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## Latin exuberance versus Chinese discipline

**One of the important economic areas where Latin America has an edge over China is its financial system. The region's banks and capital markets have been toughened up by a series of crises over the past 20 years. In 2005, the benefits of that training came though: Brazilian banks made record profits and in Mexico, the operations of the foreign banks that dominate the system powered their parents' spectacular earnings. The surge in profits at the US's biggest bank, Citigroup, was driven by the success of its Mexican operation, Banamex; Europe's biggest bank, BBVA, saw its profits surge by a similar amount thanks to its Mexican subsidiary, Bancomer, the number two in the market.**

Latin American bond markets, which for so many years were impotent and impoverishing for everyone who used them, now look powerful and enticing. Local currency bond markets in Latin America are becoming deeper and more long term. Brazil has an inflation-linked bond that matures in 2045. Mexico is now thinking about launching a 30-year peso bond. Currently its longest term issue is a 20-year bond, maturing in 2024.

China's bond markets are more embryonic. At the beginning of February, China's central bank kicked the only foreign primary dealer off the market without a clear explanation. The implication was the central bank was not happy with the performance of the only foreign bank, HSBC, in 2005. Latin America has learnt the hard way that alternative views are essential in producing an effective capital market. To be fair, China's central bank is trying to develop the domestic capital market. It allowed a couple of asset-backed issues in 2005. Brazil, however, is securitising more complicated financial assets such as aircraft leases. Brazilian, Mexican and Chilean investors are used to standing up to the government. It is far from clear that Chinese investors are as hard-headed.

The odd state of the developed world's bond markets, especially in the US and the UK, where governments have refused to borrow long-term, despite the low level of interest rates, may mean that bold pension funds from the developed world will start to look more closely at emerging market and particularly Latin American bonds. The region's credit ratings are improving and domestic-currency corporate and even municipal bond markets are beginning to develop.

Richard Fisher, the president of the Federal Reserve Bank of Dallas, noted recently that investor confidence in Mexico had risen considerably. Mexico, like Chile, is rated investment grade by all three international credit rating agencies. Brazil is now only two notches off investment grade, and its credit is improving consistently. The country's country risk premium is now nudging 200 basis points over comparable US Treasury bonds. It is worth remembering that when President Lula took over (from an ostensibly centre-right

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government) the country risk premium was over 1,400 basis points.

The other point pension funds should consider is that both Brazil and Mexico have switched their borrowing from international capital markets to domestic capital markets, even though international capital markets charged them lower interest rates. The result of this policy is now that both country's central bank reserves could, respectively, pay off half and all, their foreign currency debt. In Brazil, the government is encouraging foreigners to buy Real debt by abolishing the 15% withholding tax on interest payments to foreign bondholders. Foreign investors are disappointed that they still have to pay the CPMF tax.

It is not only bond markets that are developing fast in Latin America. Brazil's futures market has been a success. To be fair China has a globally important futures contract, the copper contract in Shanghai. The contract is important because China is the world's biggest copper user. The futures markets in Brazil should help Latin American agribusinesses which have long grumbled that US farmers have an edge over them because of US futures markets and the easy availability of farm credit. There is now, in theory, no reason why Brazilian, Mexican and Chilean farmers could not enjoy similar terms.

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One reason why Chinese interest rates are stuck is to keep yields on treasury bills low. China has to issue T-bills to pay for the dollars produced by the trade surplus. Economists expect China to issue at least US\$150bn more T-bills this year to sterilize foreign currency inflows and maintain what is essentially still a dollar peg. The emergence of a market for short-term corporate debt last year has sapped interest in T-bills. In response, the central bank widened its potential audience by giving permission to brokerage houses to trade its bills.

Both Chinese and Latin American companies have been major issuers of shares in foreign markets. In Latin America, the market for Chilean blue-chips is in New York, not Santiago. Telmex, the bluest chip in Mexico, has traditionally been the most heavily traded foreign share in New York. Paradoxically, while Latin American stockmarkets have boomed in the past couple of years, and had the kicker of currency appreciation, China's stocks have wallowed. This year, finally, there has been some enthusiasm for Chinese shares.

The index of Chinese companies which have issued shares on Wall Street rose by 5% in February. This was partly on a rising American market but also due to additional strength in Chinese equities. The big three national Chinese oil companies have outperformed global oil stocks. They may now be overvalued but interest remains strong: Canada's Ivanhoe spent US\$125m on buying a US company, China Mineral Acquisitions, as a way of getting its Chinese oil assets quoted.

The biggest Chinese gainers in recent months have not been the oil giants but aluminum leader Chalco and top insurer China Life. The latter is now auctioning a 10% stake to strategic investors for a far higher price than would have been fetched even last year at this time. Technology stocks remain weak, as does Huaneng Power.

## Up or down?

**The international oil market has been shaken by official Chinese figures that show oil imports fell in 2005 in volume terms. The fall, of 5.3% according to the cabinet's National Development and Reform Commission, was unexpected and many China watchers simply do not believe that it occurred. China is the world's third-biggest oil importer, after the US and Japan, so any change in its demand has major implications for the oil price. If the oil price were to fall substantially, Mexico and Venezuela could find themselves having to make abrupt changes to their economic policy. Our guess is that China has been running down its oil stockpile, in an effort to avoid having to pass on the higher international oil price to manufacturers and other domestic users of oil. If this is what has happened, the oil price is likely to rise further in 2006.**

"Whether China's oil imports actually rose slightly or fell is almost immaterial beside the trend. This shows that, in 2005 at least, China dramatically reduced its dependence on imported oil."

China's oil statistics come from a range of sources. They are partial and contradictory. The shock claim that the country's oil imports fell in volume terms comes from the cabinet's National Development and Reform Commission (NDRC). The NDRC, which is the country's main planning organ, claims that China's oil imports in 2005 came to 953m barrels (2.61m barrels per day), down from 1.003bn barrels (2.74m bpd) in 2004. The government claimed that the reduction was due to the successful implementation of energy conservation measures. Other official figures, from the ministry of commerce, based on customs data, show that China's oil imports increased by 3.3% to 127m t.

Whether China's oil imports actually rose slightly or fell is almost immaterial beside the trend. This shows that, in 2005 at least, China dramatically reduced its dependence on imported oil. What is clear is that the Chinese government wants to give the impression that China's reliance on imported crude oil is falling. In 2004, China's increased oil imports accounted for 30% of the world increase in oil imports. In 2005, China's share of the increase in oil imports was down to 10%.

There must be some doubt about whether, even, this big picture conclusion is correct. When King Abdullah of Saudi Arabia made his first-ever official visit to China in late January, the Chinese government released figures to show that in the first 11 months of 2005 Saudi Arabia had supplied China with 22m t of oil or "roughly" 17% of its total oil imports. This suggests that in the first 11 months of 2005, China imported 129m t of oil. It seems almost impossible that China became a net exporter of oil in December. On the Saudi data, China's oil imports would have been almost 141m t for the whole of 2005. This is equivalent to 1.033bn barrels and so up by about 2.9% on 2004.

Why China's oil imports have, at the very least, stopped rising at the 15% lick they had reached in recent years is far from clear. China watchers are sceptical about the claims for increased energy efficiency. It is true that China is rationalising its power stations and refineries and this will lead to a more efficient use of energy, but most analysts believe that the effects of this policy have yet to come through. What stumps China watchers is how the economy can grow by 9.8% (as it did in 2005) yet either reduce oil imports or reduce the pace at which they are growing. One possibility is that China ran down its oil stocks either by not buying its customary volume of oil for stock or actually drawing down from existing stocks. In either case, its oil reserves will have fallen, at least in terms of actual daily consumption.

