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Why China's growth rate may accelerate again

For some China watchers the paradox about the Chinese economy is not that it is growing so fast, but why is it growing so slowly when investment is so staggeringly high. As our sister publication China Watch has consistently warned, there is huge overcapacity in a lot of key industries. One recent calculation reckons that now there is 120m t of overcapacity in the steel industry alone. The irony of this is that as the Chinese government turns the economy to consume more and invest less, economic growth may accelerate at even faster rates.

Already China is on course to become the world's biggest economy in terms of economic output, on purchasing power parity, probably by 2012. Its economy already produces 69% of what the world's biggest economy, the US, does. What is significant that on GDP per capita, (again on PPP) China will take another generation to get up to US standards.

The World Bank points out that, on PPP, GDP per capita in China is currently US\$5,878 while in the US it stands at US\$37,437. In Mexico, which this year will grow faster than Brazil, the only other sizeable Latin American economy, GDP per capita, on PPP, is US\$9,132.

Worryingly, although Mexico's GDP per capita is currently 55% higher than China's the compounding effect of faster growth rates means when China overtakes the US in GDP per capita, sometime between 2035 and 2040, Mexico's GDP per capita, on current rates, will be only third of China's, assuming that Mexico grows at a steady 3%.

The issue is whether China's economy will continue to grow at these extraordinary rates. China's government is determined to move away from growth driven by investment and a growing global trade surplus towards growth that is one more dependent on consumption. Nicholas Lardy, in an influential paper for the Institute for International Economics in Washington, argues that only by making this change can China sustain its strong growth of recent years, achieve more rapid job creation, improve income distribution or at least slow the pace of rising income inequality, and reduce its outsized increases in energy consumption of recent years. It also would contribute to a reduction of global economic imbalances.

The problem is implementing the change. Lardy argues that the government has been too tentative in making the changes, so the underlying economic dynamic, depending on investment for growth, has not changed.

One problem is that the governing class in China, by and large, is happy with the current system which has, first, made China the world's fastest-growing economy for the past 30 years and secondly, not produced wrenching political changes.

" A better balanced Chinese economy may, worryingly, for Latin America and the industrialised economies, be an even more productive competitor. The sheer scale of recent Chinese industrial investment has been hugely inefficient. This waste has, inevitably, had an effect on productivity growth, which economists calculate, has fallen by 25% in recent years to around 3% a year. "

For Mexican commentators, the extraordinary aspect of China's growth is that so many correct long term economic decisions were taken and implemented steadily. Mexico, with its six-year electoral cycle finds such consistency almost impossible. Brazil, to be fair, has a better record in long-term investment (aerospace, alternative fuels, deep sea oil technology) but it has not achieved the consistent 5% plus rates of economic growth since the return of democracy 21 years ago.

Industrial investment has underpinned China's growth. In the first 10 years, after Deng Xiaoping switched China on to this growth track in 1978, Lardy reckons that investment averaged 36% of GDP each year. This was, he noted, relatively high by the standard of developing countries generally but not in comparison with China's East Asian neighbours when their investment shares were at their highest. What is extraordinary is that in the 1990s and beyond, China's investment surged again: in 1993 and again in both 2004 and 2005 investment as a share of GDP exceeded 42%, a level well above other countries in East Asia.

Such rates of investment are powered by a savings rate that touched 50% of GDP in 2005. In this edition of LAAR we look at two areas in which China could change policies and move on to a more conventional economic growth track. We look at bond market developments and the possibilities that healthcare reform could provide.

If the government spends more on healthcare it should, from the evidence available from other economies, find that its people start to save less and spend more. The most striking example of this happening is in Taiwan, where healthcare reform appears to have led to a 4% of GDP increase in consumption.

In China, household consumption had been as high as 50% of GDP in the late 1990s and early 2000s but fell to 38% of GDP, the lowest share of any major economy in the world in 2005, Lardy points out. In the US, by contrast, household consumption, at 70% of GDP, is powering not only the US economy but the world economy. Other countries with decent growth also have comparatively high consumption: in Britain, consumption runs at 60% of GDP; in India consumption is equivalent to 61%.

A better balanced Chinese economy may, worryingly, for Latin America and the industrialised economies, be an even more productive competitor. The sheer scale of recent Chinese industrial investment has been hugely inefficient. This waste has, inevitably, had an effect on productivity growth, which economists calculate, has fallen by 25% in recent years to around 3% a year.

There is no certainty that a switch to consumption, which will lead to massive changes in China's service sector, will re-invigorate its manufacturing industry, but the chances are that it will. The worry for Latin America is that even if China's policymakers, unusually, fumble the change the economy is still throwing off enough cash to enable it to compensate for any mistakes.

At the beginning of November, China admitted that its foreign currency reserves went over US\$1 trillion for the first time. They are rising at the staggering rate of US\$30m every hour or US\$21.6bn each week. Economists reckon that by 2010 China will have doubled its reserves again to US\$2 trillion. This is staggering since in 2001, reserves stood at "just" US\$219bn.

The Panama Canal expansion

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Although less than 25% of the Panamanian electorate voted, there was a thumping (80%) majority for the government's plans to expand the Panama Canal on 22 October. The decision has major regional and international implications.

