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Intelligence Report

Office of African and Latin American Analysis *19 January 1995*

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Implications of the Mexican Crisis for US Trade and Investment Interests in Latin America [redacted]

The reverberations from Mexico's financial crisis probably will adversely affect US exports elsewhere in the region, slow Latin American efforts to integrate with Mexico and join NAFTA, and increase Brazil's chances of becoming the hub of a South American free trade area.

-- Higher interest rates worldwide and decreased availability of financing would dampen investment growth and consumption, causing the demand for US goods to be lower than previously expected.

-- At the same time, the steep fall of the peso probably will cause Mexican goods to displace those of other countries in the US market, a trend that could increase trade friction with Central American and Caribbean governments upset by the temporary withdrawal of the proposed Interim Trade Program.

-- Brazil's proposal to forge a South American free trade area may become more attractive if other countries believe Mexican imports would present stiff challenges to domestic producers and if they worry about the effect of NAFTA membership on their trade deficits. [redacted]

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On the other hand, the tumult in Mexico could lead to greater US investment opportunities in Latin American countries not suffering from Mexico's ills.

-- Reduced lending and some governments' desire to improve foreign investors' perceptions of their policies are likely to spur the privatization of state enterprises.

-- Moreover, Latin governments' recognition of the need for increased direct foreign investment and for financial market reforms could help reduce barriers to US firms and provide arguments for enhancing protection for intellectual property rights. [redacted]

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[redacted]

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The Financial Markets' Impact on Latin American Imports

Foreign investors' shift away from emerging markets in the wake of the Mexican debacle has reduced the chances that Latin America--excluding Mexico--will post an increase in its GDP growth rate from 3 percent in 1994 to 3.7 percent during the next three years. At a minimum, even if Latin American governments can attract portfolio capital back, corporations and public-sector entities probably will face delays in placing bonds for investment projects due to turmoil in international financial markets and even higher interest rates due in part to risk premiums. If investors remain uneasy about Latin American leaders' ability to keep their economic programs on track--especially in Argentina and Brazil--and rising US interest rates further diminish the attractiveness of Latin American financial instruments and stocks, financing could become more scarce.

-- Before Mexico's crisis, the increase in real economic growth elsewhere in the region seemed likely to widen the current account deficit of the eight largest South American countries from $18 billion to $21 billion. Financial analysts had projected that direct and portfolio investments would have covered about three-fourths of this amount.

-- Potential difficulties in raising foreign financing and concerns that larger trade deficits would heighten investors' worries could prompt some governments to retrench in order to curb import growth. [redacted]

Lower-than-potential growth in Latin America would aggravate losses in US export revenues in Mexico.

-- With a 25-percent drop in the real exchange rate against the dollar and a GDP growth rate likely to range between -0.5 and 1 percent this year, Mexico probably will import about $10 billion less from the United States than if it had avoided a devaluation and grown by 4 percent.

-- Every 1 percentage point reduction in the GDP growth rate in the rest of Latin America would cause US exports to be about $800 million lower than earlier projected. [redacted]

Potential Problems Ahead for Bilateral Trade Relations and Free Trade Initiatives

The peso's plunge and the sharp contraction implied for Mexican real wages are likely to cause some displacement of Central American and Caribbean exports on the US market and create bilateral friction.

-- A likely 25-percent increase in production by Mexico's assembly plants, together with gains in competitiveness, poses a significant threat to exports to the United States of assembled garments from countries in the Caribbean Basin.

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-- Already worried about the implications of NAFTA for their clothing sectors, Caribbean and Central American leaders probably will step up pressure on Washington to give them the same access as Mexico to the US market. [redacted]

The weakness of the Mexican peso also will work against regional integration efforts.

-- Given Mexico's pressing domestic problems and its uncertain economic prospects, the Zedillo government may shift free trade negotiations with Nicaragua and Peru to the back burner.

-- Although El Salvador, Honduras, and Guatemala probably will continue free trade talks with Mexico, the president of Guatemala's Central Bank says that he will recommend revising the strategy for negotiating tariff cuts in order to guard against widening Guatemala's trade deficit with Mexico.

-- Costa Rica, Colombia, and Venezuela--which already have free trade agreements with Mexico--are likely to resort to safeguards to protect domestic manufacturers if there is a surge of Mexican imports. Some products still under negotiation in Colombia and Venezuela's free trade agreement with Mexico are virtually certain to remain excluded from the accord. [redacted]

Progress toward forming a free trade area of the Americas (FTAA) probably will slow.

-- Chile's Finance Minister has indicated publicly that he expects the timetable for free trade talks with Washington to slip because he believes Mexico's misfortunes will intensify debate on fast track in the US Congress.

-- Although the benefits of the FTAA will remain a strong lure, Mexico's balance-of-payments crisis might cause some countries to reevaluate the timing for seeking NAFTA membership. [redacted]

The situation could work to Brazil's advantage in making itself the hub of a South American free trade zone.

-- The Zedillo administration's likely continuing preoccupation with its financial troubles may give room to President Cardoso to take the lead on regional trade issues, provided that Brazil does not experience any dramatic capital flight.

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-- Brazil's proposal to concentrate on integrating regional trade blocs and to link South America to NAFTA only after eight to 10 years may gain more appeal if Mexico is perceived as a much tougher competitor and if other countries worry about the impact of NAFTA membership on their trade deficits. [redacted]

Potential Benefits for US Investors

Although the crisis may slow liberalization efforts in the next few months as other countries wait to see if the situation stabilizes, it could, on balance, have a positive effect on US investment opportunities over the medium term.

-- The decreased availability and higher cost of foreign financing probably will spur privatization and initiatives to attract foreign partners in upgrading infrastructure.

-- Latin American governments' heightened awareness of the need for increased direct foreign investment rather than volatile portolio investments could also help stimulate efforts to ease restrictions on investment and will provide an additional lever in gaining better protection for intellectual property rights.

-- Even though the crisis may prompt tighter limits on portfolio investments and probably will cause foreign exchange controls in some countries to remain in place, it may provide an impetus to open financial services to foreign banks and to draw up designs for private pension plans to promote domestic savings. [redacted]

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Table 1
Current Account Balance

Billion US $

	1992	1993	1994 (a)	1995 (b)
Argentina	-6.6	-7.5	-11.1	-5.6
Brazil	6.3	-0.7	-4.0	-11.0
Chile	-0.7	-2.1	-0.9	-1.3
Colombia	0.9	-2.2	-2.8	-3.0
Ecuador	-0.1	-0.4	-0.7	-0.7
Peru	-1.3	-1.7	-1.9	-1.9
Uruguay	-0.1	-0.3	-0.4	-0.4
Venezuela	-3.8	-2.2	4.1	3.0
Total	-5.4	-17.1	-17.7	-20.9

(a) Estimated
(b) Projected

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Table 2
Net Equity Investment Flows

Billion US $

	1992	1993	1994 (a)	1995 (b)
Argentina	4.2	6.3	3.0	3.0
Brazil	3.0	4.5	8.1	8.2
Chile	0.7	1.2	1.2	1.4
Colombia	0.5	0.9	1.6	1.8
Ecuador	0.1	0.1	0.1	0.1
Peru	0.1	0.6	2.8	1.5
Venezuela	0.6	0.3	0.2	0.2
Total	9.3	13.9	17.0	16.2

Note: Net equity flows include direct foreign investment and portfolio investment.

(a) Estimated
(b) Projected — (b)(3)

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