This theory squares with a separate piece of data from the National Bureau of Statistics that showed that Chinese oil consumption fell by 0.5%. China-watchers claim that as stocks are (probably) included in consumption data,

“Chinese officials have developed an alarming habit of believing that they are bigger than the commodity markets. Our view is that they took fright at the run-up in oil prices in 2005 and chose to run-down their stockpile while prices were high in the hope that they could rebuild it again when prices fell back.”

China must have bought less oil for stock because the economy's growth rate will have meant that final demand for oil must have, at least, held up. Our view is that not only did China buy less oil for its buffer stock, but it also actually ran down its stocks to avoid having to pass the high oil price down the supply chain. The government still sets energy prices in China.

The International Energy Agency estimates that China's demand for crude oil increased by 3% in 2005. It bases this estimate on official customs data that showed China imported 127m t of oil in 2005. The weight of oil varies according to its quality. More useful barrels of lighter crude weigh less than tar-like heavy crudes with low API numbers. Assuming that there are on average 7.33 barrels to each tonne of oil China imported, China imported 931m barrels in 2005, on the customs data. To make the customs figure match the cabinet's National Development and Reform Commission, China would have to have imported increased volumes of lighter crudes.

There is some evidence to suggest that China has switched from using heavy fuels to using lighter ones. Yan Kafeng of Cambridge Energy Associates told Reuters, a news agency, that there had been a significant drop in demand for heavy fuels in 2005. The IEA's China manager, Jonathan Sinton, said that China's energy statistics were so malleable that early figures for data on consumption and imports were probably unreliable. He said that the 0.5% drop in consumption was possible but would have to be substantiated before the IEA accepted it.

Why run down the stockpile?

Chinese officials have developed an alarming habit of believing that they are bigger than the commodity markets. Our view is that they took fright at the run-up in oil prices in 2005 and chose to run-down their stockpile while prices were high in the hope that they could rebuild it again when prices fell back. The problem is the oil price has not fallen back and at the end of February, after the terrorist attempt to attack an oil installation in Saudi Arabia, is moving towards US\$70 a barrel.

The Chinese government is clearly very aware of oil prices. Xinhua, the official China news agency, claimed that the average import price for oil was US\$51.5 a barrel. This was, Xinhua said, US\$2.5 below the international benchmark average price for 2005. Even so, in dollar terms, the import bill rose by 41% in 2005 compared with 2004 to US\$47.7bn. Working with the official average, this suggests that China imported 926m barrels of oil in 2005. This is lower, even, than the NRDC figure which so shocked the oil markets. It could be that the average figure is misleading, because in fact China imported more heavier, and cheaper, crudes. This would, in turn, mean that the government's claim that it was using cleaner lighter crudes was untrue.

China has already misjudged two other commodity markets. In 2004, the Chinese state import board got soya badly wrong. The Chinese tried to renege on soya contracts with Brazil after they were "whipsawed" by the movements of the soya market. They bought soya forward but the price then dropped significantly: The Chinese importers then tried to get out of their commitments by claiming that the Brazilian soya did not meet specified purity standards to avoid having to pay the above-market prices they had agreed.

In 2005, China appears to have made big losses in the copper market after again trying to speculate. China is the world's biggest importer of copper but it is also a significant producer. China's state copper trading company appears to have gone short on copper, probably sometime in mid-2005 in the hope of cashing in on the near-doubling of the copper price. The Chinese expected the copper price to fall back. They would then cover their short and book a profit. In fact, the copper price went on rising and is now at record levels. The copper market does not believe that the Chinese have

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covered their short position. It looks as though the price will go on rising until China covers its short. The irony is that the fundamentals of the copper market point to supply and demand balancing, or perhaps the market being slightly over supplied, by the end of this year. Nobody beyond senior Chinese officials knows how much oil China has in its stockpile.

## RENEWABLE ENERGY

### Another link

**One other area where China's insatiable need for energy will have an effect on Latin America is in its policy to move to a more sustainable energy policy. China has a policy of trying to increase the proportion of renewable energy in its energy consumption from its current level of 7% to 13%. This could lead to China importing Brazilian technology to produce flex-fuel engines that can run on petrol, ethanol or any mix of the two.**

At current prices (of oil and sugar, which is distilled into ethanol) ethanol is a cheaper energy source than petrol. The price differential is crucial: when ethanol prices rose in Brazil to around 70% of petrol prices, sales of ethanol fell sharply because Brazilian motorists realised that petrol was a more cost-effective energy source than ethanol. This is because ethanol contains less energy than petrol.

How much Brazilian sugar is turned into ethanol is a crucial issue for the world sugar market. Sugar analysts had expected Brazil to produce 16.6bn litres in the year to September 2006. If the January trend were to continue, however, less sugar would be needed for ethanol which in turn would mean that more could be exported, thus lowering prices.

China's interest in flex-fuel follows the introduction of its Renewable Energy Law that will come into force this year. Environmental activists in China say that the law is more a statement of intentions than the implementation of a coherent policy because it is far from clear how the various levels of government will coordinate their application of the law. One illustration of the problem is the change in the target for use of renewable energy. In November, the government was talking about setting a target of 15% of energy consumption coming from renewable sources.

Definitions of what is renewable are also shaky. It is not clear whether hydro-electric energy will be included in the renewable category. Environmental activists argue that hydro-electric energy is not, technically, renewable. They point out that, if hydro-electricity is deemed renewable, once the Three Gorges hydro-electric project is commissioned China will easily hit both the 13% and 15% targets. Ecologists say that wind, solar, biomass, geothermal, wave and hydrogen power are the pure renewable sources.

Ethanol-powered vehicles are as renewable as biomass. All vehicles in Brazil run on petrol that is at least partly diluted with ethanol, distilled from sugarcane. Even conventional petrol engines in Brazil run on a 74% petrol-26%-ethanol mix. Brazilian vehicle manufacturers launched the flex-technology in 2003. Until January 2006 the past 12 months had been a bumper year for flex-fuel.

When ethanol stayed at or below 60% of the petrol price, Brazilian motorists filled up with ethanol. The attraction of ethanol-powered engines means that more new vehicles in Brazil are flex-fuel powered. In December 2005, 120,000 of the 183,600 (66%) new vehicles sold were flex-fuel. In December 2004, 29% were.

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The growth of flex-fuel has an effect on the world sugar market. In February, the sugar price went over US\$0.19 per pound. This followed cuts in forecasts for the amount of sugar Brazil will supply to world markets. The forecasts are being cut for two reasons: one is a drought which has affected cane production in the north-east of the country. The other is that the high international oil price is encouraging sugar producers to distil more of the stuff into alcohol to meet the booming demand for alcohofuel in Brazil. About 80% of the ethanol Brazil produces, which should come to 16.6bn litres in the year to September 2006, is used to run cars in Brazil.

Brazil had originally been expected to produce 450m t of sugar cane (and so about 50m t of sugar, about half of which will be distilled into ethanol). The current official estimate for the cane crop is around 436m t. The next sugar crop, which is expected to be larger, will start to be harvested in May 2006. The rise demand for sugar is leading to a surge of investment in the industry. The agriculture ministry's director for sugar, Angelo Bressan, said that 40 new sugar mills and distilleries were currently under construction in Brazil. Farmers have increased their sugar acreage by about 5% in the past year to 5.88m hectares.

In 2005, Brazil exported 17.5m t of sugar worth US\$3.3bn and 2.1bn litres of ethanol worth around US\$756m.

#### The counter argument

Some oil analysts argue that China has not been running down its oil stocks but has actually been building them up. If this is the case, China will have played the market cleverly, since it need not now import as much oil as it did in 2005.

