Manufacturing in Argentina, Brazil and Chile: Challenges and Opportunities

INDUSTRIAL MARKETS
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Manufacturing in Argentina, Brazil and Chile: Challenges and Opportunities

Something new and surprising is taking place in South America: in a region often marked by risk, uncertainty, and crisis, confidence is now rising rapidly.

The economies of the region are clearly reviving. Overall growth rates are up. Currencies are appreciating. Yet inflation remains relatively low, and country risk ratings are falling. The revival is all the more surprising considering the depth of the crisis that sent an economic shockwave throughout the region in 2001, a crisis that brought the Argentine economy to its knees and which affected confidence, growth and currencies in Brazil, Chile and elsewhere.

Global demand for agricultural products and commodities have helped drive the revival. But in many regional economies, domestic demand is also strong as personal incomes rise. And companies are responding to the atmosphere of renewed confidence with significant new direct investment commitments. What is more, these investments are increasingly in the manufacturing sector. After a decade or more when the majority of direct investment in the region was driven by privatization of the services sector, investment is now returning in force to manufacturing, increasing value added and creating new jobs.

KPMG International recently asked a range of leading manufacturing companies to discuss the roots of this revival, in a series of lengthy one-to-one interviews with senior corporate strategists and CFOs. We conducted 27 country interviews, soliciting frank views on the political as well as economic foundations of the regional revival in three key economies: Argentina, Brazil and Chile. This report contains a selection of responses from those interviews. Inevitably it is only a small cross-section of corporate opinion, but we hope it is also an illuminating selection.

The message that companies are sending is that while confidence is rising, close management of both new and old regional investments remains vital. It is clear that many companies see the relative attraction of South American investment destinations rising, compared to China and other Asian destinations – not least because the prospects for near-term profitability in South America are often better. Nevertheless, informed selections of sector and geographical location remain one of the keys to investment success.

For foreign direct investors, managing South American investments is likely to remain a multi-location challenge. With this in mind we have established a central advisory capacity in Spain, in addition to our strong network of regional offices in South America. If you would like to discuss any of the issues raised in this report feel free to contact us – our details are on the back cover of the report.

Uwe Achterholt, Global Chair, Industrial and Automotive Products

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Over the last few decades South America has been a focus of enormous hopes and great disappointments for international investors. Yet to the surprise of many forecasters and analysts, Argentina, Brazil and Chile (the ‘ABC’ economies) have emerged rapidly from the recent period of economic stress. Overall growth has regained momentum, and trade in particular has revived sharply. Foreign direct investment (FDI) has increased dramatically, and the FDI resurgence is most evident in manufacturing businesses.

Growth returns to South America
The ABC economies are now reviving: they have attracted the biggest increases in FDI of any in South America. Argentina’s inward FDI flow increased by 125 percent in 2004, while Brazil increased by 79 percent and Chile increased by 73 percent.1 The revival has been underpinned by more competitive exchange rates and the worldwide boom in demand for commodities, which the ABC countries export.

Policy attitudes have also changed. Import substitution and industrial subsidization have given way to more open attitudes to inward investment: as the former Economy Minister2 of Chile Mr Jorge Rodriguez puts it: “We don’t have an industrial policy any more. We believe it is growth that will bring investment, not incentives.”

Argentina
Argentina is a medium-sized economy undergoing a slow process of recovery from a financial debt and currency crisis that engulfed it in 2001. However, the collapse of the Argentine peso in 2002 has dominated economic life in the post-crisis period. Relations between foreign direct investors and government have been severely strained, especially in the case of infrastructure and utility investors, as government has dictated that pre-existing contracts and financial holdings become ‘pesofied’ at the lower post-crisis rate of exchange.

It is the view of several companies interviewed for this report that Argentina is in some ways a test case for the ability of South American economies to reform and to normalize. Some of the companies interviewed consider the populist rhetoric of the Argentine government to be more threatening than the reality; however, many large companies active in the region say they will remain reluctant to commit further investment to Argentina unless government and policy become more pro-business. Some companies continue to invest in Argentina to maintain a diversified regional manufacturing presence. Companies interviewed say that outstanding policy issues for industrial investors include:

- The introduction of new capital and profit transfer restrictions which continue to limit financial flows and create considerable uncertainty over what financial operations will be approved by the central bank.

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1. UNCTAD World Investment Report, 2005
2. Jorge Rodriguez, Chilean Economy Minister until March 8 2006
Uncertainty over rules for settlement of disputes such as those relating to ‘pesofication’ remain unclear: in 2004 the Argentine Supreme Court ruled that ‘pesofication’ was constitutional, although lower courts are not in every case required to follow that ruling.

Brazil

Brazil is one of the largest and most dynamic economies in South America. Although investment risk is high compared to OECD economies, corporate investors are attracted to Brazil because of its size, its growth rate, and because of the trend of steady improvement on most risk measures. “Brazil is becoming more settled and predictable,” is a comment from interviewees.

Many companies remain concerned about Brazil’s sharp divisions of wealth. “Brazil has been growing fabulously, but poverty has also been growing,” says one large company. “The result is corruption, a large black economy, and a lack of transparency. Those are the problems that investors will face.” Companies are also concerned about the rising value of the Brazilian real against the dollar and the euro, which has severely eroded profit margins for exporters. However, many companies say that strong demand and productivity growth outweigh the disadvantage of a rising currency.

Foreign investment in Brazil has been very largely deregulated since 1991. There are few controls on investment capital flows. Funds can be freely transferred between Brazilian and foreign currencies at the market-determined exchange rate, and the procedures for currency exchange transactions were greatly simplified in 2000.

Most companies express concern at the difficulty of sourcing capital at competitive cost within Brazil, where real interest rates are the highest in the industrialized world.

Some companies believe that delays in shaping an attractive regulatory framework for public-private partnerships continue to inhibit investment.

The complexity and total burden of corporate taxation is a prime concern for most businesses; companies say that benefiting from tax-related incentives depends as much on relationships with local authorities as it does on objective eligibility criteria, and is difficult for new investors. Uncertainty over tax liability is also an issue. “The biggest risk factor is that you can have changes in taxation rates at any time,” says one large manufacturer.
Chile

Chile is the smallest and by far the most stable and predictable of the ABC economies, considered by many companies to be akin to a European economy in terms of investment risk. Chile is highly dependent on and open to international trade, and is seen by many respondents as a model for economic reform in South America. However, investment opportunities are limited by Chile’s small size and geographical isolation.

Foreign investment in Chile is easy to accomplish and largely free of impediments, helping the country to achieve the highest FDI to GDP ratio in South America. There are few controls on FDI in terms of ownership limits or closed sectors; investment law prohibits the state from altering the terms of any FDI contract after it has been signed. There are no controls on the transfer of capital into or out of Chile, other than administrative controls. There are no generalized foreign investment subsidies or tax exemptions available in Chile.

Some companies express interest in Chile’s Investment Platform Initiative introduced in 2002, which is designed to attract international corporate headquarters operations to Chile. The Investment Platform operates as a tax shield in cases where companies based in Chile might otherwise become liable for taxation in multiple jurisdictions.

- Protection of intellectual property rights in Chile continues to be an issue of concern to companies: Chilean authorities have made increasingly strenuous attempts to control counterfeit and pirated goods, but sanctions in Chilean courts have proved difficult and slow to obtain, and cases frequently result in light sentences by international standards.
- Companies remark on the willingness of Chilean authorities to update the legal framework for highly regulated industries.
Conclusion

"We are very bullish on Brazil. We are bullish on Chile. We are bearish on Argentina," is the comment of one large company that sums up the mood of companies interviewed for this report.

"In Argentina you have similar risks to Brazil, plus political risks and legal uncertainties," warns one company. However, risk in Argentina concerns the fundamentals of policy and the structure of the economy more than it concerns operating restrictions, says another manufacturer. “Risk may be higher, but Argentina has fewer taxes [than Brazil], and it is easier to establish businesses.”

The great majority of manufacturing companies are positive about Brazil’s growth potential and trend towards better stability and more pro-business policies. “Improvement has been gradual, but Brazil is now moving towards developing a system where there is a realistic balance of rights and duties,” says one Brazilian-headquartered international food group. “We have not forgotten the turmoil of the past, but we are reasonably confident that underlying confidence is growing,” adds one electronics manufacturer.

Chile is widely praised by companies for its record of democracy, transparency and stable economic management. “Corruption levels are very low, there is plenty of cost-effective labor, and there is plenty of skilled and professional labor too, while at the executive level Chileans are probably the best in the region,” comments one power and electrical engineering group. However, Chile’s location and small size will continue to restrict manufacturing investments to the very small scale, say respondents.
Over the last few decades South America has been a focus of enormous hopes and great disappointments for international investors. Once seen as the great economic force of the future, many of the leading economies of South America have instead suffered from repeated bouts of intense economic crisis and political and social turmoil, which have undermined investment and inhibited growth.

These destabilizing forces were especially apparent in Argentina, Brazil and Chile, the three economies which are the focus of this report. In particular, Chile underwent a political revolution in the 1970s. Argentina and Brazil experienced repeated cycles of hyperinflation, with boom-bust cycles of high growth and deep recession, which in the case of Argentina resulted in the largest sovereign debt default in history.

Underlying the roller-coaster ride that South American economies have followed is a long regional history of weak public institutions, corruption and social deprivation. “Bureaucracy and corruption are the twin evils that discourage any investor thinking about honest, long-term business,” echoes Mario Mafra, CFO of Wheaton Brasil.

In Argentina and Brazil in particular, the legacy of weak public institutions has also allowed much of the economy to develop beyond the reach of regulation and taxation, making it difficult for conventional companies to make profits. “In Brazil something like 40 percent of the economy is the black economy,” says the Vice President of Mergers and Acquisitions of one regional manufacturing group. “That means if you have a product that competes with the black economy, then you are in trouble. There is a similar problem in Argentina (although not in Chile). If you are out in the market with a product that cannot be differentiated then you are out of business.”

The cycle of boom and bust was reasserted once more in the wake of the Asian debt crisis of the late 1990s and the global downturn of the early years of this decade. Foreign direct investment flows collapsed, inflation rose, and economic growth fell sharply in Argentina and Brazil, and to a lesser extent in Chile. Once again South America was living up to its reputation for crisis.

But today that crisis is rapidly receding into history. To the surprise of many forecasters and analysts, Argentina, Brazil and Chile have emerged rapidly from the recent period of economic stress. Overall growth has regained momentum, and trade in particular has revived sharply. “The fact is that money is pouring into Brazil, and money is pouring into Argentina,” says Ronald Degen, Vice President of Mergers and Acquisitions of Chilean-headquartered food and forest products manufacturer GrupoNueva.
Above all, foreign direct investment has increased dramatically. According to the latest World Investment Report from UNCTAD, the UN body that tracks investment patterns worldwide, “after four years of continuous decline, FDI flows to South America and the Caribbean registered a significant upsurge in 2004”.\(^1\)

What is more, the FDI resurgence is most evident in manufacturing businesses, after a long period when direct investment in the region was dominated by investments in privatized service companies while manufacturing languished. The 2005 investment report from UNCTAD adds that in the subregion defined by Mercosur (the trade block that includes Argentina and Brazil, and Chile as an associate member), “the manufacturing sector has re-emerged as the leading recipient of FDI inflows”.

Clearly, something significant is happening in the leading economies of South America. After a long hiatus, private money is beginning to flow to new as well as existing productive enterprises in the region, and these investment flows are no longer being driven solely or even largely by official privatization policy.

Yet direct corporate investors have sharply contrasting views of the potential of the ABC economies, depending on the nature of the local markets in which they are active. Many companies consider Chile to be the lowest risk and most predictable economy of the ABC group. Yet Chile is also a relatively low-potential economy, say companies, due to its small size and geographical isolation. “There is not really very much that needs improvement in Chile,” says Ronald Degen, CFO of GrupoNueva.

“Corruption levels in Chile are very low, there is plenty of cheap labor, and there are plenty of skilled and professional labor too, while at the executive level Chileans are probably the best in the region,” comments Spanish power and electrical engineering group Iberdrola. And an international manufacturing services group says “In many respects Chile is like a European economy. Its only problem is that it is not in Europe.”

Many companies interviewed consider Brazil to be an economy where both risk and potential are higher. Companies are attracted by the sheer size of Brazil: “The fact that this is a market of 180 million people is in itself a huge advantage,” says a global food and beverage company. And Swiss pharmaceuticals manufacturer Roche comments, “it is also important that the current government has honored all debts with the international financial market and never signaled any intention of default, and that is clearly reflected in declining country risk for Brazil.” Luiz Murat, CFO of Brazilian food group Sadia argues that the trend of reform and normalization in Brazil is just as important as absolute country risk. “Improvement has been gradual, but Brazil is now moving

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\(^1\) www.unctad.org
towards developing a system where there is a realistic balance of rights and
duties,” he says. “In fact in some ways the Brazilian economy has reformed
more than Europe or the US – in reform of pensions and contributions, for
example.” Dutch electronics manufacturer Philips also echoes the widely voiced
view that Brazil is a risky but continually improving investment location. Says
Brazil CFO Thomas Glatzel: “We have not forgotten the turmoil of the past. But
we are reasonably confident that underlying confidence is growing.”

