Latin America, an emerging industrial powerhouse

It has long been a byword for chaos and instability, but now this huge region is stirring. Quietly over the last decade it has chalked up impressive growth figures and is set to offer major opportunities for forward-thinking European companies.

Wright Associates Services Ltd
Dickens Close, Bicester, Oxfordshire
England, OX26 2NG
Phone: +44(0)1908 365916
E-mail: rhys.torrington@wright-associates.com
Website: www.wright-associates.com

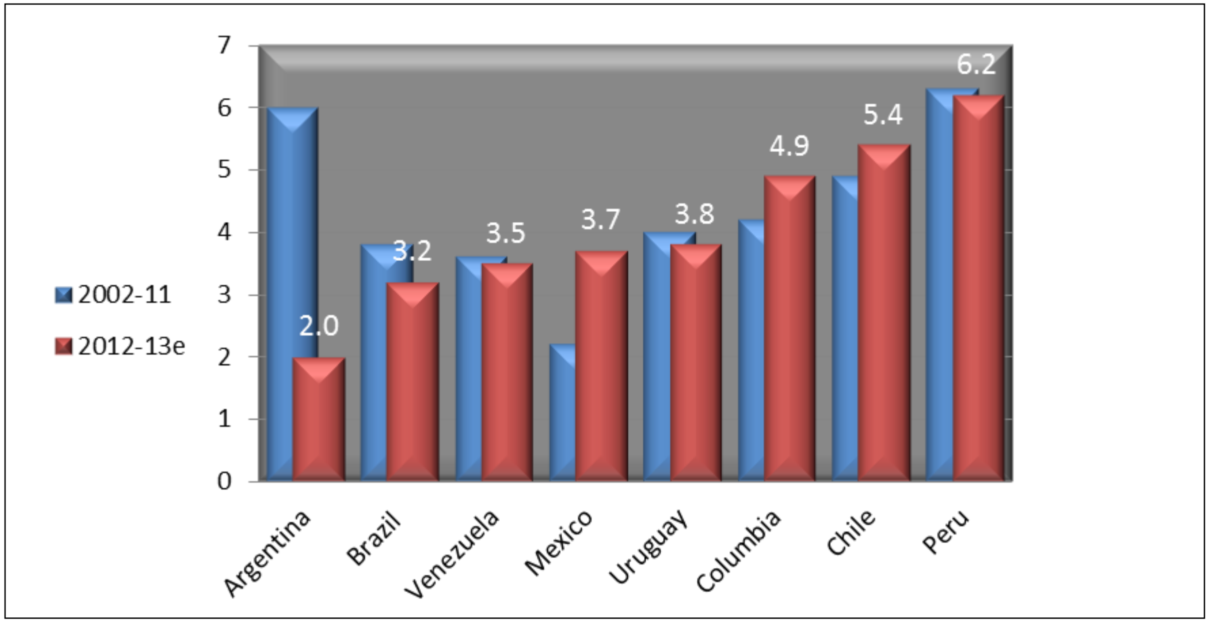
Overview

A new stability

Not so long ago very few companies relished the thought of investing in Latin America. Political instability, labour unrest and widespread corruption were fuelling rampant inflation and economic uncertainty. Even today bad press often outweighs the good, for example gang warfare in Mexico, Colombian drugs cartels and Argentinian sabre rattling. Yet underneath the news chatter there is a quiet revolution underway which offers significant opportunities to those firms willing to get involved early.

In recent years there have been heightened expectations around the prospects for the BRIC countries. This has clearly put Brazil in the spotlight, and it is certainly true that the country has become a powerful economic player. But it would be wrong to dismiss others in the region as being of significantly less importance, especially since the Brazilian juggernaut has currently returned to grinding steadily but unspectacularly through the low gears.

GDP growth (annual %)



Between them the Latin American bloc are set to grow their economies at around 4% in 2013 with some, such as Peru, Columbia and Chile, moving significantly faster, whilst Brazil keeps a more modest pace of something over 3%. Overall that compares very favourably with the US, Europe and even most of Asia. Within this, industrial output is forecast to increase by over 6% in several cases. What is behind this?

There are two key drivers

- The need for a flexible and cost-effective supply chain to service the US market;
- Steadily increasing domestic demand for locally produced manufactured items.