The big strategic question for the US is what sort of role China should play in the expansion. China is the second-largest user of the Canal, but a long way behind the US. The US accounts for 68% of Canal traffic. US Canal experts are already concerned that a Hong Kong based company, Hutchison Whampoa, has port terminals at both ends of the Canal. They fret that US Naval vessels may no longer have priority rights of passage through the expanded Canal if China is allowed to play a role in the financing of the expansion.

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China may be the second-biggest user of the Canal but Panama does not have diplomatic relations with it. Panama is one of the 24 countries, most of which are in Central America or the Caribbean, which recognise Taiwan. Taiwan is playing up this advantage, suggesting that it should be involved in the financing of the expansion. Panama's policy has been to use its relationship with Taiwan to prevent China from becoming too dominant.

The bulk of the cash to pay for the Canal expansion will come from higher Canal tolls. Under the expansion plan, the Canal will continue to operate as the third set of locks is built on the 50-mile waterway. The Autoridad del Canal de Panama (ACP) is keen on getting a credit rating from international agencies: the ACP's finance director, José Barrios, claims that the ACP's rating could be higher than the Republic of Panama's. Members of the ACP's supervisory board, however, are less keen on doing this.

Ricaurte Vásquez, president of the ACP's board of directors, suggested that the need for external financing will be much more limited than most financial analysts expect and even the ACP envisaged when it carried out its global roadshow, presenting its project earlier this year.

Vásquez claimed that Canal could, for example, cash in on the US\$300m a year the Canal's customers could make from carbon emissions trading since bigger and more efficient ships would cut down on carbon emissions. Shipping companies can monetise this environmental gain. Vásquez argues that the Canal's expansion is creating this extra cash for customers, it should take a cut.

World Bank economists reckon that the new set of locks will cut carbon emissions by 30m t annually. Currently each tonne of carbon dioxide emission fetches between US\$10 and US\$12 on the markets where such things are traded. Sellers of carbon emissions are companies which are confident that they can reduce their emissions ahead of the demands of the Kyoto schedule. The buyers are companies which do not feel that they can reduce their emissions in line with Kyoto. The idea of trading carbon emissions is that companies that invest in greener technology are rewarded financially, while those that do not are penalised.

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Regionally, the Canal expansion has significant implications. South Americans date the start of their long economic decline to the opening of the Panama Canal in 1914. South Americans, particularly Argentines, argue that the Canal switched the direction of world trade. Argentina and South America in general had benefited from North-South trade. After the Panama Canal opened trade became much more East-West. The Northern Hemisphere started to trade more with itself than with the Southern Hemisphere.

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Shipping companies point out that 30% of the ships using the port of Los Angeles in 2005 were too big for the Canal. As Los Angeles envisages its cargo handling doubling by 2020, it does not regard the expansion of the Panama as a strategic threat. So huge has transpacific trade become that shipping companies have been searching up and down the western seaboard of North America for spare capacity. Ports as far south as Manzanillo in central western Mexico have become transshipment points for goods from Asia destined for the US. Ports in Canada that were last used to service the Yukon gold rush over 100 years ago are also being brought back into service. Both Mexican and Canadian ports are attached to railway networks which transport the Asian goods to markets in the east coast of the US.

What is significant is that the expansion of the Panama Canal will have most effect on container shipping. These vessels are big but not as enormous as the new generation of bulk carriers and tankers which will still be too big for the Panama Canal. This means that manufacturers in Asia will still enjoy the huge benefits of scale that have enabled them to profit so heavily from globalisation.

All that the Panama Canal may change is to enable that ships which are almost as big as the world's biggest container ship, the Emma Maersk, which currently travels to Europe via the Suez Canal, to use the Panama Canal. The Emma Maersk delivered 11,000 containers from China to Europe at the beginning of November on her maiden voyage. Currently the biggest container ships able to use the Canal, the so-called Panamaxs, have a maximum beam of 106ft. These ships carry a maximum of 5,000 containers (called 20ft container equivalent units, teus, in Canal jargon).

The Canal's new locks will be 40% longer and 80% wider than the current locks. Even so, the Emma Maersk will be just too wide to fit through: it is 184ft wide. The new locks will be 180ft wide. The new locks, at 1,400 ft long, could handle the 1,303ft long Emma Maersk. As she only draws 50ft, she could get through without scraping the bottom. When the Canal expansion is complete, the depth of water will be 60ft.

The expansion of the Panama Canal is likely to accentuate current world economic trends. It will help China and East Asia to remain the world's manufacturing hub as it will tighten the links between producers and markets.

The Suez Canal

The Suez Canal does not have locks so it can be expanded relatively easily. Indeed, the Canal is now 14 times bigger than when it was inaugurated in 1869. The Emma Maersk can already fit through as can over 80% of the world's supertankers.

By 2010 the Suez canal should be able to handle vessels that draw 70ft. The world's biggest tanker, the Knock Nevis, which can carry up to 825,614t, is too big to use the Suez Canal, but then this vessel is, apparently, too big to use English Channel.

“Where the Canal may have a positive effect is on the economic development of central South America. Traditionally, this area has looked to Europe. In the rubber boom 100 years ago, the new rich of Manaus sent their laundry to Paris. Now the economic development of South America's bulge is likely to be geared to Pacific rim consumption. Iron ore from Mutún, or gas from Camisea, is as likely to go north to the US west coast as it is to cross the Pacific.”