The argument for this case runs like this. It is correct that final oil consumption fell in 2005. It is also correct that Chinese oil imports increased, by 3.3%, as the customs office reported. What actually happened was that the increased oil imports went into stocks. The economic argument for doing this is that with high international oil prices, oil importers would crystallise losses if they sold the oil to domestic customers at prices set by the government. By building up stocks they would not be crystallising these losses. Some analysts say if high international oil prices persist, the government will have to raise domestic energy prices. The government said on 18 January that it was committed to reforming energy prices, but it gave no timetable.

There is also some evidence to suggest that China's own domestic oil production increased in 2005. Again the figures are conflicting and do not entirely add up.

The cabinet's National Development and Reform Commission (NDRC) said that imports share of national oil consumption was down by 2.2 percentage points at 42.9% compared with 2004. The ministry of commerce reported that China exported 8.07m t (162,000bpd) of crude oil in 2005. China is reckoned to use 6m bpd so its domestic production must be just over 3.5m bpd. In 2004 China produced 3.49m bpd, according to BP, up 3% on 2003.

China's biggest oil company, PetroChina, claimed to have produced 1.5% more oil in 2005 than it did in 2005, at 842m barrels (2.3m bpd). Sinopec, the other big oil company, produced 1.7% more oil at 279m barrels (764,000bpd). These figures probably include production from fields outside China that are owned by the two oil companies.

The NDRC reported that China's domestic oil production was 1.27bn barrels in 2005. This is equivalent to 3.47m bpd and so below BP's figure for 2004 production.

What seems clear is that China's domestic production cannot have increased enough to allow imports to fall by the amount the NDRC claims. So our conclusion that stocks must have been run down stands. China has been a net importer of oil since the late 1990s.

## An inflection point?

**This year, 2006, China is on course to run a US\$250bn trade surplus with the US. Fortunately for the US, China is still recycling most of this money back through US financial markets, sustaining the US economy. The US cannot go on running trade and current accounts deficits on the scale that President George W Bush is appropriate to the world's only superpower. Eventually, investors' nerve will break, the dollar will tumble and the US will be pitched into recession. When this happens China's economy will have to take up the slack and increase its consumption. Then the Chinese economy's infrastructure will be tested as never before.**

China's economy has been twisted by its need to export, and export to the US. Without the safety valve of exports, China's economy would pop. Domestic consumption cannot provide a return on the huge investments made in the economy. Indeed prices in the domestic economy are falling, even though interest rates are barely positive. Essentially, China's economy is now at the opposite extreme to hyper-inflation. In a hyper-inflating economy manufactured and other physical assets are the only store of value. In China, where the price of goods is falling, where financial assets do not provide a real return and property is not an alternative investment, owning the means of production is the only way to stay ahead of the game. This explains the huge over-investment going on in China.

When the US economy turns down, as it must, China will suffer. The US looks as though it may be about to lurch back towards isolationism. Already anti-immigrant feelings are running high, as Latin Americans know. The chance of protectionist barriers being erected against Chinese goods are high, once the downturn comes. In 2005, the US trade deficit with China was nearly US\$202bn, 25% higher than in 2004. It took 23 years of reform for China's surplus to reach US\$100bn, and only three more years to reach US\$200bn. It would not be surprising if the surplus were to surpass US\$300bn as early as 2008, so that both political and commercial pressure is only going to get worse. Chinese imports from the US climbed 20.5% to US\$41.8bn, while exports added 23.8% to US\$243.5bn. The similar pace in import and export growth seems reassuring on the surface, yet it generated a US\$40bn increment to the surplus.

If US import growth remains constant, China's export growth would have to fall below 3% for the gap just to begin to shrink. Looked at the other way, if China held its export growth constant, its imports would have to more than double before any inroads are made into its trade surplus. Given China's anaemic domestic demand, it is unlikely to increase much, so its imports are unlikely to rise. By default, therefore, it will have to do something to disguise the rate of growth in its exports to the US.

The Mexicans appear to have understood the possibilities of the situation. The Mexican foreign minister, Luis Ernesto Derbez, suggested in his visit of Beijing at the end of February and beginning of March, that China should start to ship goods to Mexico for onward shipment to the US. The catch from the Chinese point of view is that the tariff status of these goods would have to be changed significantly for them to be able to enter the US under the provisions of Nafta.

The most likely solution to the China conundrum, however, is that the US will impose sanctions on China's exports. This could cause severe distress on the western side of the Pacific. There is no substitute for exports to the US - they stood at almost 11% of China's GDP in 2005. In addition to the growth impact, stagnation would cut FDI because a good chunk is aimed at generating exports to the US. Less FDI means slower technical progress.

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Product categories provide new concerns about free-trade viability. In the early part of this decade, textiles and toys led Chinese exports, which the US could dismiss as low-value manufacturing. While textiles and toys remain important exports to the US, they are being eclipsed by telecom equipment and, especially, computers. Domestic computer output has increased by almost a factor of 12 since 2000 and the value of exports to the US has increased five times over that period.

#### China's imports from the US

On the import side, 2005 was a good year for Boeing. It doubled the value of its aircraft shipments. The problem is repeating this pace. Other US technology exports show steady but slow growth while agricultural trade bounces up or down on the whim of Chinese health inspectors and American textile negotiators.

China's farm imports as a whole edged up only 2.4% last year, versus a 17.7% export rise. The appearance of scrap metals among the top imports, in sharp contrast to the movement of Chinese exports up the technology ladder, can only further infuriate US protectionists.

The problem for free traders on both sides of the Pacific is that the problem looks as though it will get worse before it gets better. The US has yet to publish any trade data for 2006, but China's (malleable) statistics point to the trade surplus rising, year-on-year in the first quarter. Historically, China tends to export more to the US in the second half of the calendar year. On the other hand, China's imports started strong but this was largely due to demand for crude oil, which will do nothing for the Sino-American imbalance.

China's two principal agriculture imports from the US, soybeans and wheat, both fell in January. Cotton imports from the US have skyrocketed since talks began last year to settle differences over textiles. On the other hand, the various limits on textile exports negotiated with the US, the EU, and now Brazil, also serve to cap cotton demand. The potential for chemical imports is unknown due to the Ministry of Commerce's constant "anti-dumping" findings, which are increasingly and bizarrely targeted at American companies. In mid February, an anti-dumping tax of over 100% was placed on furan phenol (used in medicine) from the EU, Japan, and the US.

Trouble is also brewing in two high-profile industries. China will become a net steel exporter this year. In January steel-product exports rose 21% to 1.81m t while imports slid 18% to 1.57m t. On most estimates, China's steel production capacity is substantially higher than its domestic demand. China also became a net auto exporter last year and growth could be explosive.

These exports have to go somewhere and the US is the world's most boisterous consumer. US congress, coming into an election cycle, will want campaign contributions from business and jobs for voters. Cheap goods and no inflation may not be the priority. The US administration, sensing the change, is for the first time actively investigating the consequences of labelling China a currency manipulator. Its decision will be announced in March: if it decides that China is manipulating the currency, a WTO investigation will convene. To head this off, China has to do more than drop hints that it will liberalise the capital account (ie allow some Chinese investors to buy dollar assets themselves).