The same potential is present in Argentina, say companies – but risk is
higher, and potential is not as great as in Brazil. Luiz Murat of Sadia voices the
pessimistic view: “We are very bullish on Brazil. We are bullish on Chile. We are
bearish on Argentina. It is true that money is pouring into Argentina because the
location is cheap, but we have no manufacturing business in Argentina.”
Companies are most sharply divided on the longer-term potential of Argentina.
“In Argentina you have similar risks to Brazil, plus political risks and legal
uncertainties,” warns an international business process outsourcing group. Says
Sten Sorensen, Brazil CFO of German electrical engineering company Siemens
VDO: “In Argentina the government is doing a very poor job on shaping the
operating environment, the privatized companies are mostly in very poor shape,
and the government’s approach to contracts is not helping either.” But a U.S.
food manufacturer points out that while Argentina may be the riskiest of the ABC
economies, it is also freer from regulation. “In Argentina the bureaucratic load is
lighter than in Brazil,” says the company. “The risk may be higher, but Argentina
has fewer taxes, and it is easier to establish businesses.”

This report seeks to use such current company experiences in Argentina, Brazil
and Chile to address the question of whether the current upturn in investment
heralds a sustained revival.

Growth returns to South America
After a long hiatus, interest in South America as a manufacturing investment
destination is reviving.

The most recent figures from the UNCTAD annual survey of global investment
flows shows that in 2004 there was a dramatic revival of foreign direct
investment in South America, with the biggest beneficiary economies in the
region also seeing a growing proportion of investment being directed towards
manufacturing operations.
One legacy of the recent economic disruption in South America has been that installed manufacturing capacity is often greater than demand, yet companies say they continue to invest in upgrading their manufacturing capacity. General Motors is typical of the trend: “We will continue to invest in the Mercosur markets,” says Jaime Ardila, Regional CFO of U.S. automaker General Motors. “We actually have enough unit capacity for the foreseeable future, but we will continue to invest in new products and new production technology.”

The ABC investment record

South America largely missed out on the boom in direct investment in manufacturing that has accompanied the growing globalization of the world economy during the last 15 years. Only in the last two years have signs emerged that the region is finally beginning to catch up after decades of underperformance. Total FDI flows to the region rose sharply in 2004, reaching US$68 billion, a 44 percent increase on the previous year. Brazil was the largest recipient of private investment capital (US$18 billion), with Chile and Argentina in third and fourth places after Mexico.

To understand why manufacturing investment is now flowing back into South America, it is first necessary to examine why the region has underperformed for so long. This underperformance is an issue that has stimulated a great deal of debate among regional policymakers and academic economists. Published work from business analysts, economists, and KPMG International’s own corporate interviews for this report suggest that there are three main contributory factors.

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1. Trade block that includes Argentina and Brazil, and Chile as an associated member
2. UNCTAD World Investment Report, 2005
• **Policy-induced instability** During the latter part of the 20th century official debt crises were almost endemic in the largest economies of South America. Governments routinely took on large amounts of sovereign debt – largely to support chronic public spending deficits – which could not be serviced from official receipts during economic downturns. These crises were exacerbated by ‘dollarization’: exchange rate policies that tied governments to U.S. dollar repayments at a time of falling foreign exchange receipts. Some companies comment that South America’s recent history of cyclical high growth followed by debt crisis and default has helped foster a damaging ‘debt mentality,’ that continues to undermine prospects for long-term investment, especially in Argentina.

• **The ‘natural resources curse’** It is widely recognized that emerging economies that base their development policies on exploitation of natural resource endowments frequently underperform emerging economies that either have less in the way of natural resources or that focus FDI policy on industrial development. The experience of the economies of South America appear to support this argument; the region is exceptionally well endowed with resources of metals ores, gas and oil, and a wide range of agricultural and forest resources, yet these economies have not grown in size and sophistication in the way that relatively resource-poor economies such as South Korea have done. A recent analytical report from LAEBA (The Latin America-Asia Pacific Economics and Business Association), a joint think-tank set up by the Inter-American Development Bank and the Asian Development Bank to compare the development experiences of Asia and South America, has suggested that investment policy focused on ‘point source’ natural resources (that is, those extracted from a narrow geographic or economic base) is strongly associated with low investment in physical and human capital. Point source natural resources investments tend to require much more investment in land and extractive equipment than in human skills; in the absence of specific government intervention to raise skill and investment levels, economies will be ill-equipped to achieve growth from higher value-added manufacturing operations. “In Brazil the fundamental problem is that there is not enough value being added in the economy,” comments Sten Sorensen of Siemens VDO. “Brazil has fabulous resources, but you need industries that add value to create large-scale employment.”
• **Closed economies** Until the 1990s most governments in South America pursued industrial development through a policy of import substitution, in part to correct the region’s chronic balance of payments deficit. Import substitution policy consists of incentives for domestic companies to manufacture consumer and industrial goods, combined with tariff disincentives for foreign companies to export to the region. This investment model was not restricted to South America – it was also applied in Africa, India, and parts of South East Asia. However, in Asia and increasingly in India the model has largely been supplanted by an export-oriented investment policy which has proved outstandingly successful in attracting foreign manufacturing investment, stimulating high levels of economic growth and encouraging a rapid transition to higher value-added industrial operations. This policy approach has also been adopted by Argentina, Brazil and Chile: however, the process of transition throughout the 1990s from import substitution to export-oriented investment has been disruptive for these economies, as many local manufacturers were exposed to global competition for the first time.

The history of domestic industry protection and high barriers to entry have had paradoxical effects on foreign investors in the region. One effect is that some established corporate investors find themselves in unusually strong competitive positions, having in the past secured investment incentives that are no longer available to new entrants. “A lot of manufacturing incentives go back for many years – in practice new entrants can’t get the same incentive regime that established companies can get,” says Thomas Glatzel of electronics manufacturer Philips Brazil.

**FDI flows: South America vs Asia**

![Graph showing FDI flows](Source: IMF, 2005)
The cost of policy errors and weak institutions in South American economies can be traced by comparing the relative FDI rates, GDP growth rates and per capita income rates in the ABC economies and East Asian economies. According to the South American and Asian Economics and Business Association, East Asia’s economies grew more than three times faster than the economies of South America and the Caribbean in the quarter-century to 1990. Even during the 1990s, a period of high investment and rapid reform in South America, South American and Caribbean economies grew at an average rate of 3.3 percent, while economies of East Asia and the Pacific grew at a rate of 7.2 percent during the same period. On average East Asian economies increased their per capita incomes eight fold between 1960 and 1995, while South American per capita incomes only doubled during that period.1

Infrastructure and investment

A recent study from LAEBA of manufacturing investments in East Asia and Latin America (Responses To Globalization in East Asia and Latin America, 2002) suggests that physical infrastructure continues to be a key determinant of companies’ propensity to make cross-border investments in manufacturing, and that the high level of infrastructure investment in Latin America, due largely to privatization over the last 15 years, is likely to pay dividends in the near future. Indeed, the evidence from the latest data on global FDI trends from UNCTAD suggests that this may already be happening.

Nevertheless, South America has struggled to achieve the same level of infrastructural investment as East Asia, as electorates have turned against privatization as a route to achieving higher levels of investment. According to data from the World Bank in a report published in 2005 (Infrastructure in Latin America and the Caribbean: Recent Developments and Key Challenges) the level of electoral support for further privatization of infrastructural provision fell by more than half between 1998 and 2004.

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1. LAEBA Manufacturing Investment Study, 2004
Privatization loses votes in South America

One result of this shift in opinion has been to hamper South America’s relative performance on infrastructure quality. Total investment has fallen as a percentage of GDP, says the World Bank, and most infrastructure services have lagged behind leading East Asian competitors, in terms of both coverage and quality. The World Bank reports that while in 1980 South America held a small advantage over East Asian tiger economies according to the World Bank’s Infrastructure Index, which includes paved roads, electricity generating capacity and telephones per worker; by the year 2000 the East Asian tiger economies recorded an Infrastructure Index score almost twice that of South American economies.

Nevertheless, companies agree that large-scale infrastructure investments have made both Argentina and Brazil more attractive as manufacturing investment locations. This is in part due to the great success that the ABC economies achieved in attracting private investment into infrastructure provision during the 1990s. According to the World Bank, South America received around half the US$786 billion worth of infrastructure projects with private participation in the developing world between 1990 and 2003, with Argentina and Brazil accounting for a large proportion of that total.

Chile, however, remains a special case due to both the small size of the economy and Chile’s geographical isolation. “No amount of infrastructural investment can alter the fact that Chile is essentially an island in South America,” says an international manufacturing services group. “This is why there is little large-scale manufacturing in Chile. Chile is small, and there are two great physical barriers in Chile that cannot be altered, with the Andes to the east and the Pacific to the west. The result is that large-scale manufacturing is uneconomic.” Jaime Ardila of General Motors agrees.
“Chile is too small to invest in automanufacturing without subsidies to sweeten the deal,” he says. “Labor costs are similar to Argentina. The tax environment is more attractive and more predictable. The infrastructure in Chile is good. But even taking all that into account you will still have an infrastructural disadvantage.”

The revival gains traction

Yet history does not have to repeat itself. The revival in the world economy since 2003 has been mirrored in South America. While 2004 was the best year for overall global growth rates for two decades, and 2005 is likely to see growth only marginally below that high level, several South American economies have also returned to growth more rapidly and more fully than was expected during the turbulent first years of the decade. As the graph below shows, FDI rates have picked up strongly in those economies that continue to stress openness to trade and equality of treatment for foreign capital, while states such as Venezuela, which have returned to policies that stress self-reliance over globalization, have seen FDI rates fall.

The ABC economies have attracted the biggest increases in FDI of any in South America. Argentina’s inward FDI flow increased by 125 percent in 2004, while Brazil increased by 79 percent and Chile increased by 73 percent.

Investment in the top ten regional economies 2003-4

Not only is there growth in the value of investment going into the region, a larger proportion of this investment is going into manufacturing. Something is clearly going right for manufacturers in the ABC economies.
There is no doubt that fairly good economic growth in the region has helped stimulate investment; the fact that exchange rates have become more competitive has also helped, as has the fact there has been a worldwide boom in demand for commodities, that the ABC countries countries export.

It is useful to compare the historic record of private direct investment in South America with that in China. The recent decade has seen China enjoy the biggest FDI boom in the history of the world. According to Chinese figures at least US$60 billion of direct investment went into China in 2004.¹

In cumulative terms adjusted for population, however, the investment that China has attracted is still considerably less than the investment stock in South America. According to UNCTAD, the entire cumulative FDI stock in South America and the Caribbean stood at almost US$750 trillion – just over three times the cumulative investment stock in China. The cumulative investment stock in Argentina, Brazil and Chile stood at US$259,126 billion, just above the cumulative total in China.

**Cumulative FDI: South America vs China**

![Cumulative FDI: South America vs China](source: UNCTAD World Investment Report 2005)

It is clear that China is catching up fast. But today Argentina, Brazil and Chile – a population grouping of around 230 million people – still have a cumulative investment stock a little greater than China, a country of over one billion people.² Adjusted for population, the ABC countries have attracted more than four times the FDI per capita than China.

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¹ TBC
² World Bank Business Environment Snapshots, 2006
How is this investment performing? While the profitability of South American manufacturing investments has fluctuated wildly, especially in Argentina and to a lesser extent in Brazil, in the current period there is reason to suspect that ABC country investments are in many cases more profitable than Chinese investments. Much of this evidence is anecdotal; it is necessary to rely on anecdotal evidence due to the difficulty of isolating the Chinese contribution to profitability from international business accounts. One very simple objective measure, however, is to track how the stock prices of listed Chinese operations are performing.

The performance of stocks is by no means an infallible guide to the fate of economies or individual companies, but it does indicate investors’ expectations of the profitability of companies in the near future. The chart below shows that stock markets in Argentina, Brazil and Chile have performed well in the last 12 months – not quite as well as some other higher-risk emerging markets, but considerably better than the mature industrial economies of the G7 (with the exception of Japan). Portfolio investors clearly expect companies in the ABC economies to make money.

**ABC stock prices rose in 2005**

At the same time the main stock index in China has fallen around 10 percent in local currency terms. China’s breakneck drive to expand manufacturing production right across the economy has led to considerable over-supply in many sectors of the domestic market: this has held down inflation, but has also held down profits as many companies report that they have little pricing power in an over-saturated market. Profits are very hard to find in China, and are likely to remain hard to find for the foreseeable future.

These statistics help to explain why the ABC economies are currently experiencing an FDI boom that in per capita terms is much greater than
that in China. The most outstanding example of this is Chile, a country that has the best investment profile of any in South America, in terms of political stability, bureaucratic transparency and efficiency, high levels of education and urbanization, and a well-defined business-friendly policy set. Chile attracted US$8 billion of FDI in 2004, or around one-sixth of the FDI that China attracted. Yet Chile has a population of only 15 million people, compared to 1.2 billion people in China.\footnote{World Bank Business Environment Snapshots, 2006} In these adjusted terms, Chile appears as currently one of the world’s most successful FDI-attracting economies.

During the later 1980s and the 1990s the pattern of FDI in South America was determined by policies designed to open up and normalize formerly protected economies. Trade tariffs were reduced rapidly: as the graph below demonstrates, trade tariffs in South America fell faster than in any other region during 1980-1999, and are now lower than in any region other than the OECD. Meanwhile, large government-owned or controlled public utility sectors were sold off to private investors. The result was that domestic manufacturing sectors, accustomed to protection behind high tariff walls, suffered high rates of bankruptcy as imported manufactures became more competitive than domestic goods.

