 levels) for Mexico, ranging from 0.13 to 4.40 per cent of GDP.
2. Hinojosa-Ojeda et al, (1995, 1997) / FTAA	Dynamic Elasticities / No	Welfare gains (measured from 1990 levels, GDP) from the FTAA (using dynamic elasticities) ranging from 0.18 (Mexico) to 2.16 (Peru) per cent of GDP.
3. Brown et al, (2000) / FTAA; associations involving Chile	Yes / Yes (Michigan model)	Welfare gains (measured by equivalent variation, from 1990 levels) from an FTA including NAFTA, Argentina, Chile, Colombia and Brazil ranging from -0.17 (for Argentina) to 0.50 (for Colombia) per cent of GDP.
4. Calfat and Flôres (1996) / EU-Mercosur; EU-Mexico	Yes / (GTAP model)	GDP gains (from 1992 levels) for Argentina and Brazil of 0.007 and 0.447 per cent respectively, from Mercosur-EU FTA; from the Mexico-EU FTA, the EU gains 5 to 7 times more than Mexico, in terms of welfare (measured by equivalent variation; 1992 levels).
5. Harrison et al, (1997) FTAs involving Chile; the paper also discusses the effects of VAT harmonisation in Chile on its trade performance	Yes / No	GDP gains for Chile, in a Chile-NAFTA FTA, ranging from -1.11 per cent (without improved access) to 1.46 per cent (with improved access plus Chile's tariffs lowered to 6 per cent). The base year is the early 1990s as portrayed in GTAP's data base version 3 (May, 1996).
6. Flôres (1997) / Mercosur	Yes / Yes	Welfare changes (in GDP, measured by compensating variation, from 1990 levels) ranging from 1.3 to 2.6 per cent (Argentina), 1.0 to 1.6 per cent (Brazil) and 2.1 to 2.4 per cent (Uruguay) with the creation of Mercosur. The base year is roughly 1990.

Note: Percentage gains relate to changes in GDP values from the model's base year.

Source: Flôres, 2001a.

IMPLICATIONS

KEY POINTS

- The major Latin American economies of Brazil, Mexico, Argentina and Chile have reformed substantially over the 1990s; as a result, they recorded strong growth over the decade, although all except Mexico experienced recessions recently.

- Despite the current economic crisis in Argentina, medium term prospects for the four major Latin American economies look bright.

- Australian governments may need to help Australian businesses build their profile in Latin America; as regional integration continues and as US and EU influence grow, Australian companies could find building a significant Latin American presence more difficult. Reinvigorating the Closer Economic Relations, CER-Mercosur dialogue and negotiating agreements with the United States and Chile may be valuable to maintain or increase market access.

- Direct investment in Latin America is particularly prospective for Australia. Significant opportunities lie in mining, agribusiness such as food processing, infrastructure and services industries.

- Future export growth opportunities increasingly should lie in elaborately transformed manufactures and services, where transport costs and distances are less a disadvantage than for lower value commodity exports.

- Australian exporters should monitor the gap between most favoured nation tariffs (which Australian companies must pay) and tariffs Latin America's trade agreement partners pay as the difference can obstruct market access. Australian investors should investigate relevant rules of origin in trade agreements so they can access the full range of tariff free export opportunities within integrated regions.

- Brazil, Mexico, Argentina and Chile are relatively open to FDI. By far, Chile's business environment is the best developed.

Latin America's openness and economic performance improved significantly during the 1990s, considerably enhancing its attractiveness as a trade and investment destination. Consequently, foreign direct investment, FDI, inflows from around the world surged. However, concurrently, the region's reliance on preferential trade agreements intensified. These agreements increase the challenges Australian businesses and governments face in expanding Australia's regional presence.

ECONOMIC PROSPECTS

Latin America is a continent on the move; all major economies have undertaken substantial macroeconomic and structural reforms since the early 1990s. Consequently, 1990s growth in Brazil, Mexico, Argentina and Chile averaged 3.3 per cent per year compared to 1980s growth of 1.3 per cent. Moreover, during the decade, Brazil and Chile survived the Mexican, Asian and Russian crises without suffering major financial crises. Chile and Brazil rebounded from their relatively mild recessions in 2000. Mexico recovered quickly from its 1994-95 peso crisis, and in the late 1990s, its close links to the United States helped its economy boom, recording 24 per cent real growth since 1996.