As our table (on p20) shows, the Renimbi has risen by barely 0.8% since it was floated in July 2005. The yuan has climbed more than four times as much against the euro over the period and 10 times as much against the yen. The problem for Chinese policymakers is that they may have missed the boat: a modest revaluation will have little effect on the trade account. This will not be

## US starts to focus on synthetics

**The US State Department claims that the country is beginning to win the war against heroin and cocaine. It claims that between 2003 and 2004 on US streets the price of heroin went up by 20% as its purity fell by 30%. US policymakers argue that if consumers have to pay more for a weaker "hit" consumption will fall. They add that the same sort of thing seems to have started to happen with cocaine. What is worrying US policymakers is that drug takers seem to be reacting to the changes in the heroin and cocaine markets and are switching to metamphetamines which have long been the big drug problem in Asia.**

The emergence of methamphetamine as a major drug of abuse and a significant domestic law enforcement problem in the US was the big drug development of 2005. Roughly 35% of the methamphetamine produced in the US comes from small toxic labs ("mom and pop labs") using chemicals procured locally, most commonly pseudoephedrine extracted from non-prescription pharmaceutical preparations.

Professional traffickers operating "super labs" (those capable of producing 10 pounds of methamphetamine in a single production cycle) rely on international sources for their chemicals. Since, depending on the efficiency of the lab, the ratio of pseudoephedrine to methamphetamine is approximately 1 or 1.6 to 1, and labs are easy to establish, traffickers can move their operations to where the chemicals are available. This occurred when many super labs moved from the US West Coast to Mexico as tighter precursor controls in Canada and better interdiction on the border cut the smuggling of precursor chemicals from the north. Mexico is now tightening its controls on methamphetamine precursors but the concern is that the precursors will be sold to countries with fewer controls and smuggled into Mexico, or the US, for drug production.

The 1988 UN Drug Convention includes pseudoephedrine and ephedrine as Table 1 chemicals, which are subject to stricter controls than those in Table II, but less strict than those for narcotic and psychotropic substances under the 1961 and 1971 UN Drug Conventions. The State Department points out that controls, however, are only as good as the ability of the countries concerned to implement them. One of the problems is that the Convention excludes pharmaceutical preparations. Traffickers are exploiting this exclusion to obtain pharmaceutical preparations from which pseudoephedrine can be easily extracted.

China is seeing an upsurge in the consumption of synthetic drugs such as ecstasy (MDMA) and crystal methamphetamine, otherwise known as "ice", according to the US State department's International Narcotics Control Strategy Report, published on 1 March. The Chinese authorities view drug trafficking and abuse as a major threat to national security, the economy and national and regional stability, but corruption in far-flung drug producing and drug transit regions limits the accomplishments of dedicated enforcement officials.

The major narcotics producing areas in Asia, Southeast Asia's "Golden Triangle" and Southwest Asia's "Golden Crescent", both border China. The "Golden Triangle" on China's southwestern border is a longstanding problem; Chinese officials now believe that the "Golden Crescent" is an increasing source of illicit drugs trafficked into western China, particularly Xinjiang Province.

In both China and Latin America domestic drug consumption is becoming a growing problem. One of the candidates in the Mexican presidential election accuses the front-runner, Andrés Manuel López Obrador, of allowing Mexico City to become a haven for drug retailers, during his time as mayor (2003 -2005).

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Drug abuse in China continues to rise and there were, as of 2004, 1.6m registered drug addicts, double the number in 1995. The majority of registered drug addicts are heroin users. China's economic growth and changes to traditional social arrangements over the past decade have dramatically increased the disposable income and leisure time of millions of young urban residents. This phenomenon has led to a rapid increase in the use of synthetic drugs just as similar economic and social developments increased use of metamphetamines in the US and Europe.

In November 2005 China passed its first administrative law on precursor chemicals aimed at preventing the illicit use of precursor chemicals to process heroin or manufacture metamphetamines. This law represents the first action by the PRC to control domestic sale of precursor chemicals; previous laws and regulations focused solely on imports and exports.

Drug seizures in China show a switch from traditional drugs, mostly opiates, to synthetics. The only big opiate seizure inside China in 2005 came in April, when 26kg of heroin were intercepted in Xinjiang. Otherwise the big seizures were of metamphetamines (first in Yunnan in May when 102kg and then in November when another 110kg were seized) and ketamine. This is an animal pain-killer widely abused in Asia. In Sichuan in September 41kg were seized and then in November in Shandong and Guangdong over 1t of ketamine was intercepted.

According to the INCSR China is a major cultivator of natural ephedra, which is used in the production of amphetamine. China is also one of the world's largest producers of synthetic ephedra, which is used for medicinal purposes but can be diverted for the production of methamphetamine. The State Department points out that unlike cocaine and heroin, methamphetamine, amphetamine and other synthetic drugs require no crops, only relatively small amounts of chemicals, and can be produced in crude labs located anywhere. The principal precursors required for methamphetamine and amphetamine are pseudoephedrine and ephedrine. Traffickers obtain them in bulk or extract them from pharmaceutical products, sold over-the-counter in many areas.

The pattern has been for small "mom and pop" labs to rely on pharmaceutical preparations bought locally and criminal "super" labs to rely on bulk chemicals. However, large traffickers are increasingly turning to pharmaceutical preparations traded internationally in large quantities. This is made possible because pharmaceutical preparations are excluded from the chemical control provisions of the 1988 United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances. Essentially, new drugs ("designer drugs") are developed that have physical and psychological effects similar to controlled drugs, but which can be manufactured with non-controlled chemicals.

The US said that its major focus in 2006 and beyond will be on better control of the chemicals used to produce amphetamine and methamphetamine, primarily ephedrine and pseudoephedrine. It wants to develop an international consensus to include pharmaceutical preparations, now being used as a source of the precursor pseudoephedrine, in these efforts.

The US intends to introduce a resolution in the March 2006 UN Commission on Narcotic Drugs requesting that countries provide to the International Narcotics Control Board annual estimates of their requirements for bulk ephedrine and pseudoephedrine and pharmaceutical products containing them. The Board would publish the results, as it does for estimated requirements for substances in the 1961 and 1971 UN Drug Conventions, to assist exporting countries in deciding the legitimacy of proposed exports of the products.

## Morales embarrasses China

"Morales's world tour demonstrated that the best (and perhaps) only time to interest the western media in Latin America comes at the beginning of the New Year. Subcomandante Marcos, the leader of Mexico's Ejército Zapatista de Liberación Nacional, was the first to realise this, launching the Zapatistas' "uprising" against Nafta on 1 January 1994 and capturing media attention at a time when news is thin."

**President Evo Morales's world tour culminated in a two-day stopover in Beijing. Morales's effusiveness about the effect Mao Zedong's Little Red Book had on him as a younger man appeared to embarrass his hosts, as did his refusal to wear a jacket and tie. It is unlikely that Bolivia and China will develop closer links, despite both countries' protestations that they want to and the mischievous arguments of some US policy analysts that a China-Cuba-Venezuela-Bolivia axis is developing.**

Morales's world tour demonstrated that the best (and perhaps) only time to interest the western media in Latin America comes at the beginning of the New Year. Subcomandante Marcos, the leader of Mexico's Ejército Zapatista de Liberación Nacional, was the first to realise this, launching the Zapatistas' "uprising" against Nafta on 1 January 1994 and capturing media attention at a time when news is thin.

Morales's world tour began, in earnest, on 3 January, though Morales had already paid a quick visit to Cuba on 30 December. In between, on 2 January, he had an hour-long and apparently cordial meeting with the US ambassador to La Paz, David Greenlee. The first stop on the world tour, shoehorned into a tight schedule at the last moment, was Caracas, where Morales met President Hugo Chávez, and more surprisingly, the Peruvian leftwing nationalist candidate in the 9 April presidential elections, Ollanta Humala.