**Latin American trade tariffs fall: 1980-1999**

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\text{Average rate of import duty (percentage)} \\
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![Average rate of import duty (percentage)](chart.png)


Meanwhile the larger part of foreign direct investment in the ABC economies went into services businesses, as Argentina, Brazil and Chile all pursued fast-track privatization programs in public utilities. Investment in manufacturing declined (in the case of Argentina it declined to zero, as shown in the graph overleaf: a similar pattern of historic decline and recent improvement in manufacturing investment is seen in Brazil and Chile). Manufacturing investment stayed low until domestic manufacturers had restructured and adjusted to the new competitive environment.
That adjustment now appears to have taken place. This view is supported by the large number of global manufacturers that have announced substantial manufacturing investments in the ABC economies in the last 18 months. For example, in the auto manufacturing sector alone, investments in excess of US$100 million in Argentina and Brazil were announced by VW, Fiat, Bridgestone, Continental, GM, Hyundai, Pirelli and Michelin between January 2004 and May 2005, while many more automakers announced investments in the US$10-100 million range.\footnote{1}

This investment pattern is the result of a dramatic turnaround in policy. South America spent the best part of the post-war era attempting to foster industrial development through protection and import substitution, a policy pattern also seen in Africa, and parts of the Middle East and South Asia. The imperative of economic self-reliance as a ‘defense’ against the demands of global capitalism is a theme that recurs throughout the modern economic history of the region, and continues to be a driving force in policymaking in economies such as Venezuela (and remains an important part of the political debate in Argentina).

However, there are signs that to different degrees the ABC economies are moving beyond this debate. The experience of East Asian economies has shown that openness to foreign direct investment is one part of a development policy that can lead to rapid industrialization and growth in per capita incomes. Policymakers in South America have seen that export-focused open investment policies have delivered more growth than substitution-focused protectionism. As the former Economy Minister of Chile, Jorge Rodriguez, puts it: “We don’t have an industrial policy any more. We have no sectoral policy, and we have no investment promotion policy. We believe it is growth that will bring investment, not incentives. We had an industrial policy 40 years ago and frankly it was a failure.”

\footnote{1 UNCTAD, 2005}
The process of adjustment to an FDI-led model of industrial development has been a painful one for South America, and it continues to be painful in Argentina. The region has cut tariffs far more deeply than East Asia, which continued to protect domestic manufacturers even while encouraging high rates of foreign and domestic investment. But having adjusted to freer trade as well as freer investment flows, the ABC economies are arguably now in a better position to benefit from globalization than competing regions.

According to research by IMD, the Swiss-based business school that tracks competitiveness in the global economy through annual surveys of over 1,000 global businesses, attitudes towards globalization are gradually improving in all of the ABC economies. Attitudes are least positive in Argentina (perhaps understandably, given Argentina’s traumatic journey towards economic and financial normalization over the last five years), but even in Argentina the graph is turning upwards, as exports and business margins continue to improve.

Globalization takes hold in the ABC economies

![Graph showing IMD Executive Opinion Survey based on an index 1-10 for Argentina, Brazil, Chile, China Mainland from 2001 to 2005.]

Source: IMD, 2006

In other words, the ABC economies are joining the globalized, FDI-led world economy. On a wide range of measures on how costly it is to do business, Argentina, Brazil and Chile – despite their very different economic settings and policy approaches – are beginning to look comparable to other investment destinations.

“There is no doubt the big economies in South America are improving,” says a major U.S. food producer. And many companies believe that the increased flow of investment capital from large manufacturing corporations is a cause as well as a symptom of the improvement. Says Ronald Degen of GrupoNueva: “The quality of business life is getting better, especially as the multinational companies come in and insist on more transparent ways of doing business.”
Sten Sorensen of Siemens VDO believes that after finding low returns in East Asia, many companies are beginning to put a higher premium on the more developed markets of South America. “There is a lot of cultural commonality, companies don’t feel so lost in the environment, and there are large developed markets,” he says.

In the immediate post-war period, the entire South American region was widely seen as a coming economic superpower, much as China is seen today. It may be we are now in the process of returning to that earlier view of the world. South America is once again poised to become a source of growth and innovation in the world economy, and to become a destination of choice for the world’s cash-rich corporations to invest their capital.
Argentina: manufacturing investment and operations

Argentina is a medium-sized economy undergoing a slow process of recovery from a financial debt and currency crisis that engulfed it in 2001. “Argentina remains a volatile economy,” warns Ronald Degen of GrupoNueva, which has made significant investments in Argentina in the last year, but he adds, “Volatility is an opportunity as well as a threat.”

Many conventional measures of growth, wealth and development are misleading in Argentina: the sharp fall in the value of the currency after it was delinked from the US dollar in early 2002 and the collapse of formal employment for many Argentines has resulted in 55 percent of the population falling below the national poverty line, according to the World Bank, despite the fact that Argentina is in many respects a highly developed economy with sophisticated institutions and a diversified industrial sector. Large companies have suffered along with individuals from the financial turmoil in Argentina: says an international manufacturing services group: “From the investor’s point of view, it has not really been a question of whether Argentina is improving, it is more a question of whether it could possibly have got any worse.”

Average per capita incomes remain above the regional average at US$3,650, putting Argentina in the national upper middle income bracket. Historically high levels of economic development are reflected in a high level of urbanization (90 percent of the population), relatively low levels of infant mortality (16 per thousand births, half the mortality rate of Brazil), a high average life expectancy of 74 years (against a regional average of 71) and very low rates of illiteracy (3 percent of the population).¹

Argentina’s currency collapse

Source: OANDA, 2006

¹ World Bank Business Environment Snapshots, 2006
The collapse of the Argentine peso in 2002 has dominated economic life in the post-crisis period. Relations between foreign direct investors and government have been severely strained, especially in the case of infrastructure and utility investors, as government has dictated that pre-existing contracts and financial holdings become ‘pesofied’ at the lower post-crisis rate of exchange. On the other hand, the collapse of the peso has also made Argentina a cheap buy for manufacturing assets, and has played an important part in driving the current FDI boom.

Government and policy

The Argentine government is led by President Nestor Kirchner of the Partido Justicialista (the PJ, or ‘Peronist’ party) with a mandate to govern until presidential elections in 2007. President Kirchner is an avowedly ‘populist’ politician who emphasizes his left-wing credentials and willingness to increase state participation in the economy. Nevertheless, high economic growth of around 7 percent in 20051 and a foreign investment boom as manufacturing investors have returned to Argentina in force have allowed populist rhetoric to be combined with economic policy that is in reality more centrist than leftist; Argentina has, for example, maintained good relations with the International Monetary Fund and, in a sign of qualified IMF approval of policy direction, is expected to sign a new ‘standby agreement’ with the Fund in 2006.

Nevertheless, the after-effects of what amounted to one of the biggest sovereign debt defaults in history continue to inhibit investment. Protracted negotiations with creditors of Argentina’s sovereign debt as well as with holders of private assets that remain effectively frozen by the government’s ‘pesification’ policy have failed to yield a debt settlement and are quite likely to continue throughout the decade.

It is the view of several companies interviewed for this report that Argentina is in some ways a test case for the ability of South American economies to reform and to normalize. Argentina is led by a government that appears to conform to many of the stereotypes of a ‘populist’ South American administration: in rhetoric it is critical of international financial institutions, corporate capitalism and calls for liberalization of the economy; yet Argentina is also experiencing a new investment and export boom that is rapidly increasing the internationalization of the economy and placing new demands on the government for higher standards of accountability and debt responsibility.

1 The Economist, 2006
“The political rhetoric is worrying,” says Jaime Ardila of General Motors, which has invested in both Argentina and Brazil in the last year. “That makes us very nervous. But on the other hand the fact is that in our case every single financial commitment by the Argentine government has been honored.” Luiz Murat, CFO of Brazil-headquartered food group Sadia, is less willing to consider manufacturing investment in Argentina under the current government. “Investment is going into Argentina because it is so cheap,” he says. “That’s because in some ways Argentina is very competitive – in the soya industry for example.”

Yet some companies believe that careful investors can be rewarded in Argentina. “It is a dangerous place for a speculator, but a good location if you focus on operations,” says Charles Kimber, Corporate Affairs Director of Chilean Forest Products Group, Arauco. “The key to success is looking at processes and efficiency. That is particularly important in a country that tends to focus on financial investments and quick returns.”

**Argentina’s privatization program**

Argentina’s experience with privatization before, during and after the financial crisis in the early years of this decade encapsulates both the hopes and fears of many foreign investors in South America.

During the 1990s Argentina attracted massive flows of FDI into the power and telecommunications sectors, as these industries were deregulated and privatized as part of a wide-ranging economic liberalization program designed to turn Argentina into a low-cost, high-growth economy. The Argentine investment climate was widely regarded to be exceptionally positive, with its convertible currency, educated workforce and wealthy and growing market.

The reform program began in 1989 under the leadership of President Carlos Menem, who devised a threefold policy of currency convertibility, trade liberalization and privatization to revive what was then a low-growth, high-inflation economy. The first phase of privatization was in telecommunications. According to a recent report on global private investment in services from Stanford University, Argentina’s telecoms privatization was marked by an almost total absence of preparation in terms of restructuring of the industry or the creation of efficient regulation. Privatization policy changed repeatedly: for example, the structure of the industry was altered arbitrarily during the privatization process, and tariff levels were altered by decree hours after the bidding for key contracts had closed. The result was an inefficient and high-cost telecoms sector.
Argentina first created an independent electricity regulatory structure in 1992, ahead of privatization. A secretariat within the Ministry of the Economy is responsible for energy policy; a federal regulator (ENRE) is in direct regulatory control of the entire sector; and an independent non-profit company, CAMMESA, is responsible for management of the transmission grid and supervises the wholesale electricity market. At the same time Argentina restructured the industry into generation, transmission and distribution sectors. Regulation was light, and primarily designed to prevent monopolistic domination of any sector of the power business. Foreign investor interest was very competitive, and benefits were felt rapidly, with lower prices and improved reliability.

However, the economic crisis dramatically altered the terms of investment for the worse for private service providers. The deep recession of 2001-2002 reduced demand for power in the economy, while a series of emergency government measures unilaterally froze utility tariffs and severely limited repatriation of profits. Dollar-linked tariffs were converted to peso-denominated tariffs, while reduction or alteration of services in response to falling revenues was outlawed. The government began efforts to renegotiate most service contracts with private providers in 2002, and although the IMF set a deadline of June 2004 to resolve these disputes, the government has repeatedly moved the deadline back and most disputes remain unresolved.

Investing in Argentina: regulations and incentives

Despite the reservations some large corporations express about Argentina’s ability to escape its tendency to boom and bust cycles, the last year has seen an exceptional FDI boom in Argentina (see FDI tables, overleaf). Some companies believe that the Argentina risk is justified in order to maintain a diversified portfolio of manufacturing in the region. “It is very important to be diversified in South America,” say Ronald Degen of GrupoNueva. “You have to be able to match the downturns with the upturns.” Charles Kimber of Arauco adds: “There are many niches where you can be quite competitive in Argentina, despite the many problems with government policy, with the attitude of anti-entrepreneurship, with labor unions and with taxes.”

There are no restrictions on FDI in Argentina in terms of ownership limits or reserved sectors, with the exception of investments in ‘cultural goods’, which covers press, publishing and Internet companies (‘cultural goods’ investments are generally limited to 30 percent of total ownership under a law enacted in 2003). However, some sectors particularly auto manufacturing, are subject to a complex regime of minimum local content rules.
Argentina has two regional tariff-exemption schemes: Free Trade Zones (FTZs) established in 1994; and a special exemption created in 1972 known as Special Customs Areas (SCAs), which are restricted to Tierra del Fuego province and which only apply to established businesses. FTZs are limited to one in each of Argentina’s 24 provinces, and allow tariff-free import and export except to and from the rest of Argentina (although value that is added to goods shipped to a FTZ from elsewhere in Argentina is tariff-free when the final product is exported). The SCAs benefit from wider tariff-free rules, in that goods manufactured in a Tierra del Fuego SCA may be shipped within Argentina free of tariffs or taxes. The SCA program is scheduled to expire in 2013.

Companies interviewed say that investors need to be aware of the background of industrial lobbying power and trade tariffs before deciding whether to invest for domestic manufacture or to export to Argentina from elsewhere in the region. “Import duties overall have fallen quite sharply over the last 20 years in South America,” says electronics manufacturer Philips. “But particular industries still have a very strong lobby with government – industries like consumer electronics, autos, and some high-technology equipment manufacturing industries – and that is why you find tariffs still quite high in those industries. On the other hand, in the new technology sectors, such as mobile communications, there is no established lobby to argue for protection and therefore lower tariffs. New entrants often can’t get the same tariff and incentive regime as established companies, and that makes it harder for them to compete.”