This will continue to leave Latin America out of the loop. The region has become a major supplier of commodities to Asia, particularly metals and food, but little of this trade goes through the Canal. Arguably, the expansion of the Canal could affect this business adversely, since US (and possibly East European) farmers could send containers of processed food back through the Canal on the ships that bring all these manufactured goods to their markets.

US Canal experts claim that US agribusinesses will benefit from the expansion because they will be able to send grain and meat down the Mississippi and through the Canal to Asia. This is a much cheaper way of exporting to Asia than their current method of moving the crops by rail to the west coast or exporting east, around Africa or through the Suez Canal, from terminals on the Gulf of Mexico.

The big question for Latin America is whether the expansion of the Panama Canal will help Latin America to diversify its exports and its export markets. The Panama Canal is unlikely to become a route from the Caribbean to Asia. Venezuela, the biggest Caribbean economy, has its refineries on its routes to its main market, the US. So although Venezuela could use the Canal to send substantially more oil to China, it probably will not. Venezuela's oil is comparatively heavy and China's refineries are used to lighter oil. It is not worth China investing in changing these refineries unless Venezuela becomes a dominant supplier. At most, Venezuela expects to sell China 500,000bpd of oil of a production that may reach 3.5m bpd. The reality is that, despite what President Hugo Chávez may wish, most of Venezuela's oil will continue to go north to the US.

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What may happen is that Panama City, at the Pacific end of the Canal, will become a transshipment point. There will be a lot of East-West trade, but an increasing amount of south-north trade up the west coast of South America. If this happens more trade will go west in South America. Argentina has long dreamt of exporting fruit to Asia, but its rivalry with Chile has prevented it using Chilean ports.

In Central America, what the expansion of the Panama Canal will do is knock out any rival scheme. In the run-up to the vote in Panama, Nicaragua revived its scheme to dredge the San Juan river and then cut a canal from Lake Nicaragua to the Pacific. The cost of this project is budgeted at US\$18bn. Besides this the Panama Canal expansion looks a snip at US\$5.25bn. In addition, the Nicaragua project involves untried technology and geology. The preliminary geological work on the Panama Canal was done in 1938, so there are unlikely to be any surprises when construction starts.

The expansion of the Canal will confirm Panama as Central America's financial centre. The centre is relatively sheltered from international financial eruptions largely because the country has always used the dollar, though it does mint its own small change. Unusually Panama has no central bank, nor a monetary board. In economic terms its scope for a monetary policy that is independent of the US's is non-existent.

This unusual financial set-up has implications for the way the Canal expansion will be financed. The safest way to finance the expansion would be to allow the ACP to issue debt: any other solution runs the risk of creating money and inflation in the Panamanian economy.

The challenge from China

"China is already the world's fourth-biggest vehicle producer. In 2005 it built 5.7m vehicles, 8.6% of the world total. In 2006, the Chinese vehicle industry is likely to produce around 7m vehicles. Brazil will build around 2.3m vehicles this year and Mexico around 2.1m."

China's motor industry will build around 9m vehicles next year. Such a level of production is almost five times what Latin America's two biggest vehicle makers, Brazil and Mexico, will produce. The true significance of this increase is that from 2007, Chinese-made cars can be exported to the US

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What is happening in the Chinese motor industry is that sales of vehicles produced by Chinese car companies are growing faster than sales of cars built by multinationals with factories in China. In the first 10 months of 2006 total vehicle sales in China were up by 26% at 3.89m, according to the China Association of Automobile Manufacturers. The Association said, but did not provide data to substantiate the point, that domestic carmakers such as Geely Automobile; Great Wall Automobile and BYD Automobile had increased sales while joint venture companies had seen their sales fall. The Association claimed that the average fall in sales for foreign companies such as General Motors, Volkswagen and Ford was 20% between September 2006 and October.

Joint ventures still produce over 70% of the cars sold in China. Domestic companies have increased their market share to 29%.

At the recent China Europe International Business School forum on the motor industry, which took place at the end of October, Li Shufu, the president of Geely, announced that the company was carrying out market research in Europe and the US in preparation for an assault on these markets. Geely is the biggest of the domestic car producers. Li Shufu said that he expected the company to start exporting its cheap, but well-designed and well-built, cars to these markets in 2007 or 2008.

Geely already sells its vehicles in Latin America, though in very small quantities: its main markets in Latin America are Venezuela; Honduras; Peru and Bolivia.

Geely's sales in Latin America have been sticky, largely because it has to sell at comparatively high prices because of the region's import tariffs. Another problem is that Chinese vehicles do not meet emission standards: this has kept them out of the Chilean market where pollution standards are enforced with a vigor that is comparable to the US or the European Union.

One example is Brazil, where sales of Chinese made vehicles in the first nine months of 2006 came to just 1,685. This is a market share of 1.4%. The worry is that in the same period of 2005, the Chinese-made vehicles had a market share of 0.15%. The bulk of the Chinese vehicles sold in Brazil are vans (light-lorries) that are cheaper than the competition.

In Chile Chinese-made vehicles have seen their market share jump from 0.15% two years ago to 0.9% in the first nine months of 2006. Motor industry analysts say that the prospects for increased Chinese vehicle exports to Chile are likely to improve once the free trade agreement between the two countries comes into effect.

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In Argentina, of the 232,000 vehicles imported in the first 10 months of the year, just under 10% (9,867) came from China.