Morales's schedule then took him to Europe. He had a series of important meetings in Spain, especially with senior executives from the Spanish-owned oil company Repsol-YPF, which has invested heavily in Bolivia's gas industry. The meetings were inconclusive and by the end of February, the president of Repsol, Antonio Brufau, was flying to La Paz to meet Morales and sort out the company's awkward position in Bolivia. Repsol-YPF fears that its Bolivian assets will be nationalised, even though Morales and his ministers have made it clear that the key element in nationalisation for them is the recognition by foreign companies exploiting Bolivian assets that the assets (such as hydrocarbons or water) are owned by the Bolivian state.

What is significant about Morales's world tour is that it avoided the US. Morales's last elected predecessor, the ill-fated Gonzalo Sánchez de Lozada, was so pro-US that he even spoke Spanish with a US accent. Goni also used the hugely successful US campaign adviser James Carville who, by his own account supervised Bill Clinton's 1992 election triumph against the incumbent president, George H Bush.

Morales's advisers say that the absence of a trip to the US is simply the result of a lack of an invitation. They say that all the countries that Morales is visiting invited him before the result of the December 2005 elections was clear. Belgium and Holland are major aid donors to Bolivia. The US is still, (at the beginning of March) unsure about what to make of Morales. President Bush did telephone Morales, in February, well after his inauguration to congratulate him but, significantly, did not invite him to Washington. By the time Morales got to Beijing, on 8 January, he was already feeling the effects of his whistle-stop tour. He had to cancel a press conference in China on 8 January, though he met Hu Jintao, China's president, on 9 January.

Morales scored brownie points with the Chinese by saying that Bolivia will "firmly adhere" to the one China policy (ie, ignore Taiwan diplomatically). This is comparatively easy for Bolivia because Paraguay, against which

“ In Bolivia, Morales's dress has been compared to Mahatma Gandhi's homespun peasant costume and (former South Africa President) Nelson Mandela's flowery shirts. Fashion and political commentators around the world have pondered on Morales's jumper and concluded that Morales is trying to show that he is something new, neither part of the jacket-and-tie-wearing elite nor a poncho-wearing Indian. ”

Bolivia fought (and lost) the War of the Chaco (1932 - 1935) is Taiwan's strongest ally in South America.

Morales's apparent refusal to wear a jacket and tie upset both the Chinese and some conservatives when he was in Spain. Morales refused to put on a tie to meet either the Spanish prime minister or the King. The Chinese former foreign minister, Tang Jiaxuan, who acted as Morales's host in Beijing, said that nobody in China minded Morales's casual dress though if he went out he should wear more than just a jersey because it was the coldest time of the year. It was 10 degrees below freezing in Beijing on 8 January.

#### Where Morales did not go

Morales decided to abandon the idea of including trips to India and Iran on his way from China to South Africa. The Bolivian embassy in Beijing said that the mooted visits to India and more controversially, Iran, could not be fitted in because of meteorological and logistical problems. Other sources say that the Venezuelan plane Morales is using is registered in the US and therefore could not land in Iran.

The decision to include Iran, with which Bolivia has only the sketchiest relations (neither country has an embassy in the other) was eye-catching and, significantly, was announced by Alex Contreras, Morales's strongly anti-US spokesman. The Iranian president, Mahmoud Ahmadinejad has, apparently, spoken by telephone to Morales.

A visit to India made more sense. India has an embassy in La Paz, though Bolivia does not have one in New Delhi. Indian companies are interested in Bolivia's iron ore assets at Mutún.

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#### Why Bolivia is important

There are two reasons why Bolivia interests the US: coca and gas. China, by contrast, is also interested in Bolivia's gas and, like India, the huge iron ore deposits at Mutún. Bolivia has over 50 trillion cubic feet of natural gas reserves. These are strategically important and the second biggest reserves in the western hemisphere after Venezuela's. Venezuela and Bolivia may end up competing for customers in South America. Venezuela is keen on building a long (8,000km) gas pipeline to take its gas to Brazil and Argentina. These two countries are, currently, Bolivia's only two export markets for its gas.

President Hugo Chávez seems determined to push ahead with the expensive (US\$17bn) pipeline to take gas from Venezuela down, through Brazil, to Argentina. It is not clear whether this pipeline will link up with the so-called energy ring in the southern cone which is supposed to take gas from the places that have it (Southern Peru and Southern Bolivia) to local and international markets. There is some evidence to suggest that Argentina and Brazil, both of whom are big gas importers, want to use the threat of Venezuelan gas to deter Bolivia from increasing the price of its gas too much. Venezuela has huge gas resources, at least 150 trillion cubic feet of proven reserves, but it has no market for them. President Hugo Chávez's anti-US posturing is deterring US energy companies for investing in developing Venezuelan gas for the US market.

Essentially, Morales and his government want two things. First they want international energy companies to pay more for producing and exporting gas from

"Farm-product imports from Chile, excluding wine, increased by only 2.6% during the 11 months from April 2004 to this February. Imports of Chilean wine, however, surged by 150%."

Bolivia. Second, they want Bolivia's main gas customers, Brazil and Argentina, to pay more for the gas they buy from Bolivia. Without the Venezuelan pipeline, Brazil and Argentina have no real alternative to Bolivian gas.

Argentina, which had been getting cheap gas from (much poorer) Bolivia was told, reasonably enough, that this arrangement had to end since Argentina itself was exporting gas at a higher price to Chile. Brazil, which has more investment in Bolivia and also more options about where it can get its gas (such as Venezuela) was treated more gently. Even so, the confidence of Petrobras's president, José Sergio Gabrielli, that Bolivia needed Petrobras more than Petrobras needs Bolivia may well be tested. Currently, Bolivia provides Brazil with about half the gas it uses. Gabrielli points out that Petrobras is Bolivia's single biggest customer. Brazil currently imports 23m cubic metres of gas a day from Bolivia but can increase its imports to 30m under the current contract. The Morales government said that this contract will be revised.

Argentina, which has skimmed on investing in energy exploration in recent years, is becoming increasingly dependent on Bolivian gas. Argentina would like to import another 20m cubic metres of gas a day from Bolivia through a new pipeline across the country's northeastern provinces. Despite this investment, Morales, and his vice president, Alvaro García Linera, made it clear that Argentina will have to pay substantially more for gas from Bolivia.

The Bolivian government's sternest treatment was reserved for the international energy companies. The government is happy to meet international energy companies but it is making it clear to all of them, even the state-owned Petrobras, that they cannot go on in Bolivia as they have been. Representatives from Spanish energy company Repsol YPF met Jorge Alvarado, the president of Bolivia's state-oil company, Yacimientos Petrolíferos Fiscales Bolivianos (YPFB), on 13 February. The meeting came after Repsol announced, at the end of January, that it was suspending US\$476m in investment in Bolivia.

The Alvarado meeting with the Repsol executives came immediately after the announcement by YPF that Petrobras, the state-owned Brazilian energy company, would invest US\$5bn in Bolivia's energy industry. Repsol YPF executives went into the meeting with YPF saying that they were annoyed with the president of YPF over his disparaging comments about Repsol YPF's apparent involvement in smuggling oil and gas out of the country. By the end of the meeting, Repsol YPF had agreed to invest US\$150m in YPF projects. Repsol YPF's president in Bolivia, Julio Gavito, said that the company wanted to remain in Bolivia and would do all that was humanly possible to achieve this. This looks like a strong hint that Repsol might break with other international energy companies that are threatening to go to international arbitration to assert their rights under controversial energy concessions awarded by previous governments.

The new Bolivian hydrocarbons minister, Andrés Soliz Rada, said that decision by Repsol YPF to restate its gas reserves and lower them by 25% was "a gigantic step in the nationalisation of hydrocarbons in terms of the fact that it will not be the international energy companies that are going to decide how our gas reserves will be managed but the national state which will decide what will be done." Soliz said that he did not believe that Repsol YPF was the only company to have counted gas reserves that did not belong to it as part of its assets, though he could not cite other examples.