The long-term FDI record

Between 1993 and 2001 Argentina allowed free repatriation of capital and profits; however, since the financial crisis foreign companies operating in Argentina have had to cope with the introduction of a large number of new capital and profit transfer restrictions which continue to limit financial flows and create considerable uncertainty over what financial operations will be approved by the central bank.
The peso has been floated at a single rate of exchange since 2002; although the central bank intervenes to smooth fluctuations, the rate of exchange is broadly determined by the market. However, the central bank continues to limit free conversion of peso funds into foreign currency (currently limited to US$2 million monthly without central bank authorization); corporate foreign currency bond issuance and some debt service payments are also subject to central bank approval, and foreign currency transfers into Argentina are required to be held within the country for a minimum period (currently 180 days). However, capital controls have been eased since the peso began appreciating in 2003, and are likely to be further eased. Companies in the mining sector are allowed to keep all their foreign currency earnings offshore, while oil, gas, fisheries and forestry companies are permitted to keep up to 70 percent of foreign earnings offshore.

Investor disputes and arbitration

The financial crisis that engulfed Argentina from 2001 resulted in a large number of new financial restrictions and controls on foreign investors designed to prevent foreign currency flight. These in turn have led to numerous disputes at national and international level between foreign investors and the Argentine government.

For companies the most onerous of the new regulations was the ‘pesofication’ of many bank accounts and all corporate contracts denominated in dollars imposed by the government in 2002. A number of companies continue to pursue claims against the Argentine government at the International Center for the Settlement of Investment Disputes (ICSID), on the basis that ‘pesofication’ amounts to expropriation of assets against the terms of the bilateral investment treaties that Argentina has with OECD and other countries. The 2003 ‘cultural goods’ legislation has also generated disputes at the ICSID, as has the government’s imposition of a freeze in utility prices. A new utility sector framework law which among other restrictive provisions includes clauses that bar foreign companies from seeking ICSID arbitration, is also likely to generate disputes. However, in late 2004 the Ministry of the Economy indicated in a press release that compensation required by ICSID judgments must be approved by Argentine courts which have discretion to alter or cancel compensation amounts; government officials have frequently hinted that ICSID compensation judgments are unlikely to be paid.
Argentina is also party to the United Nations Commission on International Trade Law (UNCITRAL) and the World Bank’s Multilateral Investment Guarantee Agency (MIGA). However, since 2003 the Argentine government has discouraged investors from seeking international arbitration in disputes over investor rights, and now seeks to settle disputes within the national Unit for the Renegotiation and Analysis of Utility Contracts (UNIREN) created in 2003 under the control of the Economy and Planning ministries. The national rules for settlement of disputes such as those relating to ‘pesofication’ remain unclear: in 2004 the Supreme Court ruled that ‘pesofication’ was constitutional, although lower courts are not in every case required to follow that ruling.

Uncertainties over Argentina’s willingness to settle claims arising from ‘pesofication’ and the complexity of the existing tariff regime have probably inhibited manufacturing investment since Argentina’s emergence from financial crisis. Says a major U.S. food group: “A lot of companies are still holding back from investment in Argentina, waiting to see what is going to happen. At the moment it is often cheaper to sell products made in, say, Brazil, in Argentina than it is to manufacture in Argentina. That is partly because Argentina and Brazil are playing a trade tariff game. Companies know that even if there are no trade barriers this year, there probably will be next year.” However, companies that benefit from a strong lobby on trade tariffs tend to be more positive on the outlook for manufacturing investment. A volume carmaker says, “The crisis in Argentina saw the market collapsing from about 450,000 units a year to around 100,000 units, but that has bounced right back and is close to the high again. Plus there has been a substantial devaluation, plus there is high productivity in Argentina. So we expect growth, and we expect export opportunities.”
Operating in Argentina: bureaucracy and regulation

Many companies consider that capital-intensive manufacturing operations in Argentina are intrinsically risky: if Argentina remains a boom-bust economy, they say, it is very unlikely that the long-term capital commitments of manufacturing can be aligned to the shorter-term cycles of the Argentine economy. “It is the hardest country to invest in, just because of the way the economy crashes and comes bouncing back,” says GrupoNueva. And an international manufacturing services company says, “Long-term capital-intensive businesses assume higher risks in Argentina. Cyclical businesses like construction are actually easier to make money in.”

Intellectual property protection remains weak

The quality of intellectual property protection in Argentina is increasingly an issue for direct investors, as competitiveness in products and processes becomes increasingly dependent on intangible assets.

Although Argentina belongs to World Intellectual Property Organization and the World Trade Organization (WTO), companies consider that protection of intellectual property remains defective, although it is improving. Argentina’s current patent law implemented in 2000 is widely considered to fall short of requirements under the international TRIPS (Trade Related Aspects of Intellectual Property) agreement, especially for protection of pharmaceutical patents. Theft of copyright and trademark-protected material through counterfeiting increased greatly following the financial crisis of 2001-2002, although since 2004 Argentina has begun to draft and implement tougher rules on monitoring and intercepting counterfeit goods, and to improve the process for trademark registration. Argentina has no law protecting trade secrets, and no law on ‘layout’ that would protect semiconductor and similar industrial designs, although the government has signed the WIPO Treaty on Integrated Circuits.

The costs of procedures for business startups and closures in Argentina are significantly higher than the average of OECD countries, although generally better than the South American regional average. A major U.S. food producer compares Argentina favorably to Brazil in terms of bureaucratic load. “Argentina has fewer business taxes, and it is easier to establish businesses,” he says.
Although companies do not consider operational costs in Argentina to be particularly onerous, the higher cost of operations compared to the OECD reflects the considerably longer time required to achieve startups, closures and cross-border trading transactions. For example, a business startup requires 32 days, compared to less than 20 days in the OECD; a business closure will require an average of 2.8 years, compared to 1.5 years in the OECD. Export and import transactions (23 days and 30 days) are around double the average in the OECD. These figures are comparable with startup, closure and import and export times achieved in China; they are much better than in India, where startups take an average of 71 days, closure an average of 10 years, and import and export periods are around one-third longer.¹

¹ World Bank Business Environment Snapshots, 2006
Damage inflicted on smaller Argentine companies during the recent financial crisis has increased costs for manufacturers, as many small and medium-sized manufacturing suppliers went out of business. “The supplier network in Argentina was decimated during the crash in 2001 and afterwards,” says General Motors; the company adds that the costs arising from the lack of a supplier network will fall if economic growth remains strong. “We are trying to help supplier companies rebuild that network in Argentina – in many ways Argentina will probably stay more competitive than Brazil – but many of them closed after 2001. However, we do believe it is possible to begin to bring them back.”

Some companies add that the rapid revival of domestic demand in Argentina has caused them to treat Argentina increasingly as a domestic market rather than an export base. “Take the example of the wood pulp business,” says GrupoNueva. “The Argentine market has really taken off, to the extent that it is no longer possible to supply Brazil any more from Argentina. As a result we are now planning build a new plant in Brazil.”

Many companies comment that Argentina’s history of currency instability means that it is prudent to make operations as ‘foreign exchange neutral’ as possible. Typical is an international business process outsourcing company, which says, “We have been in Argentina as an Argentine company since the 1960s so we understand about good times and bad times. You have to be very careful how you cash in and cash out – it is important to match costs with revenues.”

Companies consider that the bureaucratic and regulatory load is not especially high in Argentina: in regional terms it is considerably lower than in Brazil, and marginally higher than in Chile. The biggest bureaucratic hurdle for investors in Argentina is the relatively long time that trading licenses and permits take to obtain: 288 days, double the average time in the OECD and higher than the South American average of 206 days. Property can be registered relatively quickly (44 days compared to a regional average of 76 days), but enforcing contracts is also lengthy due to the extended waiting period before courts hear cases (the average case takes 520 days against 35 days in the OECD). The length of time to obtain licenses compares favorably with China (363 days), although both property registration and contract enforcement is on average faster in China (32 days and 241 days respectively). India also scores better on obtaining licenses (270 days) and contract enforcement (425 days) but marginally worse on registering property (67 days).\(^1\)

\(^1\) World Bank Business Environment Snapshots, 2006
Obtaining licenses and permits


Registering property


Enforcing contracts

Companies say that the costs of formal regulation are increased by corruption. Argentina scores very poorly in Transparency International’s Corruption Perception Index, ranking 109 out of 146 countries with a very low score of 2.5 out of a possible 10 (less than 3 out of 10 is considered to amount to ‘rampant corruption’). The Corruption Perception Index is a poll of polls reflecting analyst and business executive perceptions of the overall level of corruption in society.

Nevertheless, companies point out that Argentina’s corruption is primarily related to politics, rather than to business. “In terms of business practice, the quality is getting better,” says General Motors. “In terms of controls, businesses are becoming more professional.” And Chilean-headquartered GrupoNueva comments, “In the past corruption was made much worse by the protectionist policies of government. Now multinational companies are coming in with different values, and that is making a difference – a gradual difference.”

### Corporate tax in Argentina

The corporate tax burden has been rising in Argentina. This reflects recent reforms which have consolidated the tax system and increased tax rates, and the introduction of new taxes since 2001. Between 2002 and 2004 the corporate tax burden as a percentage of GDP grew from 16.5 percent to 22.5 percent.

- Corporate income tax has been rising since 1996 and almost all businesses now pay a flat rate of 35 percent. Operating losses may be carried forward up to five years but carry-back is not permitted. Depreciation rates vary from 2 percent to 33 percent depending on category of asset. Transfer pricing is monitored according to OECD rules.

- Payroll taxes have been rising, and industrial firms now pay 17 percent of gross salary while non-industrial companies pay 21 percent. Some payroll tax deductions have been abolished in certain regions and replaced with a system that allows a proportion of payroll tax (from 1.9 percent to 10.75 percent) to be treated as a pre-payment of VAT.

- VAT applies to most commercial transactions at the standard rate of 21 percent. Most VAT exemptions have been abolished since 1998; the cost of education, books and home rentals are now the only remaining exemptions. The use of debit cards attracts a VAT rebate of five percent and some credit cards attract a three percent rebate.
• Import and export taxes: exports are VAT exempt but attract a range of separate export taxes depending on the category of export (most commodity exports are liable at 20–23.5 percent; industrial exports pay 5–20 percent; agricultural goods are liable at 10 percent; oil exporters pay a sliding tax, depending on international prices, between 25 and 45 percent). Import taxes are assessed on a percentage basis that ranges from 0.1 percent to 60 percent. Some goods such as fuel are taxed by volume in addition to taxation by value.

• Financial transaction tax is charged at 0.6 percent with 0.2 percentage points allowable as a VAT prepayment on every financial transaction except transactions within the financial system. Direct salary transfers into current accounts are exempt. Supermarkets and medicine wholesalers pay a reduced rate of 0.075 percent per credit and debit.

• Other taxes include provincial and municipal sales taxes; the standard rate is three percent but can be higher. An asset tax of one percent on assets that exceed Argentine Peso 200,000 is treated as a corporate income tax prepayment but is not deductible for loss-making companies. There is no tax on dividends unless they exceed net income in the previous fiscal year; in that case a tax similar to the corporate tax rate is levied.

• Remittances: withholding tax on payments of interest to non-residents in most countries is assessed an effective rate 15.05 percent. Royalties and fees remitted to foreign licensors are subject to a withholding tax at varying effective rates. Patent royalties pay 28 percent; other royalties and fees attract an effective rate of 31.5 percent except for technical assistance not available in Argentina (21 percent) and author copyrights (12.25 percent). Rental of foreign-owned assets attracts rates of 14–21 percent. Argentina has double taxation treaties that reduce these rates with Australia, Austria, Belgium, Bolivia, Brazil, Canada, Chile, Denmark, Finland, France, Germany, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland and the U.K.

• Tax-related incentives include an accelerated amortization scheme (acceptance into the scheme is at official discretion, depending on the added value of the amortization, as well as its export and job-creation potential). Mining exploration and machinery investments also qualify for 100 percent tax deduction. Company headquarters that do not generate local income are not subject to income tax.
Wage rates in Argentina have become increasingly competitive despite high social security costs, thanks in part to the devaluation of the peso since 2002. Demand for jobs is high: official unemployment is around 13 percent but real unemployment is closer to 20 percent. A large number of workers are in ‘informal’ employment as domestic employers seek to avoid the high tax costs of formal employment. Companies frequently comment that despite strong economic growth there remains a ‘buyers’ market’ for skills in Argentina. “Skilled staff availability is excellent in Argentina,” comments one diversified industrial group, adding, “That is why Spain has had so much immigration from Argentina in recent years: it is mostly skilled and professional people looking for a better economy.”
Hiring and firing

Labor relations in the period of economic crisis and its immediate aftermath were marked by frequent and occasionally violent disputes, as foreign investors in the energy industry in particular were targeted by unions. Workers are highly organized and mobilized by labor unions, and this is reflected in the level of labor disputes: Argentina lost 253 working days per 1,000 inhabitants to industrial disputes in 2000, compared to 25 days in India and 33 days in the U.S. (the International Labor Organization has not updated Argentina’s industrial dispute data since 2000).

The government has introduced two rounds of labor law reform, in 2000 and 2004. The 2000 reform was most significant, making it easier for employers to hire on a temporary or ‘trial’ basis, and lowering payroll taxes. The difficulty of hiring is significantly greater than in China (a World Bank difficulty of hiring index score of 44 compared to 11 in China) while the difficulty of firing is the same. Both hiring and firing are much easier than in India (which scores 56 and 90 respectively on the World Bank difficulty of hiring and firing indexes).