Argentina was hit hard by the Asian and Russian crises and the Brazilian real's depreciation in early 1999; currently, it faces a serious debt payment crisis. Ultimately, Argentina's current problems flow from its exchange rate, which is pegged to the US dollar at an unrealistic level. This severely constrains external competitiveness and macroeconomic flexibility. However, many Argentine businesses and households hold extensive US dollar liabilities, so breaking the peg could cause bankruptcies and major banking sector problems.

In Brazil and Mexico, business should watch for bank credit to start flowing, fiscal discipline, stronger tax bases and management of external debt burdens. Governments in both countries recognise the need to strengthen their insolvency regimes to lift bank credit growth; Mexico's new bankruptcy law may achieve this objective. Brazil's new fiscal responsibility law should reinforce fiscal discipline.

In Argentina, business should watch for changes to the pegged exchange rate, developments on debt repayments, enforcement of fiscal discipline and bank credit to start flowing. If the Argentine Government can unpeg the exchange rate without inducing a major recession or financial system crisis, as Brazil did in 1999, Argentina's economic prospects will improve significantly.

In Chile, bank credit contributed to growth throughout most of the 1990s, and fiscal discipline is strong. Business should watch for debt servicing remaining at sustainable levels (currently it is 33 per cent of exports), growth returning to pre-1998 levels and less dependence on primary commodities, especially copper.

IMPLICATIONS FOR GOVERNMENT

The Australian Government may need to provide more help to Australian businesses wishing to build a profile in Latin America, as regional integration continues and as US and EU influence grow. Already, the North American Free Trade Agreement, NAFTA, is thriving and Mexico has a free trade agreement with the EU. If Mercosur deepens, and finalises its free trade agreement with the EU, or if the Free Trade Area of the Americas, FTAA, eventuates, Australian companies could find building a significant Latin American presence much more difficult. If Latin America's web of free trade agreements evolve to discriminate against direct investment from third countries, the potential to boost Australia's investment presence in mining, mining services, agriculture, agribusiness and related industries would decline, mutually disadvantaging Australia and Latin America.

In the short term, the Australian Government continues to establish Investment Protection and Promotion Agreements, IPPAs, and Double Taxation Agreements, DTAs, to improve Australian business' position in Latin America. Already, Australia has IPPAs with Argentina and Chile, a DTA with Argentina and is negotiating both these agreements with Mexico, with the DTA close to completion; Australia's strong investment presence makes negotiating a DTA with Chile logical.

In the medium term, Australia will need to ensure it is not excluded from increasingly integrated Latin American markets, and especially, an integrated Americas under the proposed FTAA. In this context, the bilateral free trade agreement currently under discussion with the United States has strong rationale. If the FTAA gave Latin American economies preferential access to US agricultural markets, a bilateral agreement would prevent trade diversion undermining Australia's A$2.5 billion agricultural export market in the United States. Reinvigorating the Closer Economic Relations, CER-Mercosur dialogue also seems a useful way to keep pressure on for access to these markets.

Similar Australian and Latin American export structures motivate Australia and Latin America developing more joint positions in international forums, particularly on agricultural trade and environment issues. The Cairns Group of free trading agricultural nations (Australia, Argentina, Brazil, Uruguay, Paraguay, Chile and Colombia) demonstrates such international cooperation. As Mexico, Chile and Peru are Asia-Pacific Economic Cooperation, APEC, members, their commitment to continue trade liberalisation to meet Bogor's free trade and investment goals by 2010 and 2020, also should provide a basis for common positions in international forums.

Latin American tourism and study in Australia are important service export growth areas. Growing people-to-people links generate trade and investment growth. In this context, the rapidly expanding numbers of Latin American tourists and students in Australia is encouraging, as is Qantas' additional weekly flight to Buenos Aires, taking flights to three per week. Government efforts to remove obstacles to Latin American airlines flying to Australia or tourists and students coming to Australia should bring long term benefits. Youth exchanges and working holiday schemes also develop such links.