Bolivia's 48.7 trillion cubic feet of gas are the country's main natural resource. Soliz reckons that the proven reserves alone are worth US\$150bn. Bolivia's GDP is not more than US\$8bn.

Soliz reckons that the proven reserves are only an indication of the size of

“ Building a mine and its associated infrastructure in Mutún will be expensive. The government reckons that it will take US\$2.5bn to get the project off the ground. ”

the country's actual reserves. He forecasts that in the next few years proven reserves would be increased to between 200 trillion and 300 trillion cubic feet. Soliz, who met representatives from the international energy companies in early February, said that he reckoned that most of them would accept the new terms offered by the Morales government. Thierry Desmarest, the president of the French-based oil company, TotalFinaElf, concurred. He said on 15 February that he expected to negotiate new gas concessions in Bolivia.

### The Mutún project

President Evo Morales postponed the auction of the strategically-important iron ore deposit in the east of the country at Mutún. The outgoing government had organised a sealed bid auction in which the bids would be opened on 21 February. Businessmen and rightwing politicians wanted the deposits sold off quickly (and some analysts would say cheaply). Most of the pressure for a quick sale came from the Comité Cívico pro Santa Cruz, which trade unionists say was heavily lobbied by a Brazilian mining company. Mutún is close to the Brazilian border: the idea is that the iron ore would be shipped out through Puerto Busch.

The government used a legal loophole to halt the auction in mid-February. The mining minister, Walter Villaroel, said that the auction was unconstitutional because it had not been authorised by the state-owned mining company, Comibol, but the Empresa Siderúrgica de Mutún.

The government subsequently stressed, on 17 February, that the auction had only been delayed, not cancelled. The government also says that it wants to examine proposals under which the iron would be processed inside Bolivia, using the country's natural gas. In this way, value would be added to the iron-ore which in turn would lead to higher royalties for local municipalities and the department. These levels of government were particularly keen for the auction to go ahead.

The planning minister, Carlos Villegas, said that the government would set a new deadline for the project. He added that the government was much keener on exporting industrial products rather than just raw materials and he wanted the country to develop a steel industry.

Mutún has an estimated 40bn t of iron ore. Bolivian trade unionists say that the deposit is easy to work and does not need, as the rightwingers claim, state of the art technology.

The government said that five companies had expressed an interest in bidding for Mutún. Villegas said that they seemed prepared to accept the government's arguments for a delay. He added that they seemed to understand that the government wanted them to pay a much higher price for the iron ore at Mutún.

The five companies interested in Mutún are: Jidall Steel and Power (from India); EBX Siderúrgica (Brazil-Bolivia); Shandong Corporation (China); Mittal Steel (India) and Siderar SAIC (Argentina).

Under the terms set by the previous government, the bidders had to offer between US\$500m and US\$5bn. The government reckoned that the project would produce at least US\$100m in export revenues a year, even if just raw iron-ore was exported.

Businessmen in Bolivia say that Morales's world tour has been hugely beneficial to the country. The president of the Confederación de Empresarios Privados de Bolivia, Roberto Mustafá, said that Morales had done what other people could not have managed. He pointed out that Morales had been received by presidents and prime ministers and had collected some tangible support, ranging from anti-poverty help in the form of teachers and nurses from Cuba; US\$30m in aid from Venezuela and US\$150m worth of diesel; and the cancellation of US\$120m worth of debt to Spain. The European Union and the Netherlands also promised to continue with their (substantial) aid to the country. China did not give Bolivia anything as tangible.

## Close and getting closer

**Cuba and China have seen their relations become closer over the past 15 years. Cuba was one of the few countries not to criticise China's butchering of protesters in Tianamen Square in 1989. Previously Cuba's close alignment with the Soviet bloc had kept relations with China cool, even though Cuba had been the first Latin American country to recognise the People's Republic of China in 1960.**

"The links between China and Cuba are now growing fast. China can count on Cuba's unquestioning support in international fora for its dubious human rights record (Cuba's is just as poor). Some US officials claim China also uses the Soviet-built listening stations on the island that can track US internal communications."

The links between China and Cuba are now growing fast. China can count on Cuba's unquestioning support in international fora for its dubious human rights record (Cuba's is just as poor). Some US officials claim China also uses the Soviet-built listening stations on the island that can track US internal communications.

Trade is the most tangible evidence of the links between the two countries. This has boomed since China's President Hu Jintao visited Havana in November 2004. He was accompanied by a delegation of 200 Chinese businessmen. The most obvious product of Hu Jintao's visit was the agreement by China to invest US\$500m in Cuba's nickel industry. China is now Cuba's second-biggest trading partner after Venezuela, which supplies Cuba with cheap oil. In the past year China has overtaken Spain in the ranking of Cuba's trade partners.

In the year to October 2005, bilateral trade between China and Cuba increased from US\$551m (in the year to October 2004, and so immediately before President Hu's visit) to US\$775m. This increase moved China up from fourth to second in Cuba's ranking of trade partners. Venezuela is Cuba's most important trading ally, thanks to its provision of 90,000bpd of cheap crude oil. Spain had been third thanks to its investment in Cuba's tourist industry.

From a Chinese point of view Cuba is small beer, despite President Hu's claim last November that "Cuba is one of China's largest commercial partners in Latin America." Brazil, Argentina, Mexico and even second-tier economies such as Chile, Peru, Colombia and Venezuela all have more trade with China than Cuba. President Hu's visit to Cuba was important to President Castro because it allowed him to play up China's and Cuba's shared ideology. "Socialism will remain, in the end, the only real hope for peace and the survival of our species," Castro declared, before adding that China was an economic powerhouse and an example to all developing countries.

Fidel and his brother, and designated successor, Raúl Castro, and most other top Cuban leaders, have visited China at least once. One Chinese president, before Hu, visited Havana while other senior Chinese politicians been regular visitors to Cuba. Raúl Castro and several other Cuban leaders are intrigued by how China has managed to liberalise its economy (to some extent) without allowing political reform.

Even deeply anti-Chinese US politicians only speculate that Cuba is now allowing China to use the Lourdes and Bejucal listening posts built by the Russians. For decades Lourdes was the largest Soviet overseas espionage base. President Hu visited it on his November 2004 trip: Lourdes now seems to be mainly a new University of Information Sciences (UCI). Hu said that most of the thousands of computers there are from China. The base at Bejucal may also provide US communications intercepts to China, but no-one is saying so.

Although Cuba's listening post attributes may be important to China strategically, the Chinese have been very cautious about drawing US attention to them. US allies, such as Israel, have been much more clumsy in their spying

"China's support helped Cuba to overcome the economic crisis that began in the 1990s, after the collapse of the socialist bloc in Eastern Europe and the disintegration of the Soviet Union. China's surge up the world economic rankings also encouraged Cuba to reverse its tentative steps towards economic liberalisation, taken in the mid-1990s, and switch back to a centrally planned economy."

in and on the US. China prefers to play up its trade links with Cuba. China now accounts for over 10% of Cuba's trade. Cuba's exports to China are dominated by nickel and sugar. Since 2000, half of China's imports of nickel, used to make stainless steel, has come from Cuba.

Cuba sees China as "a reliable, stable partner that does not impose political conditions" on business deals. Apart from Venezuela, which is similarly uncritical, other countries insert conditions into their trade with Cuba. Even longstanding unaligned countries such as Mexico are now far from uncritical about Cuba's human rights' record. The European Union is more critical than friendly while the US has tightened its trade embargo, in place now for over 40 years.