Many companies comment on the ease with which experienced senior managers capable of managing in Argentina’s challenging economy can be recruited. “The very difficulty of doing business in Argentina and Brazil has meant that both these economies have developed a hugely talented business class, managers who know how to manage through crisis,” says GrupoNueva.
Brazil: manufacturing investment and operations

Brazil is one of the largest and most dynamic economies in South America. Although investment risk is high compared to OECD economies, corporate investors are attracted to Brazil because of its size, its growth rate, and because of the trend of steady improvement on most risk measures. “Brazil is becoming more settled and predictable,” says Luiz Murat of food group Sadia. “Of course we know there is no free lunch anywhere, but most of the signs in Brazil are positive.” And a global food and beverage company adds, “The fact that this is a market of almost 180 million people is in itself a huge advantage.” “In general Brazil is a pro-business and inviting environment,” adds forest products group Arauco. “The trend is very positive.”

On regional comparisons Brazil remains a relatively poor country that is developing rapidly with high current levels of GDP growth, foreign direct investment, and personal income growth.

Brazil’s population of 176 million accounts for almost a third of the total population of South America and the Caribbean. Brazil is somewhat poorer than the regional average: per capita annual incomes of US$2,720 are in the upper range of the lower middle income bracket and lag behind the regional average of US$3,260. On current World Bank indicators Brazil records high levels of poverty (22 percent of the population is below the national poverty line), high infant mortality (at 33 per 1,000 births), comparatively low life expectancy (average 69), and moderately high levels of illiteracy (14 percent of the population aged 15 years or above).1

Brazil remains marked by unusually sharp divisions of wealth. “Brazil has been growing fabulously,” says Ronald Degen, of GrupoNueva; “But poverty has also been growing. There is a class war between those who have and those who have not: the result of that is that there is corruption, a large black economy, and a lack of transparency. Those are the problems that investors will face. It is not that there is any lack of growth – it is that growth is so uneven.” Wealth disparities are also strongly regional and sectoral. Average industrial wages in São Paulo, for example, are around three times the level of average retail wages in the northeastern state of Bahia.

As many companies point out, Brazil’s income and poverty figures would appear worse if not for the Brazilian government’s policy of maintaining the currency, the real, at a high level against the U.S. dollar.

However, a currency that some companies regard as over-valued is outweighed by the dynamism of the economy, say some companies. “The high value of the real is not hurting as much as it might because we are achieving excellent productivity improvements in Brazil,” says Odair Bobbio, regional CFO of U.S. diversified industrial group, General Electric.

1 World Bank Business Environment Snapshots, 2006
“Also, exporters have pricing power; the prices of Brazilian exports are rising. Of course, if the market changes – if prices start to fall – then I would expect the government to review the strong real policy.”

Charles Kimber of Arauco agrees that the relatively high value of the real is manageable. He says that companies could cut costs further to maintain export competitiveness. “Companies complain about the high real but they can still make profits. If there is an export problem, it is not so much the real, but rather that Brazil needs a more efficient export infrastructure.”

Another advantage of Brazil is the sophisticated manufacturing supply chain, believes Sten Sorensen of Siemens VDO. “The availability of corporate partners is not an issue – the supply chain is very complete, and that is partly because the economy was isolated for such a long time.”

Brazil’s currency gradually strengthens

However, companies add that they find it difficult to source capital at competitive cost within Brazil. “The real is making a lot of industries very uncompetitive, as is the high cost of financing in Brazil,” warns Thomas Glatzel, CFO of Philips. “When you factor in higher than average country risk, plus foreign exchange uncertainty – the real tends to be unstable – plus the difficulty of obtaining local funds, it adds up to an uncompetitive financial cost base. Even A grade companies can’t get capital at less than 14 percent interest rates in real terms.”
Government and policy

Brazil’s government has been led since 2002 by Luiz Inácio Lula da Silva (universally known as President Lula), a former union leader who has followed a largely conciliatory and centrist business-friendly policy of reform and stabilization. Fears that President Lula’s term would be marked by a return to populist policies of high central government spending and possible suspension of Brazil’s international debt obligations have not been realized. President Lula campaigned on a pledge to meet debt repayment and public spending and borrowing targets set by the International Monetary Fund, and these pledges have been met.

“The arrival of Lula as head of the government made investors think that there was a great risk of economic policies that could break the Brazilian macroeconomic equilibrium,” says Iberdrola, the regional power and electrical engineering company. The company adds, “But Lula promised orthodox economic policies, and he has fulfilled that commitment. The risk of a policy switch is now low – and what is more, there is a good consensus in politics that the current policy direction should continue.”

Charles Kimber of Arauco agrees that the quality of government is improving the business environment. “In Brazil the fundamentals are far stronger (than in Argentina), and the economy is no longer cyclical,” he says. “Lula has been a surprise to everyone. He is very much pro-business, and there is a new focus on exports.”

Brazil has a long history of domestic over-borrowing to fund consumption, as well as sovereign over-borrowing. The result has been many boom and bust cycles of rapid growth, accompanied by inflation, currency fluctuations, and consequent debt crises. The Lula government has maintained a high interest rate policy (interest rates at an average of over 14 percent during the current administration are the highest in the industrialized world) to control inflation and limit consumption, and has succeeded in cutting external debt and improving the public sector surplus close to the target of 4.5 percent of GDP. The cost of these policies, complain many manufacturing companies, has been very high domestic costs of capital and a tax burden that is increasing in intensity and scope.

Brazil’s privatization drive

Between 1991 and 2002 Brazil sold off more than US$100 billion worth of state assets, amounting to the largest privatization program in the world.
The privatization drive made Brazil the second-largest emerging market destination for FDI in 2000, with inflows of over US$32 billion. Privatization supported Brazil’s balance of payments account throughout the 1990s: FDI fell steeply in 2002-3 with the end of the privatization program (privatization sales accounted for only US$2 billion in 2002, and nothing at
all in 2003), but the recovery of the Brazilian export sector and increased FDI in manufacturing have replaced FDI in services as a balance of payments support.

Many large state enterprises have now been sold to the private sector, with the exception of power generation and a small number of financial enterprises (the state still owns the domestic reinsurance monopoly, the Brazil Reinsurance Institute [RB], for example). Companies interviewed say they expect that private investment in power will soon constitute a second round of private infrastructure investment. “The country needs new electric power infrastructure, and the Brazilian government is requesting bids for power generation concessions,” says power utility and electrical engineering company Iberdrola, but the company suggests there is room for improvement in the process of granting licenses. “The government is managing the construction permits but leaves it up to the winners of the bid to obtain the operating licenses. These are very complex procedures, particularly because the institutions in charge of granting them have been very restrictive in the past.”

The ability of President Lula’s administration to achieve promised reforms in areas like tax reform, new investment rules for public-private partnerships, and in the reduction of bureaucracy and corruption has been severely compromised by corruption scandals in the President’s own party (the Workers’ Party or PT) relating to a ‘cash for votes’ scheme in Congress. Although the Lula administration achieved sweeping reform of the public pensions system early in its term, most companies and most independent commentators believe that further real reform is unlikely before Congressional and Presidential elections in October 2006.

However, some companies believe that the corruption scandals that dominated public life during 2005 have been beneficial. “The financial scandals in politics are negative because they reveal the depth of Brazil’s corruption problems,” says CFO of General Electric in Brazil, Odair Bobbio, who adds, “But they are positive in a different sense – they show that we are beginning to deal with the issue, and they show people that things are going to be better in the future. People are having to resign now – that would never have happened 10 years ago. So overall the signs are good.”

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1 IMF, 2001
Manufacturing in Argentina, Brazil and Chile

Thomas Glatzel of Philips voices a similar opinion. “Brazil has just been through a year-long political corruption scandal,” he notes. “Paradoxically, that has been quite positive: we have seen the first signs that people are really beginning to act on corruption. People are getting fired because of corruption. That suggests that Brazil is getting to the next level of development, where political crises do not mean that everything collapses. Compare this to the past, where political crises always led to currency instability.”

Investing in Brazil: regulations and incentives

Foreign investment in Brazil has been very largely deregulated since 1991, when the government began a program of rapid privatization. Although FDI is governed by a basic law of 1962 (the Foreign Capital Law), this has since been substantially amended, allowing foreign investment in the Brazilian stock market in 1991 and abolishing most but not all distinctions between foreign and domestic capital in 1995 with further rounds of liberalization in 2000 and 2002.

There are few controls on investment capital flows. Funds can be freely transferred between Brazilian and foreign currencies at the market-determined exchange rate, and the procedures for currency exchange transactions were greatly simplified in 2000. There are no controls on companies borrowing money abroad for Brazilian operations. However, there is an administrative requirement to register most foreign currency transactions with the central bank, and with the Brazilian patent authority (INPI) in the case of intellectual property-related currency flows such as royalty payments.

The government is trying to encourage public-private partnerships (PPPs) in infrastructure: a new PPP enabling bill was passed in 2004. However, foreign investors are still limited to no more than 30 percent ownership of Brazilian media companies, and FDI is effectively barred in a small number of sectors including nuclear energy, health services, fisheries, postal and related services and aerospace. Foreign investment in banking is subject to case-by-case approval (technically banking investment remains forbidden under the 1988 constitution, but most FDI applications since 1995 have been approved: foreign banks account for around a third of the total net worth of banking assets in Brazil).

According to Mario Mafra of Wheaton Brasil, delays in shaping an attractive regulatory framework for PPP continues to inhibit investment. “The main impediment to industrial investment in Brazil, besides high taxation and bureaucracy, is the inadequacy of the proposal for private-public partnerships,” he says. “They have not taken off because the government has not defined the regulatory limits for any sector of the economy.”
Brazil operates a number of federally administered tax-related investment incentive schemes, designed to attract foreign investment to less industrialized regions such as the north-east of Brazil and the Amazon region. Individual states have also offered tax incentives and infrastructural support to investors on a case-by-case basis.

Companies say that benefiting from tax-related incentives depends as much on relationships with local authorities as it does on objective eligibility criteria. “Good relationships at the state level and even at the city level are absolutely vital to maintaining the incentive package,” says electronics manufacturer Philips. “Having a long-standing positive relationship is very important when it comes to retaining incentives.”

One global consumer goods manufacturer adds that for new entrants to Brazil, the only viable route in many sectors is to look for local partners that can ensure that incentives and tax advantages available in theory are also available in practice. “A recent example would be Toshiba’s relationship with local electronics brand SEM,” says the company. “The classic first move is to look for a local partner. This is why non-global brands are very visible in Brazil.”
Investor disputes and arbitration

There have been no recent cases of expropriation of foreign investor assets in Brazil. However, in recent years a number of disputes have arisen over the alteration of contract terms by state governments.

Such disputes are usually settled in Brazilian courts: Brazil is not a member of the International Center for the Settlement of Investment Disputes (ICSID) although it is a signatory to the 1975 InterAmerican Convention on International Commercial Arbitration and the 1979 InterAmerican Convention on Extraterritorial Validity of Foreign Judgments and Arbitral Awards. Although it remains unclear whether binding foreign arbitration judgments are legal under Brazil's constitution, in practice many contracts with foreign investors recognize such judgments. However, uncertainty over this issue has blocked the ratification of bilateral investment agreements with numerous countries as these normally call for arbitration by either ICSID or a panel set up under the United Nations Rules for International Commercial Law.

Operating in Brazil: bureaucracy and regulation

Brazil is an economy where many companies believe that a high risk in operations is justified by growth opportunities. “Brazil is a fast-growing market, and there are much higher risks than in, say, Chile,” says an international manufacturing services group. “If you are careful you can invest in Brazil and make money, but that word ‘careful’ is important. Controlling risk is important. The most significant risk is client risk. When you work closely with clients you can build up confidence and trust. But if that doesn’t exist then quite often you will need to get pre-payments for contracts, unusual in Europe but quite common in Brazil.”

High on the list of operating challenges for many companies are the complexity and cost of taxation rules, and the burden of bureaucracy and corruption.
Companies’ perceptions of business challenges

<table>
<thead>
<tr>
<th>Percentage of firms identifying indicator as a major or severe obstacle to business</th>
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<tbody>
<tr>
<td>EP - Economic and regulatory policy uncertainty</td>
</tr>
<tr>
<td>MI - Macroeconomic instability</td>
</tr>
<tr>
<td>C   - Corruption</td>
</tr>
<tr>
<td>CD - Crime, theft and disorder</td>
</tr>
<tr>
<td>AC - Anti-competitive practices</td>
</tr>
<tr>
<td>LS - Legal system</td>
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<tr>
<td>AL - Access to land</td>
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<tr>
<td>TR - Tax rates</td>
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<td>TA - Tax administration</td>
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<td>CT - Customs and trade regulations</td>
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<tr>
<td>LR - Labor regulations</td>
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<tr>
<td>SE - Skills and education of workers</td>
</tr>
<tr>
<td>BP - Business licensing and permits</td>
</tr>
<tr>
<td>AF - Access to financing</td>
</tr>
<tr>
<td>CF - Cost of financing</td>
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</tbody>
</table>

Source: World Bank, 2005

An intellectual property enforcement challenge

Companies say that most problems in protecting intellectual property in Brazil relate to enforcement, rather than policy. Brazil is a signatory to most updated international intellectual property agreements, including the Trade Related Aspects of Intellectual Property (TRIPS) Agreement. Brazil is a member of the World Intellectual Property Organization (WIPO) and a signatory of the Bern Convention on artistic property, the Washington Patent Cooperation Treaty, and the Paris Convention on Protection of Intellectual Property. The 1996 Industrial Property Law brings Brazil in line with most although not all standards in patent and trademark protection.