The US market magnet

Many major US corporations are increasingly trying to construct agile, lower cost supply chains for the domestic market. Latin America has therefore emerged as an attractive sourcing and manufacturing base for organisations targeting the US market. Mexico is a prime example, though it would be unwise to dismiss it merely as America's sweatshop. Asia remains the most usual destination for offshore sourcing but nearshoring to Latin America potentially offers three crucial benefits: cost, flexibility and integration capabilities.

The labour cost differential between Latin America and Asia, particularly China, has been narrowing as domestic, and some international, pressures have pushed up wages and improved conditions. This trend has been further accentuated by dollar exchange rate movements favouring Latin America. Just as significantly, the region offers lower logistics costs in satisfying the US market, plus shorter lead times which can dramatically affect cash tied up in inventory. A recent survey of major US corporations found that more than half placed managing demand volatility high up on their list of issues. Nearshore manufacturing in Latin America means a faster response and greater flexibility. It can also offer a greater degree of integration into the total process – for example R&D effort in US facilities can be transformed more easily into full production, so getting the new product to market faster. This can be further fuelled by the greater economies of large scale production as domestic demand for quality goods also takes off in these blossoming economies. Quality is just as important and it the high standards being achieved have recently encouraged major corporations such as Daimler and the Chinese PC giant Lenovo to invest heavily in local plants. As a further incentive to invest, almost all the critical players in Latin America have signed Free Trade Agreements with the United States and also Canada. Taken as a whole this means that Latin America has become a viable and attractive strategic alternative to Asia for companies wanting to better serve existing markets or open new ones in America.

Domestic demand

The second major driver behind the Latin America phenomenon is the internal growth in wealth which in turn is fuelling domestic demand. Quite clearly many people still live at or below the poverty line but, as in many African countries, there is a fast-growing middle and professional grouping that has both the money and the desire to enhance their lifestyles. This growth in domestic GDP is most marked in the US-centric central and northern continental countries such as Mexico, Brazil and Colombia and conversely less so in the more Asia-influenced south. Analysts' 2013 GDP growth rate estimates for the leading lights are impressive, see the table on page 1.

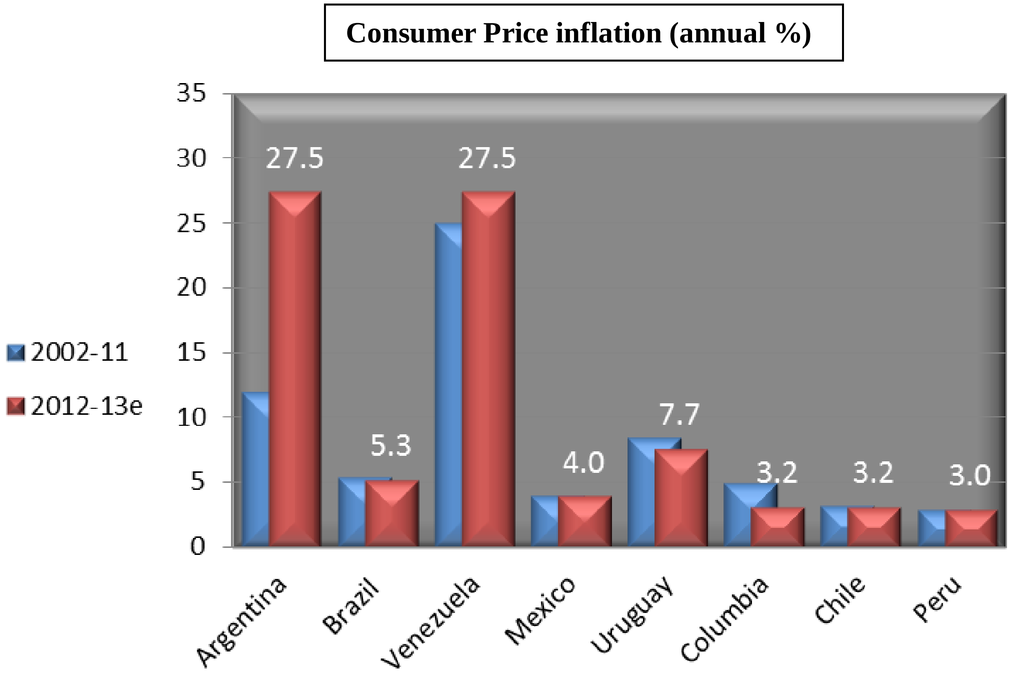
"In this era of globalisation, many US companies are finding that that their operational footprints cannot deliver the margin improvements and customer responsiveness critical for success."