China's support helped Cuba to overcome the economic crisis that began in the 1990s, after the collapse of the socialist bloc in Eastern Europe and the disintegration of the Soviet Union. China's surge up the world economic rankings also encouraged Cuba to reverse its tentative steps towards economic liberalisation, taken in the mid-1990s, and switch back to a centrally planned economy. In 2005, the government of Fidel Castro struck the latest blow against reforms which were timid, but helped to keep the economy afloat after the loss of Cuba's privileged relationship with Moscow in the 1990s. It enacted a series of measures to recover state control of finances and other strategic sectors.

China exports manufactured goods to Cuba such as buses. In mid-February Castro announced that the purchase of 8,000 additional buses is being negotiated with the mayor of Zhengzhou, in the eastern Chinese province of Henan, where the Yutong factory is located. Other purchases for the transport sector include railway engines and carriages. Other Chinese goods exported to Cuba include white-goods, the machinery for manufacturing bicycles, and equipment to modernise the country's telecommunications, for a total cost of US\$200m. Besides sugar, nickel and tobacco, Cuba also exports Biorat rat poison, the medical drug interferon, high-technology medical equipment, vaccines and shellfish to China. So far, the two nations have entered into 10 joint ventures, according to the Ministry for Cooperation and Foreign Investment.

#### China and Venezuela

Venezuela has the largest oil reserves outside the Middle East and is the world's fifth-largest oil exporter. Russia, whose oil reserves are much closer to China and almost as big as Venezuela's is a more obvious supplier, but China and Russia have, historically, been suspicious of each other.

China has started to buy a small amount of Venezuelan crude, even though its refineries cannot handle the heavy Venezuelan crude. By December 2005, Venezuela was exporting 140,000bpd of crude to China. All the crude was used, reportedly, for asphalt. In late February, Venezuela's oil minister, Rafael Ramírez, said that the government was working on building up alternative markets to the US, which currently imports about 1.4m bpd of Venezuelan crude, should President Chávez order a halt to exports to the US. China is likely to have been earmarked to take more Venezuelan crude. Some in the Venezuelan government have speculated that Venezuela could, eventually, supply between 15% or 20% of China's oil import needs. That would mean supplying between 400,000bpd and 600,000bpd.

Even so, the Chinese ambassador in Caracas noted in August 2005: "the natural markets for Venezuelan oil are North and South America." In these and other comments, he seemed to imply that China is not yet convinced of Venezuelan seriousness and competence to switch to meeting China's oil import needs.

Venezuela has received radar equipment and is acquiring a communications satellite from China. Unlike Russia, China has yet to supply Venezuela with military equipment.

Energy  
On 22 February  
China's president, Hu  
Jintao, said that  
China had to change  
its economic  
development model  
because the current  
version was not  
sustainable. He said  
that the new model  
must take peoples'  
resources and the  
environment into  
account. The World  
Bank director for  
China and Mongolia,  
David Dollar,  
elaborated on this,  
arguing that China  
must think about  
imitating Europe and  
introduce taxes on  
energy to discourage  
wanton consumption.

**Singapore and Panama:** Panama and Singapore signed a free trade deal on 1 March. Panama wants to model itself on Singapore, which developed from a British naval base into the financial and communications hub for south-east Asia. Panama claims that its infrastructure and communications make it a sensible place for Asian companies to base their Latin American businesses.

What is interesting about the Panama-Singapore FTA is that it focuses on two areas: foreign investment and the service sector.

Already, two Singaporean companies are interested in investing in Panama's maritime industry. SembCorp Marine is interested in a dockyard on the Atlantic side of the canal. The Singapore Ports Authority, which recently lost out to Dubai in the take-over battle for a British-controlled international port operator P&O, is interested in bidding in Panamanian projects for a new mega-port and for the expansion of the canal.

Singapore Technologies Aerospace has, according to the deputy trade and industry minister, Carmen Vergara, signed a deal to set up aeroplane servicing and repair operations in Panama.

Singapore is Panama's second-biggest Asian trading partner, after Taiwan. In 2005 Panama and Singapore trade goods worth US\$1.96bn.

**Health & education:** The World Bank said that China should learn from health projects launched in Mexico and Central America on how to reduce poverty. Frannie Léuatier, a vice-president of the World Bank, said that the bank had been surprised by the success of projects in Nicaragua, El Salvador and Mexico and these projects could have lessons for China. Léuatier was speaking in China about lessons that could be applied in China from the 100 best anti-poverty programmes launched by the World Bank. Léuatier praised the EDUCO project in El Salvador in which parents run a lot of rural schools and Oportunidades in Mexico which links payments to poor families to the achievement of simple targets such as consistently sending their children to school.

**Tourism:** Mexico's foreign minister, Luis Ernesto Derbez, said on a visit to Beijing that Mexico has the goal of attracting 5m Chinese tourists to Mexico over the next 10 years. Derbez said that the Chinese government had told him that it expects the number of international tourists from China will rise from its current level of 50m to 100m over the next 10 years. The two countries intend to discuss the topic further at their Second High-Level Meeting, scheduled for 18 and 19 May in Mexico City. The two countries yet to have direct flights between them. Derbez said that he expected Mexicana to start a flight from Mexico City to Beijing, via Tijuana next year.

**Mexico:** The foreign minister, Luis Ernesto Derbez, also discussed the measures Mexico intends to take to protect its textile and shoe industry from cheap competition from China. Derbez stressed in Beijing, however, that he did not believe that China and Mexico were just competitors in the US market. He said that the Mexican government considered that China was a "strategic ally and not a rival."

Derbez said that he expected the Chinese trade minister, Bo Xilai, to attend the High Level Meeting in May and that the minister would be in Mexico from 18 to 25 May. He said that Bo had said that he would be willing to meet Mexican textile companies and shoemakers affected by Chinese competition.

India and Chile Jaime Gazmuri, the deputy president of the Chilean senate, visited India in February with a specific brief to look at developing links between the countries' bio-technology industries. A delegation of Indian politicians visited Chile in June 2005 to look at ways of boosting links. Gazmuri is particularly interested in applying Indian scientific techniques to boosting Chilean agricultural output. He visited the MS Swaminathan Research Foundation in Madras (now Chennai). Swaminathan was the father of the Green Revolution in India which enabled the country to become self-sufficient in basic grains.

Derbez made a pitch for China to start shipping goods to Mexican ports for onward delivery to both sides of the US. West Coast US ports are unable to cope with the volume of Chinese exports to the US.

**The Mexican motor industry:** The deputy minister responsible for high technology industries at the economy minister, Humberto Jasso, pointed out that motor exports increased by 80% between January 2005 and January 2006. According to figures from the Asociación Mexicana de la Industria Automotriz, in January 2006, the motor industry exported 112,165 vehicles, of which 99,086 went to the US and just under 8,000 to Europe with the balance going to South America, Central America and the Caribbean. Jasso said that some benefits of the free trade agreement between Mexico and Japan, signed in April 2005, were beginning to come through. Subaru, part of Nippon Heavy Industries, has started to market its vehicles, made in the US, in Mexico. If the Mexican market takes off Subaru may start manufacturing in Mexico.

**Freetrade agreements:** Mexican foreign trade officials pointed out, that if trade with the US is excluded, Mexico actually ran a trade deficit with all (46) countries with which it has free trade agreements. In the first 11 months of 2005, this deficit amounted to just over US\$6bn. Mexico ran a US\$59bn trade surplus with the US. In the first 11 months of 2005, Mexico exported US\$194bn worth of goods and services to the US and Canada.

Mexico has 12 free trade agreements covering a total of 46 nations. Mexican officials point out that trade is not the only goal of the FTAs. They note that Mexico has attracted US\$180bn in foreign direct investment from the US since Nafta came into force in 1994. The official claim that FDI from the US has tripled from its pre-Nafta levels.