An outstanding issue in patent protection is the compulsory licensing provisions of the Industrial Property Law, which in principle makes patent owners liable to compulsory licensing provisions if they do not exploit their patents within Brazil within three years of the patent’s establishment. However, compulsory licenses have yet to be granted. Brazil lacks legislation to protect integrated circuit layouts, although a draft bill has been under discussion since 1996.
Piracy of copyright material and counterfeiting of trademark-protected goods remain widespread, despite the fact that penalties for IP theft were greatly increased in legislation passed in 2003. In 2004 the Brazilian government created a new inter-ministerial initiative (the National Council to Combat Piracy and Intellectual Property Crimes) to develop a new national plan for controlling IP theft.

The costs of procedures for business startups and closures in Brazil are significantly higher than the average of OECD countries, higher than for the South American region as well as higher than for either Argentina or Chile. A U.S. food group comments, “In Brazil generally the bureaucratic load is heavier than either in Argentina or Chile.”

**Business startups**

<table>
<thead>
<tr>
<th>Procedures (number)</th>
<th>Time (days)</th>
<th>Time (years)</th>
<th>Cost (% of estate)</th>
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<tbody>
<tr>
<td>Brazil</td>
<td>Region</td>
<td>OECD</td>
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<tr>
<td>150</td>
<td>120</td>
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Companies consider that operational costs in Brazil are high, and represent a significant drag on competitiveness. For example, a business startup requires 152 days, compared to only 32 days in Argentina and less than 20 days on average in the OECD; a business closure will require an average of 10 years, compared to 2.8 years in Argentina and 1.5 years in the OECD. Import and export transactions (39 and 43 days respectively) are around three times the average in the OECD. These figures are worse overall than India, and much worse than China.1

Many companies comment on the unusual intensity of bureaucratic regulation in Brazil. Typical is pharmaceuticals manufacturer Roche, which says that “Brazil is characterized by a highly bureaucratic public system, where the use of intermediaries for even the simplest red tape in dealing with any governmental entity is necessary”.

1 World Bank Business Environment Snapshots, 2006
Companies believe that part of the bureaucratic load is due to the fact that regulatory agencies for sectors such as telecommunications, energy and transportation are a relatively young phenomenon in Brazil: among government agencies, the National Petroleum Agency (ANP) is commended by the industry for its fair handling of auctions of oil exploration blocks and its willingness to assist industry in seeking to simplify regulatory procedures such as environmental licensing. The federal government in 2003 passed legislation setting fixed three-year terms for directors of the regulatory agencies. New legislation to further clarify the roles and responsibilities of the regulatory agencies and consolidate the multiple laws governing each separate regulator is being considered by the Congress.

**Cross-border trading costs**

![Cross-border trading costs graph](image)

*Source: World Bank Business Environment Snapshots, 2006*

**Obtaining licenses and permits**

![Obtaining licenses and permits graph](image)

*Source: World Bank Business Environment Snapshots, 2006*
Registering property

![Bar chart for Registering property](image)


Enforcing contracts

![Bar chart for Enforcing contracts](image)


Bureaucracy and corruption – the “twin Brazilian evils” according to a U.S. agribusiness group – are also cited by foreign investors as strong disincentives to bid for public contracts.

Several companies comment, that despite bureaucracy, the quality of the financial system remains outstandingly good. “The Brazilian financial system is the best in the world,” believes Sten Sorensen of Siemens VDO. “Nowhere else in the world is the system of financial transactions so reliable and so fast. That is a legacy of very high inflation rates in the past.”
Brazil scores significantly better than Argentina in Transparency International’s Corruption Perception Index, ranking 59 out of 146 countries (compared to Argentina’s score of 109), with a low score of 3.9 out of a possible 10. The Corruption Perception Index is a poll of polls reflecting analyst and business executive perceptions of the overall level of corruption in society.

Corporate tax in Brazil

Many companies consider taxation to be the most significant disincentive for investment in Brazil. Pharmaceuticals manufacturer Roche adds “The taxation structure is too complex, and easily interpreted in an abusive way by the tax authorities. States use the tax system to encourage existing businesses or new investors to move location, while tax strategy is fundamentally a short-term one looking for immediate collection targets, without a long-term view that would promote economic growth and increase future public revenues.”

Uncertainty over tax liability is also an issue for investors. “The biggest risk factor from our point of view is uncertainty,” says General Electric. “You can have changes in taxation rates at any time, and it is very difficult to know what your liability is going to be next week. From that point of view Brazil is worse than Argentina.” Luiz Murat of Sadia considers that taxation would be less of a burden if companies did not have to compete with the informal market. “Taxation in Brazil can amount to a tremendous disadvantage, and a disincentive for companies to invest,” he says. “For example, Sadia was the largest slaughterer of beef cattle in Brazil up until 1999. But the VAT system made it impossible for us to compete against the informal market slaughterers who pay no VAT and no social contributions, and as a result we sold all our facilities except one.”

The tax burden is rising: tax receipts grew 16.9 percent in the first half of 2005 year on year. The tax system is undergoing a continual process of reform: a major reform in 2005 saw the merging of the federal taxation and pensions agencies to create a single taxation and public pensions agency, the Brazilian Federal Revenue Agency.

- Corporate income tax (IRPJ) has remained unchanged at an effective 34 percent for some years, although deductibility has altered frequently. The IRPJ base rate is 15 percent; companies also pay a 10 percent surcharge on monthly income exceeding BRL20,000 and a mandatory contribution to the social-security system (CSLL) at 12 percent, although certain businesses may pay up to 32 percent. Operating losses may be carried forward indefinitely, limited to 30 percent of each year’s taxable income.
Carry-backs are not permitted. Depreciation is allowed at rates between 4 and 25 percent depending on asset; higher rates are allowed for companies with high capacity utilization rates or in special cases requiring an independent asset utilization analysis. Transfer pricing is regulated by Brazilian law.

- There are three important taxes on turnover or billings: national social security tax (CINSS) charged at varying rates on sales; provisional financial transaction tax (CPMF) at 0.38 percent until 2007 when it is due for abolition; and social integration program tax (PIS/PASEP) payable on monthly gross revenue at 1.65 percent for most companies.

- VAT includes standard VAT on manufactured goods (IPI) with rates varying from 0 percent up to 365.6 percent for some luxury goods; VAT on financial transactions (IOF) such as interest payments on domestic bank credit and insurance at 0-25 percent, although most foreign capital is exempt; and social security tax (Cofins) which was recently reformed as a unified VAT at 7.6 percent (Cofins now represents almost a quarter of Brazil’s tax revenue).

- Local taxes: Brazilian states and the federal district of Brasília impose VAT on goods and services (ICMS) at varying rates, and taxes on inheritances, gifts and motor vehicles. Municipalities charge taxes on services (ISS) at 2-5 percent, urban property holdings (IPTU) and urban property transfers (ITBI).

- Tax-related incentives are numerous but modest in value. Special corporate income tax deductions apply to investments in northern Brazil, and investments in computers and employee training. From June 2005 tax exemptions were introduced for companies that earn at least 80 percent of their revenue from export-related activities, including exemptions from PIS/PASEP and Cofins taxes on investments in industrial goods and technology. There are no tax provisions to encourage international companies to establish regional headquarters in Brazil.

- Remittances: interest remitted abroad is subject to a 15 percent withholding tax as are royalties and other fees paid to foreign companies (royalties and license fees are deductible up to 5 percent of pre-tax income). Tax may be lower for countries where Brazil has double-taxation treaties, which include Argentina, Austria, Belgium, Canada, Chile, China, the Czech Republic, Denmark, Ecuador, Finland, France, Germany, Hungary, India, Italy, Japan, Luxembourg, the Netherlands, Norway, the Philippines, Portugal, South Korea, Spain and Sweden. Brazil has signed, but not yet ratified, tax treaties with Israel, Mexico, Paraguay and Ukraine. Negotiations with the United States are ongoing.
• Other taxes: special taxes apply to corporate formation, real estate transfers and rural land ownership. Vehicle owners pay an annual ownership tax and a stamp tax for use of federal highways. Owners of urban property pay an annual municipal property tax.

Brazil’s tax bureaucracy

Labor

Overall, companies find that labor availability, direct cost and productivity in Brazil is good enough to be an incentive to invest. “There is no skill shortage in Brazil – the trained labor pool is excellent,” says one U.S. food group, adding, “Brazil is cheaper than Mexico, and overall there is no problem of cost or of availability.” But some companies find that certain seniority levels are still difficult to fill.

“Shop floor skills in manufacturing are not the biggest challenge, because there is high unemployment and it is easy to train labor,” says electronics manufacturer Philips. “And at the top level it is also quite easy to find experienced Brazilians, managers with global experience. But at middle-management level it is different: at the middle level there is considerable shortage of talent.”

Nevertheless, Philips says that compared to China, “Brazil is a better location. In China there is a huge shortage of both middle-level and senior-level talent.” Companies also tend to prefer the workplace atmosphere of Brazil. “The great advantage of Brazil is the willingness of Brazilians to engage in work,” says Sten Sorensen of Siemens VDO. “If you go down a production line in Brazil people are happy, they enjoy their work, and they want to do it to perfection.”

Women account for an increasing share of the employed labor force – currently over 40 percent. Registered unemployment is high at over 10 percent, although this figure is likely to be an over-estimate as informal untaxed employment is estimated to account for more than half of all actual employment in Brazil. Self-employment is unusually high, accounting for a quarter of formal employment. Under the Labor Code all workers in formal employment are guaranteed relatively generous terms of employment, including 30 days’ annual vacation and an annual bonus of one month’s salary.

Real wages have been rising over the last two years: the minimum monthly wage was raised in 2004 to 260 reals, and the average urban wage was 905 reals in 2004. Regional average wage rates are considerably higher in the industrialized southeast than in the less developed northeast. Brazilian workers are on average slightly less well educated than workers in Argentina and Chile.1

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1 U.S. Department of Commerce, 2006
The difficulty of hiring is considerably greater than in China (a World Bank difficulty of hiring index score of 67 compared to 11 in China), yet the difficulty of firing is much less (a World Bank index of 20 compared to 40 in China). The difficulty of hiring is only marginally less than in India, while the difficulty of firing is much less (India has a difficulty of hiring index score of 90).

Labor unions in industrialized regions of Brazil are well organized, especially in traditional manufacturing businesses, and are represented in many governmental and business federations. Around 12 percent of the workforce is formally unionized, but the results of collective bargaining over pay affects more than twice this number of workers (this is in part because unions are largely funded by mandatory employer contributions and represent all workers in a profession or region irrespective of whether workers are formal union members). Although Brazil has a very large number of unions, they are grouped in four large federations or 'centrals': the Workers’ Unitary Central (CUT); the Union Force (FS); the Workers’ General Confederation (CGT); and the Social Democratic Union (SDS).1

Disputes are dealt with by specialized labor courts which are exceptionally slow to deliver judgments: five years is not unusual for a routine dispute. Labor courts deal with routine pay and conditions bargaining issues that in most other countries would be settled between companies and unions, although the rate at which disputes go to court has been declining. Nevertheless strikes are common, particularly in the public sector.

Companies are generally upbeat about organized employer-union relations: many believe that the quality of relations with labor unions has improved markedly in the last decade and a half. “Brazilian companies are more conscious of their social responsibility and the unions are more pragmatic and less ideological,” says Wheaton Brasil. “For these reasons negotiations are more balanced and more effective.” And according to one U.S. food group, “Brazilian labor relations work. The labor environment is not perfect, but it works. One feature of Brazil is that a lot of labor issues tend to go to court rather than being settled between employers and unions, and the court system overall is good and fair. Brazilian labor unions are organized by state – there isn’t a federal dimension, and that means they are weaker than they would be if centralized.”

1 U.S. Department of Commerce, 2006
Some companies point out that such positive views represent a new era in labor management in Brazil. “Brazilian labor unions are very receptive to the need for productivity improvement, but that wasn’t always the case,” says Odair Bobbio of General Electric. “Labor relations have been very productive over the last two or three years, but this is quite different to how things were in the previous 10 years. Today unions realize that productivity is a job issue – productivity means lower prices, lower costs, and better competitiveness.”

“It is really not necessary to have union problems in Brazil,” adds Sten Sorensen of Siemens VDO. “I would rather deal with a union problem in Brazil than in the U.S. or in Europe. Things are probably getting marginally worse rather than marginally better, but we are still a lot better off than elsewhere.”

**Hiring and firing**

[Chart showing hiring and firing data for Brazil, Region, and OECD]


Overall, companies now appear to see labor in Brazil as more a resource and less a management and cost challenge. “I no longer see a problem,” says Mario Mafra of Wheaton Brasil. “Knowledge in Brazil, just as in the rest of the world, is a commodity that is available for anyone who is prepared to pay for it.”
Chile: manufacturing investment and operations

Chile is the smallest and by far the most stable and predictable of the ABC economies, considered by many companies to be akin to a European economy in terms of investment risk. Chile is highly dependent on and open to international trade, and is seen by many as a model for economic reform in South America. However, investment opportunities are limited by Chile’s small size and geographical isolation.