BUSINESS IMPLICATIONS

Latin America offers significant investment and trade opportunities for Australian companies. Direct investment is particularly prospective, due to similar export patterns and sectoral specialisation, the region's openness to FDI, the network of trade agreements discriminating against non-partner exporters like Australia, and distances from markets.

Investment opportunities

Australia already has reasonably significant direct investments in Latin America, worth up to A$7.4 billion by 2000 according to project based data (A$2.4 billion according to ABS survey data), but considerable potential exists to expand these in future. Australia's most significant investment opportunities lie in Latin America's export-oriented mining sector; already, Australian companies have major investments in Brazil, Argentina and Chile. The Brazilian, Mexican and Argentine mining sectors offer further growth potential; Chile's copper industry is huge, with opportunities to diversify into other minerals. Mining service companies establishing a strong presence may be able to grow with the market, like Australian explosives producer Orica has done in Chile.

In agribusiness, investment opportunities include food processing, infrastructure and services industries. Brazil bans agricultural land ownership by foreigners, constraining investment opportunities in its huge agricultural sector, but Argentina, Chile and most areas of Mexico do not restrict land ownership. Profitability pressures and consumer expectations of quality products create many opportunities to export agricultural equipment and services. In Argentina and Chile, directly investing in the large, increasingly export-oriented wine industry is increasingly prospective, as Australian companies can contribute their export-oriented production and marketing expertise. Already, Mildara Blass and Viña Santa Carolina in Chile have a successful joint venture. Australian wine companies are yet to move into Argentina's huge market, despite major opportunities from producers' attempts to upgrade quality.

Given the four economies' web of preferential trade arrangements, Australian investors should investigate relevant rules of origin in trade agreements their host country enters. This will ensure they comply with these rules and access the full range of tariff free export opportunities. For example, in Mexico, investors meeting complex NAFTA rules of origin can access the US market, while in Chile, investors can access markets with up to 470 million people through Chile's web of agreements; 80 per cent of exports to these markets are duty free.

Trade opportunities

Australian exporters also have opportunities in Latin America. Current exports of $1.1 billion to Brazil, Mexico, Argentina and Chile are relatively small, and the large resources and bulk agricultural trade underpinning Australia's exports of A$70 billion to Asia will never develop. Latin America competitively produces many mineral and agricultural commodities, and transport costs from Australia to Latin America are high compared to the value of commodity exports.

Hence, the best future merchandise export opportunities lie in elaborately transformed manufactures and the supply of inputs to export-oriented primary industries and natural resource based manufacturing. Australian exporters should watch out for the tariff gap between most favoured nation tariffs (which Australian companies must pay) and often zero tariffs facing Latin America's free trade agreement partners. In Chile, this gap is never above 8 per cent and will be 6 per cent by 2003. However, most favoured nation tariffs average 13.7 per cent in Brazil, 17.6 per cent in Mexico and 13.5 per cent in Argentina, making these gaps a potentially major market access barrier for affected Australian exporters.

Services exports with good prospects include tourism, education, financial, information technology, leisure and telecommunication services. Latin America's middle classes are focusing more on Australia as a tourist destination, particularly since the Olympics. Latin Americans value foreign qualifications highly, and some are starting to see Australia as a low cost, quality alternative to the United States and Europe. Several Australian companies are investing successfully in Latin America's service sectors.

Business environment

Brazil, Mexico, Argentina and Chile are relatively open to FDI. By far, Chile's business environment is the best developed. The 45 or so Australian companies in Chile include BHP Billiton, Orica and Mincom; these have their Latin American headquarters there. In other markets, companies should allow time for dealing with the slow moving bureaucracy, and be aware lower levels may lack transparency. Businesses should establish systems to ensure customers and distributors make timely payments, as in Brazil, Mexico and Argentina, deferred payment still is a substitute for bank credit. Businesses also need to avoid legal disputes requiring recourse to the slow and unpredictable courts system, undertake thorough due diligence when undertaking investment and implement risk management systems. Finally, while local labour laws can be rigid and make labour expensive, foreign investors cannot operate in the informal labour market, although many of their local competitors can.