Currently Geely is building about 200,000 vehicles a year and exporting about 10,000. Most of the export sales are, the company admits, made at a loss. Once export volumes rise, the company claims that exporting will become more profitable. By 2015 the company expects to be producing 2m vehicles a year. According to Li Shufu, a third of this output will be exported.

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Latin America's motor manufacturers are more concerned at the challenge China poses. Luis Gómez Sánchez, the director of government and corporate relations at Daimler Chrysler Mexico, said on 6 November that Mexican carmakers had to think of themselves as North American businesses. He said that Mexico had to see itself, with the US, in competition with China.

Gómez Sánchez said that one of the big problems for Mexico is that tighter US border controls are blunting the advantages Mexican carplants have in integrating themselves in to the US supply chain. Gómez Sánchez argued that Mexican companies had to integrate themselves with US companies so that North America competed as a region or else they would be pushed out.

World vehicle demand

Futurologists guess that the bulk of the new demand for vehicles will come from emerging markets. Global Insight forecasts that between 2007 and 2011 demand for new cars in China will rise by 56%. In the rest of Asia demand will increase by 48%. By contrast demand for new cars in Latin America will rise by only 16%. In Eastern Europe, demand will rise by 19%.

Global Insight forecasts that there will be little change in demand for new cars in the established markets of the US; Europe and Japan. All three markets will suffer from either sluggish economic growth or a lower rate of household formation, or a combination of these two phenomena.

US Integration

Mexico's motor industry is already pretty integrated with the US's. Mexico's economy minister, Sergio García de Alba, said that Mexico had to be concerned by the US\$5.8bn third-quarter loss Ford declared on 23 October. García was quick to add he did not expect the cutbacks Ford is implementing in North America would affect the company's three plants in Mexico. More at risk may be Daimler Chrysler's plants in Mexico.

What is undeniable is that Mexico's motor industry, the country's biggest foreign exchange earner, above even oil, is now inextricably linked to the US economy. In the first nine months of this year Mexico's carmakers exported 1.13m of the 1.48m vehicles they produced. Compared with the first nine months of 2005, production was up by 31% but exports were up by 41%. Just over 1.04m of the total vehicles exported went to North America. Less than 50,000 of these vehicles went to Canada, so virtually all of the vehicles Mexico exports to North America go the US. In the first nine months of 2006, Mexico shipped 997,000 vehicles (cars and trucks) to the US; this was up 38% on the same period of 2005.

“ Motor industry analysts have fretted about the possibility of one of the big three US carmakers going bust. The most vulnerable is probably Chrysler, which is now owned by the German vehicle manufacturer, Daimler-Benz. On 25 October, Daimler executives did not deny that the company was contemplating spinning off or selling Chrysler after revealing that Daimler Chrysler's quarterly loss came to US\$1.5bn. ”

The problem Mexico's motor industry faces is that the big three US car companies, GM, Ford and Daimler Chrysler, all have major problems with their North American operations. All three are cutting back costs and restructuring their expensive US operations. All have shifted some production to Mexico, where labour costs are much lower.

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Chrysler, like all the US motor manufacturers has plunged into losses. Higher petrol prices have meant that Sports Utility Vehicles (SUVs) and pick-ups have become harder sells. Seven years ago Chrysler's Jeep Grand Cherokee and its Dodge Ram pickups were best sellers. US consumers have switched to smaller, more efficient vehicles. Chrysler was hit disproportionately hard because 75% of its sales are of SUVs and pickups. Chrysler's third quarter losses were mitigated by its assignment of 100,000 vehicles into something it calls an order bank. These are cars that are neither assigned to dealers nor held as inventory. It is not clear that Chrysler will be able to sell these vehicles at a profit.

China's opportunity?

If Daimler were to sell Chrysler, the most likely buyer would be the Renault-Nissan combo. An alternative buyer could be a Chinese car company. Both of these options could have severe implications for Mexico. Nissan is already well established in Mexico and if it takes over Chrysler, there is no guarantee that it would continue with Chrysler manufacturing operations in their current form. When Nissan merged with Renault, Renault's small Mexican manufacturing business was wound down.

A Chinese takeover would be even more worrying. There is no guarantee that a Chinese company would not shift production back to China. So far Mexico has managed to head off any shift by the US motor industry to produce vehicles for the US market from China. If one Chinese company proved that exporting vehicles from China to the US was feasible, the outlook for the whole Mexican vehicle industry would become problematic.

In Mexican terms, the biggest carmaker is GM which built 380,182 vehicles in the first nine months of 2006. The second-biggest vehicle producer in Mexico is now Nissan which built 296,097. The third-biggest carmaker is Ford (258,096) followed closely by Volkswagen (256,103) and then Daimler Chrysler (240,809). What all these companies do is use Mexico as a manufacturing platform for exporting, to the US principally. In the first nine months of 2006 domestic car sales (including imports) were up by only 0.7% at 799,676. Yet exports were up by 42% at 1.138m. Imports of new vehicles into Mexico were 462,000 for the first nine months of 2006. This was down 2.5% on the same period of 2005.