“Chile has a solid economy and well-established and reliable institutions,” says an international business process outsourcing company. “The only real difference between Chile and a European country is that Chile is in South America – the main risks are neighbor risks, and also there are physical communication difficulties.”

“Chile is pro-business,” agrees Arauco’s Charles Kimber. “There have been decades now of good macroeconomic management and good microeconomic management. There have been low tariffs and there are trade agreements with everyone you can think of. Yet Chile will never be taken seriously as a manufacturing center – it is just too small.”

Chile’s population is very small at 15.8 million inhabitants; it is one of the wealthiest regional economies in per capita income terms ($US$4,390 against the regional average of US$3,260) putting Chile in the World Bank’s upper middle income bracket. Some 17 percent of the population remains below the national poverty line; life expectancy (76 years) and infant mortality (10 per thousand births) are better than either Argentina or Brazil, and illiteracy is very low for the region at only 4 percent of the population.1

Modest peso decline has reversed

Source: OANDA, 2006

1 World Bank Business Environment Snapshots, 2006
Government and policy

Chile’s record of stable government and moderate business-friendly policy is outstanding in the region – a record of stability, accountability and good economic management matched by no other South American state. This record is all the more remarkable given that Chile has emerged in recent memory from the period after the 1973 coup which saw the leftist regime of Salvador Allende replaced by a military dictatorship led by General Augusto Pinochet.

A civilian democratic government took power in 1990 and built on economic reforms initiated by the military government. The center-left governments that have ruled Chile since 1990 have emphasized economic caution and continuity of policy.

In presidential and congressional elections in December 2005 the candidate of the ruling center-left coalition, the Concertacion de Partidos por la Democracia (or ‘Concertacion’) Michelle Bachelet, won a five-year term and is expected to continue the moderate economic management approach of her predecessor Ricardo Lagos. “We will have continuity of policy,” says Mr Jorge Rodriguez, Economy Minister until March 8 2006. “There is a consensus in Chile about the need for a stable macro-economic policy.”

Growth has been consistently high since the introduction of civilian government; in common with other South American economies Chile experienced a downturn after 1999, although this was less pronounced than in either Argentina or Brazil. Recent growth rates have been strong, with GDP increasing over 6 percent in 2005 as investment and consumption has boomed; at the same time Chile maintains a strong public sector surplus. Inflation remains low and within the official target range of 2-4 percent, although monetary policy is expected to tighten moderately during 2006. Some economists forecast Chile recording a small trade deficit in 2006, although exceptionally high prices for copper (Chile is the world’s largest producer of copper) may prevent this.

Investing in Chile: regulations and incentives

Foreign investment in Chile is easy to accomplish and largely free of impediments. Throughout the 1990s Chile attracted very high levels of FDI for an economy of only US$72 billion and a population of less than 16 million: the country has the highest FDI per capita ratio and the highest FDI to GDP ratio in South America.¹

“We don’t have an industrial policy any more,” says former Economy Minister Jorge Rodriguez. “We have no sectoral policy, and we have no investment promotion policy. We believe it is growth that will bring investment, not incentives. We had an industrial policy 40 years ago and frankly it was a failure.”

¹ World Bank Business Environment Snapshots, 2006
He adds, “We treat foreign investors exactly the same as we treat Chilean investors. As a result about 60 percent of our GDP has come from foreign investment. We give foreign investors complete freedom to repatriate profits without any constraints at all.” Investment is governed by Decree Law (DL) 600 of 1974, which is administered by the Chilean Foreign Investment Committee (FIC). There are few controls on FDI in terms of ownership limits or closed sectors, and DL 600 prohibits the state from altering the terms of any FDI contract after it has been signed. Investment contracts can be implemented over any period up to three years (and longer for industrial or mining investments). All foreign investors have a legal right to treatment equivalent to domestic investors, to hold assets indefinitely and to remit any earnings at any time. Foreign investors can either choose to be taxed as domestic firms (the current corporate tax rate is 35 percent) or at a guaranteed tax rate (currently set at 42 percent) for a period of up to 20 years, irrespective of variations in domestic tax rates.

The remaining limits on FDI are primarily in fisheries and the media sector, where FDI is only permitted if investing companies are based in a country that allows equivalent investments from Chile. Mining, fisheries, banking and insurance investments require authorizations from ministries or regulatory bodies. Telecommunications investments are subject to license, and licenses may be limited. Projects with environmental impact require authorization from the National Environmental Commission (CONAMA) or the Regional Environmental Commission (COREMA).

There are no controls on the transfer of capital into or out of Chile, other than administrative controls and there are no generalized foreign investment subsidies or tax exemptions available. However, there are regional incentives available through co-financing of feasibility studies and land purchase incentives, as well as accelerated depreciation tax treatment for retained earnings. There are two tax-free zones, in the northern port of Iquique and in the southern city of Punta Arenas. Manufacturers in these zones are exempt from corporate tax and VAT and customs duties where goods are re-exported (products that are sold within Chile must pay VAT and import duties on leaving the zone). The same exemptions are available in two industrial parks (Chacalluta and Las Americas) in Africa.

Chile’s laissez-faire attitude to inward investment is in strong contrast to the interventionism of both the socialist government under Salvador Allende and the early years of the subsequent Pinochet regime, which subsidized manufacturing heavily on a regional basis. General Motors (the only automaker that continues to assemble vehicles in Chile) was one of a number of auto manufacturers that benefited from the subsidy regime, which was concentrated on the marginal northern region of Arica (where subsidies were used in part to secure the region...
against territorial claims from neighboring Peru). “Chile used to give a lot of incentives to locate there – at one time there were 10 automakers with plants in Arica,” says General Motors. “Then the Socialist government under Allende came in and confiscated all the plants, including ours. Then Pinochet came in and gave the plants back, until finally in the 1990s Chile chose to follow a different business model where now they subsidize the population of marginal regions directly, rather than through companies. Today there are no real manufacturing subsidies in Chile.”

The Chilean government says that it is not concerned about the relatively low proportion of FDI that is going into manufacturing, saying that Chile now needs to develop manufacturing selectively in areas downstream of the economy’s strengths in commodities and agriculture. “Only 13 percent of FDI goes to manufacturing but that’s not a problem,” says former Economy Minister Jorge Rodriguez. “We know we have to develop in areas where we have advantages. For example, we didn’t have a salmon industry in 1980 – now we are the world’s biggest exporter of salmon and salmon products. That means not only a primary agricultural business, but also processing and new agricultural technologies. In forestry, 15 years ago we were exporting logs and a little wood pulp. Now we have moved much further up the chain, with much more manufacturing value added in forestry products.”

An international manufacturing services company agrees. “Chile has done very well at what it does best, which is to focus on specialized smaller-scale manufacturing rather than on building an integrated manufacturing economy,” he argues. “Specialization is the way to succeed.”

The long-term FDI record

Source: UNCTAD/IMF, 2005
In 2002 Chile launched a new FDI incentive called the Investment Platform Initiative designed to attract international corporate headquarters operations to Chile. The Investment Platform operates as a tax shield in cases where companies based in Chile might otherwise be liable for taxation in multiple jurisdictions. Investment Platform companies are exempt from Chilean tax on profits derived from investments outside Chile, although they must pay tax on profits from investments within Chile.

One company that has taken advantage of the Investment Platform tax regime is GrupoNueva: the company’s CFO says, “We did move our global HQ to Chile, because the tax advantage for HQs is attractive. But the important thing about Chile is that they don’t over-tax you anyway, and the country has a stable financial market.” Former Economy Minister Jorge Rodriguez adds, “The Investment Platform program is partly there to overcome the triple taxation problem, but also to capitalize on the favorable business environment. We want to say to companies, if you want to work in South America why not locate your HQ functions and your high-tech workers in Chile where you will get a great education system, a good banking environment, and a predictable and stable business environment?”

Strict controls on capital flows were in force from the late 1980s to the early 1990s, but these have now been largely lifted, although the central bank retains the right to reimpose the one-year lock-in or ‘encaje’ for investment capital (lifted in 2000). Central bank approval is no longer required for repatriation of profits or dividends, although royalty payments in excess of 5 percent of sales can be restricted by the central bank.

**Investor disputes and arbitration**

Although the Chilean government has the legal right to expropriate property for reasons of national interest, such expropriation requires immediate payment of compensation at market prices, and there have been no cases of expropriation since 1973.

Many investor disputes are settled in Chilean courts, which are widely considered to be transparent and independent by international standards. Some bilateral investment treaties allow investors to opt for international arbitration, while others require disputes to pass through the Chilean legal system before being referred to international arbitration. Chile is a member of the International Center for Settlement of Investment Disputes (ICSID).
Operating in Chile: bureaucracy and regulation

Companies accustomed to the regulatory and bureaucratic challenges of working in South American economies universally praise the efficiency and transparency of public administration in Chile. “There is not really much that needs improvement in Chile,” says Ronald Degen of GrupoNueva. “You could argue that there is a problem with the over-valued currency, and some exports suffer from that. But the fact is that everybody is very bullish in Chile.”

Companies remain concerned about IP protection

Protection of intellectual property rights in Chile continues to be an issue of concern to companies: Chilean authorities have made increasingly strenuous attempts to control counterfeit and pirated goods, but sanctions in Chilean courts have proved difficult and slow to obtain, and cases frequently result in light sentences by international standards.

Chile is a signatory to the TRIPS agreement, and finally approved legislation in 2003 to bring Chilean copyright protection closer into line with the TRIPS obligations. Chile signed the World Intellectual Property Organization (WIPO) Treaties on Copyright and Performances and Phonograms in April 2001.

The weakness of Chilean patent law is an issue of continuing concern, and has been a matter of dispute between the United States and Chile. In particular the U.S. has objected to the Chilean Institute of Public Health’s granting of approvals to unauthorized copies of patented products as well as of products whose patent application is in process. Trademark holders have also complained of inadequate enforcement of trademark rights.

Although companies frequently remark on the ease of doing business in Chile, the amount of time and number of procedures required to achieve business startups, closures and cross-border trading transactions are significantly more than the OECD average, although somewhat better than the South American average. For example, a business startup requires 27 days, compared to less than 20 days in the OECD; however, this is better than either Argentina (32 days) or Brazil (152 days). Business closures at 5.6 years take longer than in Argentina (2.8 years) or in the OECD (1.5 years), although closures in Brazil can take as much as 10 years.¹

¹ Business Environment Snapshots, 2006
Business startups

Export and import transactions (23 and 24 days respectively) are almost double the OECD average, but somewhat better than either Argentina or Brazil. These figures are comparable with startup, closure and import and export times achieved in China; they are much better than in India, where startups take an average of 71 days, closure an average of 10 years, and import and export periods are around one-third longer.¹

Cross-border trading costs

¹ World Bank Business Environment Snapshots, 2006
Companies remark on the willingness of Chilean authorities to update the legal framework for highly regulated industries. “For example, Chile faced natural gas shortages due to export restrictions imposed by Argentina, and needed to reduce dependence on Argentine imports,” says power utility and electrical engineering company Iberdrola. “Chile moved quickly to reform the regulatory framework to allow a higher but more stable price of electricity. Chile understands the need to allow the kind of prices that will attract investment. We do not expect the government to intervene to push down prices.”

However, potential investors stress that for all Chile’s stability and predictability, investment will continue to be limited by the realities of geography. “Labor costs are similar to Argentina, the tax environment is more attractive and more predictable, and the infrastructure in Chile is good,” says General Motors. “But even taking all that into account you will always still have an infrastructural disadvantage, due to its relative isolation.”

Companies say that the bureaucratic and regulatory load is low in Chile. Trading licenses and permits are obtained in less than the regional average, although somewhat above the OECD average. Property can be registered quickly (31 days on average) and it takes 305 days on average to complete a contract enforcement case, much faster than in either Argentina or Brazil. Obtaining permits is significantly faster than in either China or India; however both property registration and contract enforcement is on average faster in China (32 days and 241 days respectively), although slower in India (270 days and 67 days respectively).  

### Obtaining licenses and permits

![Chart showing procedures and time for obtaining licenses and permits in Chile, Region, and OECD.]


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1 World Bank Business Environment Snapshots, 2006
Chile scores unusually well on international measures of transparency and corruption. “Corruption levels in Chile are very low compared with South American standards,” confirms Iberdrola. Chile scores highly on Transparency International’s Corruption Perception Index, ranking 20 out of 146 countries, ahead of France, Spain and Japan (compared to Argentina’s score of 109 and Brazil’s score of 59), with a high score of 7.4 out of a possible 10. The Corruption Perception Index is a poll of polls reflecting analyst and business executive perceptions of the overall level of corruption in society.
Corporate tax in Chile

Chile’s tax regime is simple and predictable. The direct corporate income tax burden has risen modestly in recent years but for most businesses is still lower than in Argentina and Brazil, while the burden of indirect taxes is considerably lower. Tax-related incentives are few, the main incentive being the option to use Chile as a tax shelter against double and triple taxation for regional headquarters.

• Corporate income tax is assessed in two stages. Corporate income is liable for a ‘first-category’ tax of 17 percent; ‘second category’ tax at 35 percent is levied on profits distributed to shareholders or partners, or repatriated to a parent company abroad, with ‘first category’ tax being treated as a tax credit. The minimum effective corporate tax rate is therefore 17 percent, with the maximum up to the 35 percent ceiling depending on the amount of earnings re-invested. Foreign direct investors can opt for a different regime (DL 600) in which corporate income tax is fixed at 42 percent for 10 years irrespective of changes in the standard rate. Most direct business costs are deductible.