PROSPECTS

Although numerous preferential trading arrangements span Latin America, only Mercosur and NAFTA significantly increase intra-American trade. However, these agreements, and a future FTAA, may inhibit efficient free trade and development in the region, and Australian companies' access to Latin American markets. Hence, the Australian Government actively is exploring the possibility of a free trade agreement with the United States and considering other strategies to maintain trade and investment access.

Despite the current economic crisis in Argentina, medium term prospects for the four major Latin American economies look bright. All have opened their markets significantly and embraced democracy. Chile is most advanced, and provides the most stable business environment. Argentina also has initiated many major reforms over the last decade, and has huge productive and human resource potential. However, its economy has not adjusted to its extremely rigid exchange rate regime; this is driving the country into an untenable recession and debt crisis. If Argentina can resolve this dilemma, its long term growth prospects will be good. Brazil and Mexico are making considerable strides to becoming modern, globalised economies, and trade and investment opportunities are expanding commensurately. Australia has much to offer these four major Latin American economies and their growth and dynamism also provide many opportunities for Australian exporters and investors.

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Bancomext (Foreign Trade Bank)
Website: www.mexico.businessline.gob.mx; www.banamex.gob.mx

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Central Bank of Chile
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Foreign Investment Committee
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General Direction of International
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www.chileinfo.com

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Business directory for companies in Chile.
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World Bank
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Inter-American Development Bank
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Institute for the Integration of Latin American and the Caribbean, INTAL
Website: www.iadb.org/intal/ingles/i-default.htm

International Finance Corporation
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United Nations Economic Commission on Latin America and the Caribbean, ECLAC
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ASEAN	Association of South East Asian Nations, encompasses Brunei, Cambodia, Indonesia, Laos, Malaysia, Burma (Myanmar), the Philippines, Singapore, Thailand and Vietnam
CACM	Central American Common Market encompasses Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua
CER	Australia and New Zealand Closer Economic Relations
Central America	Belize, Costa Rica, El Salvador, Guatemala, Honduras, Mexico, Nicaragua and Panama
CET	Common external tariff
CPI	Consumer price index
CU	Customs union; all members charge the same set of customs duty, or CET, rates on imports from non-members
DTA	Double Taxation Agreement
East Asia	ASEAN and North Asia
ECLAC	Economic Commission for Latin America and the Caribbean (CEPAL in Spanish)
EFTA	European Free Trade Association
ETM	Elaborately transformed manufactures
EU	European Union
FDI	Foreign direct investment
fob	Free on board
FTA	Free trade area; trade between the members is duty free, but each member can set its own duty rates on imports from non-members
FTAA	Free Trade Area of the Americas
G3	Group of 3 encompasses Colombia, Mexico and Venezuela
GATT	General Agreement on Tariffs and Trade
GATS	General Agreement on Trade in Services
GDP	Gross domestic product; the value of all goods and services produced in an economy in a specified time

GNP	Gross national product; GDP plus income earned by residents overseas less income earned domestically by foreigners
IADB	Inter-American Development Bank
IFC	International Finance Corporation
IMF	International Monetary Fund
IPPA	Investment Protection and Promotion Agreement
IPR	Intellectual property rights
ISI	Import substituting industrialisation
LAIA	Latin American Integration Association (ALADI in Spanish)
Latin America	Central and South America
Maquiladora	A Mexican industry sector of in-bond plants which could import inputs duty free so long as they exported their output; in 2001, NAFTA brought about changes to this treatment
Mercosur/Sul	Common Market of the South
MFN	Most favoured nation; where each member to a trade agreement is to treat all others equally, so that if it improves the benefits it gives to another trading partner, it has to give the same 'best' treatment to all the other members
NAFTA	North American Free Trade Agreement
North Asia	China, Hong Kong, Japan, Republic of Korea, Democratic People's Republic of Korea, Macau, Taiwan, Mongolia
OECD	Organisation for Economic Cooperation and Development
PTA	Preferential trade arrangement
South America	Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Falkland Islands, French Guiana, Guyana, Paraguay, Peru, Suriname, Uruguay and Venezuela
STM	Simply transformed manufactures
TRIPs	Trade Related Aspects of Intellectual Property Rights
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
VAT	Value added tax; a tax on the value added at each stage of production
WTO	World Trade Organization

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.

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