César Flores, the president of the Asociación Mexicana de la Industria Automotriz, said that he expected the industry to do 1.2m in domestic sales this year; produce 1.9m vehicle and export 1.6m. Mexican policymakers, such as García de Alba, expect Mexico to benefit from the restructuring of the US motor industry. In June Ford leaked detailed plans on how it would imple-

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Vehicle production and exports, Jan to Sept 2006 (000 vehicles)

	<i>production</i>	<i>exports</i>
DaimlerChrysler	241	231
Ford	258	223
GM	380	319
Honda	18	12
Nissan	296	139
Toyota	26	3
Volkswagen	256	210
Total	1,475	1,138

source: AMIA

ment its initial plan to cut 30,000 jobs and close factories in the US but expand and upgrade production at its three Mexican plants. In the plan, the three Mexican plants that will get the investment are: Cuautitlán, (Estado de Mexico); Hermosillo (Sonora) and the company's engine plant in Chihuahua.

The Ford plan, known as the 'Way Forward', was announced in outline in January, and called for a completely new plant to be built in North America, probably in Mexico. If the plan is implemented, Ford's production capacity in Mexico will double to 850,000 units a year. The plan would also create 150,000 new jobs in Mexico. In October, Ford's chief executive, Alan Mulally, said that the "Way Forward" would now involve the loss of 44,000 jobs in the US (though he used the euphemism, North America) and the closure of 16 factories. Ford has yet to announce how much it plans to invest in expanding its operations in Mexico, where labour is cheaper, but informed leaks suggest that the figure will top US\$9bn. The investment should attract tax credits from Mexico worth about US\$500m. Ford said in the 'Way Forward' document that the Mexican investment would lead to a 300% increase in the use of Mexican-made components and would also increase Mexico's motor exports by US\$18bn a year.

Ford claimed, after the leak, that 95% of the company's investment over the next six years will continue to go into its US plants with only 5% going to Mexico. Even so, the shift should save the company about US\$1.8bn a year. The 'Way Forward' plan calls for a new US\$1.4bn plant that could produce 280,000 vehicles a year. The new plant would be designed to enable flexible working practices that allow managers to match output more quickly to demand. Hermosillo opened in 1986 and produces sedans. 'Way Forward' envisages an investment of US\$1bn in this plant which would have its capacity increased to 305,000 vehicles a year. García de Alba said on 23 October that Hermosillo had already secured new investment to enable it to produce Fusions and Lincoln Zaphyrs for the US market.

The older Cuautitlán plant builds Super Duty pickups and Ikon small cars. Under 'Way Forward' the plant's capacity would be increased to 220,000 vehicles a year. The Chihuahua plant would get the biggest investment (US\$2.3bn). The attraction of expansion in Mexico is clear. Mexican autoworkers are paid, on average, just under M\$200 (US\$17.4) a day. US autoworkers, according to the Union of Autoworkers, earn US\$27.3 per hour. In the third quarter, Ford lost US\$2bn on its North American operations as its sales fell from US\$18.2bn in the third quarter of 2005 to US\$15.4bn in the third quarter of 2006. For the year so far, the Ford Motor Company worldwide has lost US\$7.24bn.

The problem facing the Mexican motor industry is that 80% of the country's vehicle output is exported, mostly to the US. If the US economy slows down, which is likely despite the US Federal Reserve Board's efforts to ensure a "soft landing" for the US economy, demand for Mexican-built vehicles will be affected.

India

On 8 November, Renault and Mahindra, an Indian conglomerate announced that they would set up a joint venture to build a car plant capable of producing 300,000 vehicles a year. The plant will come on-stream in 2009 and build the Logan saloon. The plant's output is designed to be sold entirely in India.

Brazil

Brazil's motor industry is not integrated into the US supply chain. Arguably the industry has closer links with Europe. A lot of Fiat's engines, for example, are now made in Brazil. Overall the motor industry in Brazil is having a good year. One major reason for this is the surge in demand for flex-fuel vehicles: these run on a mixture of petrol and alcohol. Currently there are over 40 models available in Brazil which use flex-fuel engines. Flex-fuel vehicles account for over 80% of new car sales in Brazil.

In the first 10 months production was up by 4.5% at 2.2m units. In October, production increased by 11% compared with September, and domestic sales by 10%. Exports in October were 6% up on September's. According to the Associação Nacional dos Fabricantes de Veículos Automotores (Anfavea) domestic vehicle sales in the first 10 months were up by 12% at 1.54m. Exports were up by 8.5% in value terms at US\$10.1bn in the first 10 months.

Fiat is one of the great successes of the Brazilian motor industry. Over the next four years it expects to increase its sales in the region by 12.7% to 620,000 vehicles by 2010. By 2010, Fiat's director for Latin America Clerdovino Belini reckons that 4.3m new cars will be sold in Latin America. Fiat's biggest market is Brazil, where it accounts for over a quarter of new vehicles sold. Belini expects Fiat to hold on to that market share, which will mean that the company will sell 488,000 new vehicles in 2010. This is 6% up on this year's likely sales. Belini sees the region's other main new vehicle markets as Argentina, Mexico and Venezuela. Fiat expects its sales to these markets to rise from 71,000 now to 97,000 by 2010. By then Fiat's market share should be over 5%. Currently it is less than 2%.

The tyre industry in Mexico

The worry for Mexican economic policymakers is what has happened to the tyre industry in Mexico. At the end of 2001, three significant tyre producers, Euzkadi, Goodyear and Uniroyal shut down because their output was not competitive. The closure led to a major fall in tyre production. In 2000, Mexico produced tyres worth US\$905m. In 2002, tyre output was down to US\$426m. To be fair the tyre industry has recovered since. In 2005 output was back up to US\$639m.