Jim Takach - PRTM Director, PWC

Within this, the acceleration in industrial production is often a point or two higher as the share of agriculture in these economies begins to decline. Of course the picture is not universal. Argentina and Venezuela in particular should be doing better but are held back by the latter's over-dependence on oil revenues and in both cases unhelpful interference from their respective presidents. Again, with these two exceptions, the old bogey of uncontrollable inflation appears to have been banished. That is not to say that everything elsewhere is perfect. In Brazil, for example, the easy consumer-driven spurt in demand has been replaced a more cautious approach as families concentrate on paying off debts. Investment here is now too low at just 18.7% of GDP as compared to 30% in Peru and 27% in both Chile and Colombia – the region's new high growth economies. But the story is really told by looking at the vast amount of foreign investment going into the leading Latin American countries – even in Brazil over $60bn in the past year alone.

In conclusion

Taken together, this nearshore facility for the US market and the parallel increase in domestic spending mean that now is the time for wise investment in Latin American business. This is particularly true for those companies who can provide high quality tools, components and services to fuel the growth in manufacturing.



"Latin America will stand out as a relatively bright spot"

The Economist: "The World in 2013" 21st November 2012

"Decelerating but continuous growth momentum"

Scotia Bank Regional Outlook July 2012

Mexico

The country's GDP is $852bn and it is forecast to grow at just under 4% in 2013. Of this, both exports and imports are around 28%. The industrial sector represents 35% of the overall economy whilst services dominate with 62%.

65% of the population is of working age (15-64), with an overall average of 27.4 years.

The North American market has fuelled recent growth. Mexico accounts for 12% of all US imports and 5% of Canada's. This has encouraged a significant amount of foreign investment, for example Air Liquide recently commissioned a new $35m plant specifically to serve the US.

However, there is a danger of overdependence on the US and therefore being tied to its economic cycles. Another corollary is that there is comparatively little R&D at only 0.4% of GDP, relying on manufacturing goods developed elsewhere. In 2011 Mexico only filed 90 patents compared to Brazil's 215 and 1,234 in India. The dominance of large conglomerates in business is slowly dissipating, with the World Bank's 2012 Doing Business index ranking Mexico at 53 out of 183.

Brazil

As the "B" in BRIC and with a permanent seat on the UN Security Council, Brazil is something of a standard bearer for South America where it is the largest economy with a GDP of $971bn, forecast to grow 3.2% at best in 2013. Of this the industrial sector makes up 28% and services currently flat-lining at 67%. However, a steady overall growth performance since 2002 at or around 4% allowed Brazil to overtake the UK in 2007 as the world's 7th largest economy.

Exports total $263bn with 18% destined for China, 10% the USA and 9% to Argentina. Imports are slightly higher at $291bn with 15% coming from the US, 14.5% from China and 7% from Germany.

There will be significant spending on transport and communication infrastructure leading up to the World Cup in 2014 and the Olympics in 2016. Current estimates have this additional government and private investment at around $500bn in 2011-14. This could have an impact on inflation which is always at risk but currently under control at 5.3%.

Domestic consumer spending has levelled off recently after the seemingly constant increase has given way to a more wary attitude to personal debt. In an effort to rekindle greater investment interest rates have been continuously cut over the past eighteen months. However, so far this has not had the desired effect as the Government's equally strong determination to direct spending has dampened business confidence. Brazil also needs to focus on productivity and find a way of loosening the rigidity in the labour market which is a significant negative element, together with taxes and red tape, in the high cost of doing business there.

Of equal concern is the low rate of R&D investment at only 1% of GDP. The government is trying to stimulate this with tax breaks – up to 100% on depreciation and 200% against income tax. This adds to a total tax system which is somewhat complex and can be a barrier to business. More so is both real and assumed corruption – Brazil is 73 out of 183 on Transparency International's Corruption Perception Index.

Overall Brazil represents a solid and robust industrial engine which attracts inward investment from major corporations such as Daimler, BMW, Emerson and Lenovo.