Mexican officials claim that Mexico still gains from FTAs. They note that trade with the US and Canada has tripled since Nafta came into force. Trade with Colombia and Venezuela has increase by a similar proportion while trade with Bolivia has doubled since the FTA came into force. The star, however, is Costa Rica where trade has risen ninefold since the FTA.

**Chile and Japan:** Carlos Furche, the director general of international economic relations at the Chilean foreign ministry, claimed that the first round of talks over a free trade agreement with Japan had gone well. The first round lasted two days and took place in Tokyo at the end of February. The Japanese team was led by Seiichi Kondo, an ambassador for international trade and economic relations.

Furche said that both sides had surprised themselves at the progress they had made. They said that they had both agreed almost completely on the scope of the agreement and on the schedule for future rounds. The second round is due to be held in Santiago, Chile in May. The unofficial target is to get the deal agreement before the end of Prime Minister Junichiro Koizumi's mandate this September.

Furche said that both countries want the FTA to boost trade and investment, though both side recognised that there were also sectors which were sensitive to both countries. Furche added that Japan understood that one of Chile's priorities was to use the free trade agreement to improve its access for its agricultural products to Japan. Furche added that Chile also realised that some sectors of the Japanese agricultural market were particularly sensitive. He argued that basically the two countries' agricultural industries were complementary since Chilean fruit and vegetables were in season during the northern hemisphere winter.

Furche argued that a FTA with Chile would have more than macro-eco-

Cementos  
Mexicanos:

Lorenzo Zambrano, the chief executive of the world's third biggest cement company, said that he was looking at ways at expanding his company's business in India and China. Zambrano said that he was looking at possible acquisitions. In recent years the company has moved into Central America, Spain, Britain and Indonesia. Zambrano admitted that Cemex would have to make a big bet (over US\$1bn) in a market where all its rivals had had problems. The world's top two cement companies, LaFarge, from France, and Holcim, from Switzerland, have both gone into China and India.

conomic benefits. He said that Chilean consumers would benefit because they would be able to buy Japanese goods more cheaply after the FTA was implemented.

Chile has signed 36 free trade agreements. Furche said that the Japanese negotiators had learnt a lot from having negotiated a free trade agreement with Mexico that was signed in 2004 and came into force in April 2005.

Persuading the Chilean congress to accept an FTA with Japan should not be too difficult, Furche said. He noted that the President-elect, Michelle Bachelet, supported the negotiations with Japan and Chile's large (5% of GDP) fiscal surplus mean that the cost of implementing a FTA (and possibly compensating losers) could be met easily. Chile is currently negotiating FTAs with Peru and Ecuador and is looking to start negotiations with other countries in Asia, but the government said that the priority is the deal with Japan. Chile has a FTA with South Korea.

**Chile and Japan:** A study for the cabinet office in Japan reckons that a FTA will increase Japanese exports to Chile by 42% and increase Japanese imports from Chile by 15%. The cabinet office reckons that Chilean salmon, wood and foods, notably pork, will be the biggest beneficiaries of a FTA.

Japanese carmakers are pushing hard for a FTA because Chile levies a 6% tariff on their products. Korean-made vehicles do not face this tariff, following the Chile-Korean FTA. In 2004, Chile's exports to Japan were worth US\$3.7bn, while Japan's exports to Chile came to US\$800m. The rise in copper prices will have increased the value of Chile's exports to Japan in 2005.

**Chile and China:** The state-owned Corporación del Cobre revealed details of its deal with China's main copper importing company, Minmetals, under which it will sell 836,000t of fine copper over the next 15 years. Chile is the world's biggest copper producer, digging out and exporting just under 5m t of the metal each year. China is the world's biggest importer, though no one knows exactly how much it imports.

In the deal Codelco agreed to ship 55,750t a year. Minmetals is paying US\$550m up front for the copper and will then pay a premium, based on market prices and adjusted for US inflation, when each monthly shipment is dispatched. Codelco said that for the first five years of the arrangement, the Chinese had agreed to pay an average price of between US\$1 and US\$1.20 per pound. The current international copper price is around US\$1.30 per pound.

**China and Argentina:** The Chinese government accused Falun Gong and its supporters of making mischief by claiming that the Chinese government was persecuting its members. The Argentine supreme court declared, on 24 February, that it was incompetent to rule on the issue. China said that Falun Gong and its supporters were trying to disrupt China's relations with foreign countries. An organisation sympathetic to Falun Gong had asked the Argentine courts to indict Luo Gan, one of the nine members of China's Politburo, for persecuting Falun Gong members. Falun Gong has been a prohibited organisation in China since 1999. Falun Gong claims to be a religious organisation and has 80m adherents in China, more than the membership of the Chinese communist party.

Luo became a target when he visited Argentina in December 2005. Luo Gan is coordination director of the Falun Gong control office.

The Argentine courts are following the precedent set by the Spanish courts that ruled in 2003 that they were not competent to judge Luo and a former Chinese president, Jiang Zemin, for what they were doing to Falun Gong.

## COMPARATIVE ECONOMIC DATA

The big moves in the past couple of months involve real interest rates in Venezuela and Mexico. Although nominal interest rates in Venezuela are just negative they are much less so than they were in December when inflation was running at over four percentage points above nominal domestic interest rates. In Mexico, interest rates and inflation have both fallen in the past couple of months. Economists are now beginning to lower their inflation forecasts for 2006. It is quite possible, but amazing to long time Mexico watchers, that this year inflation in Mexico could be significantly lower than inflation in the US.

Comparative data	GDP growth		Consumer price index		GDP US\$bn 2003	Real interest rates %	Exchange rate local currency vs US\$	
	% change year-on-year	quarter	% change	12 months to			% change since 1/1/04	rate on 2004/05
China	9.5	Q1	2.7	Mar	1,300	-0.5	0.0	8.28
Hong Kong	7.1	Q4	0.8	Feb	161.5	1.7	0.0	7.8
India	6.2	Q4	4.2	Feb	510.2	1.1	0.5	43.7
Indonesia	6.7	Q4	8.8	Mar	172.9	-0.5	-12.8	9,585
Japan	0.8	Q4	-0.3	Feb	4,000	0.3	2.0	107
Malaysia	5.6	Q4	2.6	Mar	94.9	0.2	0.0	3.8
Philippines	5.4	Q4	8.5	Mar	78	-2.5	0.5	54.4
Singapore	2.4	Q1	0.0	Jan	87.0	2.1	4.3	1.65
South Korea	3.3	Q3	3.1	Mar	476.7	0.5	16.2	1,011
Taiwan	5.1	Q4	2.3	Mar	281.5	-0.9	9.2	31.5
Thailand	5.1	Q4	3.2	Mar	126.9	-0.6	3.3	39.4
Argentina	8.4	Q4	9.1	Mar	102.0	-4.5	-1.5	2.90
Brazil	4.9	Q4	7.5	Mar	452.4	12.0	5.0	2.55
Chile	7.3	Q3	2.4	Mar	64.2	1.0	-4.0	577
Colombia	4.3	Q3	5.0	Mar	80.9	2.5	14.6	2,343
Mexico	4.9	Q4	4.4	Mar	637.2	5.2	0.0	11.1
Peru	6.8	Feb	1.9	Mar	56.5	1.1	5.7	3.26
Venezuela	11.2	Q4	15.8	Mar	94.3	-3.1	12.0	2,800*
US	3.9	Q4	3.1	Mar	10,400	0.0		
<b>Sources-</b> Official data; CPI: LAWR; Real interest rates: LAAR estimate, based on short-term money market rate * Free market rate; official rate is Bs2,150=US\$1								

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