The problem for the industry is that tyre imports now swipe almost two-thirds (63%) of the national market. On top of this, tyres are also smuggled into Mexico. In San Diego, used tyre markets sell tyres for US\$1 each. These tyres are invariably shipped to Mexico. The Mexican tyre industry reckons that 3m used tyres are sold in Mexico every year.

The value of the Mexican tyre market has continued to rise, as vehicle production has grown. The problem for Mexican tyre makers is that they have not been able to increase their share of the market significantly.

What Mexico's tyre makers are lobbying the government for is to impose an anti-dumping duty on tyre imports from China, South Korea and India. The industry claims that it cannot compete with tyres from these countries, which are, the Mexican industry claims, exported at below cost. The Mexican tyre makers say that they have no problem competing with tyres made in the US; the European Union; the US; Brazil; Japan and Chile.

The Mexican tyre market				
US\$m	2002	2003	2004	2005
Total sales	1,287	1,301	1,410	1,676
Mexican companies sales	426	469	549	639
Market share of Mexican companies (%)	33	36	39	38

source: Asociación Nacional de Distribuidores de Llantas y Plantas Renovadores.

Mexico and Brazil export pilots to Asia

Forecast growth in Air Traffic between 2005 and 2009

	%
Poland	11.2
China	9.6
South Korea	9.5
Qatar	9.2
Turkey	8.9

source: IATA

Brazil

Over the past few years at least 114 Brazilian pilots have signed up with Chinese airlines. The prolonged crisis at the Brazilian national flag carrier, Varig, is the main reason.

Brazilians are even moving in to management positions in Chinese Airlines: Armando Viriato Souza Freitas worked for 16 years at Varig before becoming, in 2003, the manager of Shenzhen Airlines's aviation department. He said a experienced Boeing 737 pilot in China earns US\$8,750 a month. In Brazil, pilots get US\$4,000 a month.

Mexico has started to export pilots. It currently has around 7,000 unemployed but qualified airline pilots aged between 30 and 45. Around 400 of them have found work with foreign airlines, often in Asia.

Mexico has around 10,000 trained and experienced pilots, but only about 3,000 of them work in the domestic market. Another 100 or so work for cargo carriers. Although low-cost carriers have started to set up in Mexico, the big demand for pilots is in the Middle East and Asia. The International Air Transport Association (IATA) believes that the Asian demand for pilots will continue for the foreseeable future. Between 2005 and 2009 it expects civil aviation in Asia to grow by 9.5% a year: this will mean more jobs for pilots.

Jorge Sunderland, the spokesman for the Asociación Sindical de Pilotos Aviadores, said at the beginning of September that the biggest hirers of Mexican pilots had been China Air and Singapore Airlines but that airlines from the UAE; Malaysia, Vietnam, Qatar, India and even Sri Lanka were catching up fast. India's demand for pilots is such that the aviation minister, Praful Patel, said that recently planes had to be left on the ground because there were not enough pilots. India has 2,500 pilots. Of these 400 are foreigners. The Asia-Pacific Aviation Center says that India needs at least 450 more qualified pilots.

Emirates Airways is probably the biggest foreign employer of Mexican pilots: 20 of its 100 pilots are Mexicans. Alfredo Velázquez, president of the Asociación Mexicana de Centros de Capacitación y Formación, said that Mexican pilots are wanted for two things, principally: their experience of flying in mountainous areas which do not have radio beacons warning pilots of dangers and, secondly, their knowledge of US airports and airspace. Almost all Mexican pilots have US qualifications and international licences which makes them highly employable.

Most Mexican pilots also have bags of experience: Asia airlines demand a minimum of 5,000 flying hours and 500 hours on a specific airliner. Most Mexicans have between 15,000 and 20,000 hours of flying time which includes between 2,000 and 8,000 hours on Airbus 320s, one of the Asian fleets' main workhorses. The big attraction for Mexican pilots is the pay in Asian airlines. In Mexico pilots expect to earn between M\$70,000 and M\$90,000 a month (between US\$6,400 and US\$8,250). In Asia the average pay is US\$11,000 a month.

Brazil's problems with China

Three years ago Brazil's aerospace company, Embraer, went into a joint venture with a Chinese aerospace company, Avic II, in Harbin, north-eastern China. Embraer executives are increasingly frank about the difficulties of doing business with the Chinese.

The original plan was for Embraer's joint venture to build 20 regional ERJ 145 jets a year with Avic II. The jets seat 50 people. So far the joint venture has failed to produce more than 16 aeroplanes. Worse, in March this year another Chinese aerospace company, Avic I, announced that it would start to build a regional jet that would compete with the ERJ 145: the only comfort for Embraer is that the Chinese jet was slightly bigger.

Embraer executives stress that they are in China for the long term. By 2020, if current trends hold, China will be the world's second-biggest aviation market and the biggest market for regional jets.

How Latin America's approach differs from China's

"In China, the commercial banking system does not work properly. At the end of September 2006, commercial banks in China had deposits that were roughly 11 trillion yuan (US\$1.4 trillion) bigger than their loan books, which stand at 33 trillion yuan (US\$4.2 trillion). To make a return on this money, banks have been speculating in the domestic bond markets."