Colombia

Despite for decades being synonymous with narcotics and guerrilla warfare, Colombia has demonstrated solid economic performance in recent years under a stable government. In May 2011 this resulted in all three ratings agencies upgrading its status to "invest". A lot of this success has resulted from a firm commitment to free trade with a treaty being ratified by the US in 2012, plus the EU, Canada and Mexico - though there is still an overdependence on oil revenues and transport infrastructure remains inadequate.

GDP is $472bn and forecast to grow at around 4.9%. Of this, exports make up 13.4% with the main customers being the USA, taking 38%, the EU 15% and China 3.5%. Imports represent 17.9% of GDP with the US making up 25%, China 15% and Mexico 11%. Inflation is relatively stable at 4.9%. The industrial sector represents 37.5% of the economy and services 55.5%. The underlying industrial growth rate is 4.8%.

President Santos has set a target of 6% for future GDP growth and is pushing innovation, particularly in the technology sector. However, R&D investment is woefully low at only 0.16% of GDP, little of this from private business, and few patents were registered in 2011. The legal system is improving markedly though corruption still plays a part, as it does in most areas. Colombia comes in 78th place on Transparency International's Corruption Perception Index. It is also one of Latin America's most unequal societies with 5% of the population owning 90% of the property and 60% of families living below the poverty line.

Chile

Chile has a market-oriented economy characterised by a high level of foreign trade plus a reputation for strong financial institutions and sound policy that have given it the strongest sovereign bond rating in South America. It is often considered a model for free trade, having signed agreements of varying sorts with 58 countries, representing around 60% of the global population. It currently has free trade agreements with the USA, Canada, the European Union, China, Mexico, Japan, South Korea, Australia, and Peru amongst others. In 2010 it became the first South American country to join the OECD.

GDP (purchasing power parity) in 2011 was $300bn, representing a growth of just under 5%, having averaged around 4% since 1999. Of this, 37% was in the industrial sector, where the production growth rate was 6.1%, and 59% in services. The value of exports against GDP was 47.9% with the main customers being China at 22.8%, the US 11.1%, Japan also 11.1% and Brazil taking 5.5%. Similarly, imports represented 43.1% of GDP with the US contributing 20.1%, China 16.9%, Brazil 18.3% and Argentina 6.3%. Inflation is around 3.2%.

The Government's target GDP growth rate for 2011-15 is 6%. To fuel this there is an effort to stimulate innovation and move R&D up from the low rate of 0.7%.

Tax breaks mean that the Government would cover $46 of every $100 invested but the impact has been marginal, especially among foreign firms, and only 27 patents were filed in 2011. Another challenge is the steady erosion of the trade surplus.

Despite a lingering culture of corruption in some areas, Chile is seen as a good place to do business. In 2011 it claimed 11th spot in the Wall Street Journal Index of Economic Freedom which focuses on attracting foreign investment and the ease of repatriation without impediment. Chile is also one of the most equal societies in South America as evidenced by the sharp increase in income between 1997 and 2010 being mirrored by an overall reduction in poverty

Peru

Peru's economy has traditionally relied on extraction which makes up over 60% of its exports. Whilst undoubtedly generating a lot of income, it does make the economy vulnerable to fluctuations in world commodity prices. There is a naturally strong focus on international trade, there being FTAs in place with the USA, the EU, Canada, China, Mexico, Japan and Chile amongst others. Brazil is now the Government's stated focus of attention.

GDP currently sits at $302bn using constant prices and has grown since 2002 at an average 6.4%, hitting 7% in 2011 due to a significant

increase in private investment around extraction. A conservative forecast for GDP growth in the period 2012-16 would be 5.8% per annum. The industrial sector forms 33.7% of the economy and services 58.4%. Inflation was at 3.4% in 2011, hopefully a temporary blip over the target range of 1-3%.

Exports in 2011 totalled $46.3bn, of which 18.3% were destined for China, 17.8 the EU, 15.2% the USA and 11.4% to Canada. Imports meanwhile totalled $37bn with the US accounting for a 24.5% share, China 13.7%, the EU 10.6%, Brazil 6.7% and 5.9%. Unemployment has traditionally been high but has come back to 7.9%. Unfortunately, 20% of the population still earns less than $2 a day.

Sources for this report include: CIA - The World Factbook; Datamonitor; Scotia Bank; The Economist Intelligence Unit; PWC; WASL associates.