Depreciation is usually calculated by the straight-line method, and depreciation periods have recently been shortened; some companies can negotiate accelerated depreciation programs with the tax authorities for assets acquired after 1977.

• VAT is levied at 19 percent on sales of most goods and some services; real estate trading is exempt, as are some capital goods purchases by foreign investors. Penalties for non-payment can be stringent, including fines and closure of businesses for up to 20 days. Repeat offenders may be imprisoned. Exports are VAT exempt. Luxury items are liable to higher VAT rates of 47.9-51 percent.

• Chile’s only significant tax-related incentive is the Investment Platform Law of 2002 which allows multinational companies to avoid double taxation on earnings from their international operations if their headquarters are in Chile. Investment Platform companies are subject to special requirements designed to prevent evasion of taxes on local earnings.
• Remittances: the standard rate of withholding tax for services provided abroad to entities not domiciled in Chile is 35 percent; royalties are subject to a 30 percent rate; and technical assistance is taxed at 20 percent. Powers exist to increase these rates to 80 percent for services considered not to further economic development but are not currently used. These tax rates may be reduced for countries with which Chile has double-taxation treaties, including Argentina, Brazil, Canada, Ecuador, Mexico, Norway, Peru, Poland, South Korea, Spain and the U.K. Treaties under negotiation or awaiting ratification include those with China, Croatia, Cuba, the Czech Republic, Denmark, Finland, France, Hungary, Ireland, Italy, Malaysia, the Netherlands, New Zealand, Paraguay, Russia, Sweden, Switzerland, the United States and Venezuela.

• Other taxes: interest payments are subject to the 35 percent ‘second category’ corporate income tax unless they are paid to foreign banks or authorized foreign financial institutions, when the rate falls to 4 percent. This is the basis of a widely used tax-avoidance scheme that uses back-to-back loans contracted with foreign banks. At present foreign loans at the lower tax rate are permitted up to 75 percent of an investment. Real estate is subject to a municipal land tax at an annual rate of 1.5 percent of assessed value. Local municipalities also levy business license taxes at varying rates.

### Chile’s tax bureaucracy

![Chart showing payments and time for different regions and countries](chart.png)

Labor

Overall productivity

Chile’s labor relations climate is benign: strikes are infrequent by regional standards, and many fewer days are lost to industrial disputes than in Argentina or Brazil. Also, the great majority of labor disputes take place in the public sector and do not directly affect private sector businesses.

Bargaining over pay and conditions with labor unions is highly flexible in Chile: multi-union workforces are common, and it is largely up to companies whether they negotiate pay and agreement conditions collectively or on a union-by-union basis. Most pay and conditions agreements are concluded at the individual business level, although moderately generous minimum wage, maximum work week and holiday entitlements are established by law. Maternity benefits are also generous: female workers get 18 weeks’ maternity leave and an extended two-year period of immunity from layoffs. The maximum work week was reduced to 45 hours from 48 hours in 2005 (the result of an earlier presidential election campaign pledge).

"Chile has plenty of cheap labor, especially unskilled labor, with an unemployment rate among this group of workers often higher than 20 percent while the national average is 9 percent," comments Iberdrola. "But Chile also possesses plenty of skilled technical and professional labor, and at the executive level they are rated among the most qualified in the region." Nevertheless, some companies caution that businesses can find it difficult to recruit talent at certain levels of seniority. "There is a skills issue, especially at the middle-management level," says Charles Kimber of Arauco. "At the top there is a very small, very talented labor pool. At the bottom unskilled labor is good, and productive, and disciplined."
The ease of hiring and firing in Chile is a significant advantage for investors. The difficulty of hiring is much less than in India (a World Bank index score of 33 against 56 for India) but somewhat greater than in China (a World Bank index score of only 11). Firing is easier than in either India or China, and also easier than in the OECD and the South America region.

### Hiring and firing

![Graph showing hiring and firing indices](image)


Some companies raised the concern that the labor law has become more rigid, raising the costs of layoffs, raising minimum wages and also raising barriers for new hireings, resulting in increased unemployment among unskilled workers. Relating unions, the level of union organization is low, presumably because, in general terms, the legal framework favors the employee over the employer.

However, former Economy Minister Jorge Rodriguez says that companies can expect more deregulation of the labor market in the new president’s term. “We need to make it easier to hire part-time workers, and easier to get women into work,” he says. “We have no plans to change women’s maternity leave rights but what we will do is work to make part-time work for women easier. And we will ease the minimum wage restrictions for the employment of young people.”
Conclusion

This report addresses the question of whether large companies believe the ABC economies of South America are becoming increasingly ‘normal’ investment destinations for international manufacturing operations, where political and economic risks are at least comparable to risks in the high-FDI locations of Asia and Eastern Europe.

The high level of manufacturing FDI that Argentina, Brazil and Chile have attracted during the last two years would seem to suggest that conditions in those economies have changed. The outstanding question is whether investors are merely taking advantage of short-term growth cycles on high-risk terms, or whether there has been a more deep-rooted change in the mix of domestic policymaking and global economic conditions that determine investment attractiveness.

Global conditions have certainly favored manufacturing FDI, suggesting that the recovery in FDI in the ABC economies is at least partly driven by factors unrelated to change in South America. Firstly, global growth has been high: average global GDP growth was higher in 2004 than at any time in the previous two decades; 2005 was only marginally slower, while early indications are that growth in 2006 may be accelerating again.¹ Economic growth and the industrialization of Asia, particularly China, has fueled demand for energy, industrial inputs and manufactures, all of which the ABC economies export.

Freer trade and lower interest rates worldwide have also driven manufacturing investment in the ABC economies. In the last 20 years trade tariffs have fallen more steeply in South America than in any other global region, bringing average tariff levels close to OECD levels.² Average interest rates worldwide have been at a historic low for the last decade, dramatically reducing the cost of capital for direct investors.

A more realistic attitude to the likely returns from investments in East Asia may also be behind some companies’ increased interest in South America. “A lot of companies became euphoric about China,” says Sten Sorensen, CEO of Siemens VDO in Brazil. “Now they are getting experience in China and they find it is not as easy or as simple as they thought to make profits there. And they start thinking that perhaps South America is not all that bad after all.”

In many emerging economies, attitudes towards manufacturing FDI have also changed. A policy of import substitution behind trade and non-tariff barriers has given way to a more open approach to direct investment, allowing companies to develop a globalized manufacturing network. States that have benefited most from this increase in cross-border manufacturing investment have been those

¹ The Economist, 2006
² World Bank, 2004
that have provided a set of stable policies towards international investors, with relatively easy regulatory and licensing conditions and a positive attitude to companies’ concerns on the business environment, especially issues of labor, infrastructure, IP protection and taxation.

In the recent past these requirements have not been met in Argentina and Brazil, say companies, although they have been met in Chile. Are there signs of positive change? On the basis of corporate interviews conducted for this report, the answer is a heavily qualified yes.

**Argentina** remains the riskiest investment destination among the ABC economies. Manufacturing investment is no longer threatened by direct appropriation, or de facto appropriation in the form of ‘pesofication’ of contracts and blocked repatriation of profits or assets. Yet companies believe that attitudes to FDI remain strongly negative. “The problem in Argentina is the political and business culture,” says an international business process outsourcing group. “The culture does not protect foreign investors, and this is a very dangerous situation for Argentina. They believe that companies ought to invest there, but there is no concept of investment in terms of risk and reward.”

Companies say these attitudes are reflected in the protracted and acrimonious negotiations between the Argentine government and infrastructure investors over the alteration of the terms of utility contracts struck in the 1990s. This leads many companies to take a strictly pragmatic attitude towards manufacturing investment.

Several companies express the view that investing in Argentina is still a matter of making money while conditions are good, while expecting another debt and inflation crisis. Says Sten Sorensen of Siemens VDO: “Investors still do not want to venture into Argentina. There is still a job of shaping the operating environment, the privatized companies are mostly in very poor shape, and the government’s approach to contracts is not helping either. Government is still using the typical South American policies of controlling prices while subsidizing key businesses – and that means that a close encounter with reality is still likely, some time soon.”
Nevertheless, some companies continue to recommend Argentina as a destination for cautious and well-founded manufacturing investment. “Argentina has been very good for us,” says Charles Kimber of Arauco. “It is a dangerous place for a speculator, but a good location if you focus on operations. The key to success is not being speculative, and looking at processes and efficiency. That is particularly important in a country that tends to focus on financial investments and quick returns.”

Corporate investors consider Brazil to be in sharp contrast to Argentina, and clearly the most attractive of South America’s economies for direct manufacturing investment. Brazil’s size and economic growth potential is allied to a marked improvement in the business environment.

“Brazil is improving. The economy is normalizing, and the exchange rate is fairly stable,” says a U.S. food group, adding “A lot of investment is going into Brazil: country risk is priced lower than at any time in the last 10 years. We invested US$250 million in 2005 and we will invest more in 2006.”

Companies point to the positive economic management of the Lula government in Brazil as the most important of the factors that have changed the investment atmosphere. President Lula’s administration has reduced external and internal debt and encouraged direct and portfolio investment, despite opposition in Congress. “There is evidence of the slow maturing of Brazil as a state,” says Thomas Glatzel of Philips. “Brazil still has to go through political crises. But if it can do that without the currency collapsing and exports collapsing and investment collapsing, that shows this is becoming a more resilient system where there is more underlying confidence. We have certainly not forgotten the past – but we are reasonably confident that underlying confidence is growing.”

Luiz Murat of Sadia agrees. “Brazilian institutions are much stronger than in the past,” he says. “We have a new kind of politics today. There is an understanding that there are limits to public expenditure, everyone has rights as much as obligations, and there is an understanding that in the end it is society that pays for expenditure.”

Reservations about Brazil as a manufacturing investment destination focus on three issues: the prevalence of the black economy, which undermines the competitive position of investors; the complexity and extent of the taxation system; and the level of corruption in public life.
Manufacturing in Argentina, Brazil and Chile

Taxation is also considered to be an obstacle to investment – not just because of the overall tax burden, but also because of the complexity of taxation. “The tax system eats up our time, eats up government time and money, and generates a lot of needless legal work as well,” says Luiz Murat of Sadia. And companies add that, unlike other high-tax investment locations, Brazil offers few tax-reduction options. “As far as tax and bureaucracy goes it doesn’t really make much difference where you locate in Brazil,” says Sten Sorensen of Siemens VDO. “The real problem is that Brazil has at least 69 different types of tax, and the very best subsidy package you are going to get anywhere is not going to deal with any more than about 3 percent of your total tax burden.”

Companies add that they are lobbying hard for tax reform. Says Luiz Murat of Sadia: “We believe tax reform is coming. We believe it will happen in the first term of the next president. It is something the whole of Brazilian society is waiting for.”

Nevertheless, companies are without exception positive on Brazil’s prospects as an improving economy, where incomes and demand are growing fast. “We are very bullish and positive about Brazil,” says Thomas Glatzel of Philips. “We see growth of at least 3-4 percent in the long term, and in the short term – over the last two years – growth has been in the 20-30 percent range as Brazil has bounced back from the crisis earlier in the decade.” Above all, manufacturing companies like the ease of operations in Brazil. “The great advantage of Brazil is the willingness of Brazilians to engage in work,” says Sten Sorensen of Siemens VDO. “If you go down a production line in Brazil people are happy, they enjoy their work, and they want to do it to perfection.”

“Despite all the complexity and associated challenges many large companies consider Brazil to be a ‘Blue Ocean’1 – Uncontested Market Space for investments in the ABC region” says a global food and beverage company.

Chile is the South American exception, say companies. Chile is the best-run South American economy: the economy is stable and growing; inward investment is encouraged and protected; government is democratic, accountable, and transparent; corruption is almost unknown. Yet Chile is small, with a population of only 15.8 million, geographically isolated by the Andes and the Pacific Ocean, and offers no incentives to manufacturing companies to overcome its disadvantages. “Chile is a great country that happens to be too small,” says Sten Sorensen of Siemens VDO. “They are reasonable, open to the world, and quite negligible – simply too small to make a dent in any statistics.”

The Chilean government believes that incentivizing manufacturing investment is not a cost-effective way of growing the economy. “We think that it is growth, not industrial policy that will bring industrial investment,” says Jorge Rodriguez, Chile’s former economy minister. But most companies interviewed by KPMG International say that while they applaud the policy and record of the Chilean government, they no longer plan large-scale manufacturing investments in Chile.

“We are very bullish about Chile – as a great market for imported auto products,” says General Motors. “But Chile is too small to invest in auto manufacturing without subsidies to sweeten the deal – you need the kind of financial protection that Chile is no longer willing to provide.”

Only one company expresses reservations about the direction of policy in Chile: forest products company Arauco, one of Chile’s largest exporters, believes that government could do more to encourage dynamic foreign direct investment. The company says, “We are open to FDI, but there are actually rather few examples of successful joint ventures between Chilean companies and foreign companies. We are like Japan used to be – we still have to make the leap to going more international. That does not mean Chile is a bad investment environment: even if there is no change, in five years’ time I’m sure we will still be saying that Chile has done pretty well and is a good place for investors to come.”
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