Latin America's debt crises have prompted the region's big economies to try to develop their own, local bond markets. In both Brazil and Mexico over half the public sector's debt is denominated in local currencies. Less than a generation ago the bulk of the debt would have been in dollars. Domestic investors in Latin America are less trusting than expatriate emerging market investors, so they have forced substantial fiscal improvements on their governments. In China, local bond markets have developed for very different reasons. Along with property and shares, they are one of the few ways that local savers can invest. Essentially, they are a way of soaking up excess savings. Individuals and banks are huge investors in the markets and their presence has pushed down yields.

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The Chinese bond markets are huge. Bonds in issuance now top 8.9 trillion yuan (US\$1.1 trillion). Even though the central bank has been trying to tighten monetary policy (and so push up interest rates) yields on domestic bonds have fallen because there is so much cash chasing the bonds. The yield on the benchmark 10-year government bond is just 3.01%.

The Chinese bond market is liquid. Roughly 2% of the stock of Chinese bonds is traded every day on the electronic over-the-counter market. Bonds are also traded on the stockmarkets at Shanghai and Shenzhen. On 6 November, the central bank announced that it would permit bond borrowing. This will mean that short-selling will now be possible. Short sellers are investors who sell bonds they do not own in the expectation that the price will fall. The short seller has to borrow the bond to sell it.

The arrival of short selling is a step back towards allowing derivatives in Chinese financial markets. These came to an end in 1995 following a series of price manipulation scandals.

State companies and development banks dominate the new issuers in China's bond markets. The government has also been trying to encourage domestic companies to issue debt rather than shares to raise funds. This year the government has already authorised 80bn yuan (US\$10.2bn) of corporate issues. Most analysts expect the market to absorb around 100bn yuan of corporate debt. This will represent an increase of 56% on 2005 issuance.

The main reason why China's banks and investors are awash with yuan is the size of the country's foreign exchange reserves. These topped US\$1 trillion at the beginning of November. The central bank has to pay almost eight yuan for each dollar in reserves. Doing this inflates the money supply and prompts a huge amount of unnecessary and speculative investment and undermines the authorities' efforts to tighten monetary policy.

The obvious way out of this problem, taken by Latin American governments, is to allow local investors to hold dollars. At the beginning of November there was a considerable debate among China watchers over whether the authorities would take steps towards doing this. One intermediate step would be for the ministry of finance to issue bonds to the central bank which would pay for the bonds with at least some of the dollars it has in its reserves.

“Sales of debt to the Venezuelan government do not provide creditors with an opportunity to interfere. Since 2005, Venezuela has bought about US\$3.4bn of Argentine debt.”

The problem with this is that the ministry of finance would have to pay at least US rates for the dollars. These are two percentage points higher than yuan rates. Another problem is that the government would have to spend the money internationally in order to avoid inflating the domestic money supply.

Interestingly, Venezuela has tried to deal with a similar (though much smaller) problem, by buying debt (issued in dollars) by other countries. China could do this on a far more dramatic scale than Venezuela's US\$3bn or so purchases of Argentine debt. Venezuela's government bought the bonds and then sold them on to local banks who were delighted to diversify out of Bolívares assets. The banks sold the Argentine bonds onto their customers who could pay for the bonds in Bolívares in Venezuela but sell them for dollars outside the country. This allowed banks and their customers to get around exchange controls.

The Argentine government floated the idea, at the end of September, of selling debt in Asia. This is a development of the current programme under which the government sells debt to Venezuela. Since Argentina defaulted on its foreign debt in 2001, Venezuela has been the only international buyer of its paper.

Argentine officials said that they were looking at selling debt to China, South Korea and Malaysia. One issue the Argentine government will have to deal with is existing creditors who did not take part in the 2005 exchange offer that paid creditors just 30% of what they were owed. These creditors may use the court to seize any interest payments Argentina makes on new debt.

Sales of debt to the Venezuelan government do not provide creditors with an opportunity to interfere. Since 2005, Venezuela has bought about US\$3.4bn of Argentine debt.

On 13 November Venezuela and Argentina went a step further and launched a joint US\$1bn bond issue. This is the first joint issue by two sovereign nations. The nearest precedent is, probably, bonds issued by Colombia that were guaranteed by the World Bank. The Argentine-Venezuelan issue, called by the governments Bonds of the South were sold in Venezuela. Investors could buy the dollar securities with Bolívares.

The two governments said that the issue was popular with investors, who lodged bids for US\$9bn worth of the securities. Although there is a single wrapper around the issue, in fact Venezuela and Argentina are issuing their own securities.

Venezuela is issuing US\$500m of public debt due in 2017; and Argentina is issuing US\$300m of floating rate debt, due in 2012 and US\$200m of fixed rate debt carrying a coupon of 7%. These bonds mature in 2015. Investors got a mixture of all three securities.

The Venezuelan government has become Argentina's banker in the past couple of years and made a good return on the business. The Venezuelan government has sold three-quarters of the Argentine debt it bought on to local banks in Venezuela. They are keen buyers since they can use the bonds as a way around exchange controls.

The Venezuelan government is keen on issuing dollar debt, which can be bought with Bolívares, as a way of taking excess Bolívares off the local money market. Otherwise the excess Bolívares would chase the price of goods higher.

“ Latin America's bond markets have developed in a more traditional way. On 24 October, Mexico passed another landmark by becoming the first Latin American country to launch a long-dated, fixed-rate bond in local currency. ”

China's Internationalisation

A year ago, in October 2005, the Asian Development Bank and the World Bank's affiliate, the IFC, became the first foreign borrowers in the Chinese domestic bond market. The ADB tapped the so-called Panda market for 1bn yuan (US\$125m). The ADB had previously issued local currency bonds in India and the Philippines. The IFC issued a similar amount when the market opened.

The Chinese authorities laid down tough rules for foreign issuers in the Yuan market. They insist that all the proceeds have to be used on development projects in China. This restricts the internationalisation of the currency and the creation of swaps and forward markets. Mexico and Brazil, by contrast, revel in the fact that vibrant derivative markets in their currencies now exist.

Asia bond markets have gone much further than Latin American bond markets in developing asset backed securities. Mortgages are commonly securitised, as are credit card receivables. China issued 17bn yuan (US\$2bn) of asset-backed securities in 2005. The bank for International Settlements points out that the law on mortgage foreclosure is still untested in China, so until there is some clarification, the further development of the mortgage-backed securities market may be hindered.

Latin America's bond markets

Latin America's bond markets have developed in a more traditional way. On 24 October, Mexico passed another landmark by becoming the first Latin American country to launch a long-dated, fixed-rate bond in local currency. It sold M\$2bn (US\$182m) of 30 year peso bonds at a yield of 8.08%, significantly better than what trading on the pre-market had indicated.

The main reason why the yield was lower than the 8.26% the grey (or pre-) market had expected was that demand for the paper was huge. The treasury had bids worth M\$12.6bn (or for 6.3 times the amount of paper the government was offering). Although the government offered only M\$2bn worth of paper, the yield on the 30-year debt is three basis points lower than 20-year paper, suggesting that investors are prepared to pay a premium to buy 30-year paper. The government says that it expects to issue 30-year paper once a quarter. At the end of August the Mexican government had M\$2.1 trillion of debt outstanding. Of this M\$1.3 trillion was issued in the domestic market. Currently Mexico has foreign debt of only US\$40.4bn.

Arguably, Mexico and Brazil, the biggest issuers of domestic debt in the region have missed a trick by developing their domestic bond markets when US interest rates have been at a cyclical low. Now that US rates have been rising, and the outlook for the US economy is uncertain, the benefits of developing domestic bond markets should begin to appear. In both Mexico and Brazil, foreign currency reserves are greater than outstanding dollar debt owed by the public sector.

What the issuance of the fixed-rate bond on Mexico should do is encourage further development of securitisation in Mexico. A proper yield curve helps bankers to price transactions better. Securitisation, the turning of financial obligations into tradeable securities, has been big business in Mexico for the past couple of years. In 2004, Mexico accounted for over half of the almost US\$9bn in securitised deals.

In 2005 it accounted for about 40% of a market that had grown by 50%. Most of the obligations securitised in Mexico are debts issued by the Instituto para la Protección al Ahorro Bancario, which bailed out Mexican banks from the 1995 crisis. The next most important sorts of loans securitised are construction loans and then mortgages.

Chile

It is worth noting that Chile's pension funds, which are predominantly bond investors, had assets of US\$79.9bn at the end of August 2006. Almost a third of these assets (31%) are invested in foreign stocks and bonds. The problem for the pension funds that the highest risk category of investment (A) has been returning by far the highest yields: 11.9% in the year to August. The least risky category of pension fund investment (E), which is 80% in fixed rate assets returned only 0.5% in the same period.

The region's markets

The table shows what has happened in Latin America's (and China's) domestic bond markets and compares them with the world's most important bond market in the US. It is worth noting that both Brazil's bond market and China's are, in GDP terms, larger than the US's. Yet foreign involvement in the Brazilian bond market has been limited. This is despite falling interest rates (10 consecutive interest rate cuts) and a currency that has strengthened significantly against the US.

It is worth noting that Latin American bonds are much less heavily traded than the US bonds. The Emerging Markets Trade Association said that its members traded about 1.3trillion worth of Latin American domestic bonds. This is about 1.3 times the stock of bonds. By comparison the volume of trading in US Treasury securities was US\$139 trillion (or equivalent to 22 times the stock).

The market with the heaviest trading is Mexico where five times the stock was traded in 2005. Mexico is, clearly, the Latin American market with the greatest possibilities for growth. The stock of domestic debt is equivalent to only 21% of GDP. A growing pension and savings sector means that demand for new paper is likely to continue to be strong.

The heavy over-subscription for the new 30-year bond underlines this point. The untapped possibilities of the Mexican bond market suggest that parastatals such as the state oil company Petróleos Mexicanos could tap the market to fund future developments.

The Bank for International Settlements points out that Mexico's debt has moved from being predominantly floating rate to being substantially fixed rate over the past five years. In 2000, only 5% of Mexico's total debt was fixed rate. By the end of 2005, 40% was fixed rate. In Brazil, the proportion of fixed rate debt has doubled from 15% of the total in 2000 to 30% by the end of 2005.

Carbon bonds: Cervecería Nacional, in Panama, part of South African Breweries (SAB) is preparing to issue carbon bonds. The market for carbon bonds is in Europe and allows companies who are failing to meet their targets for carbon emissions under Kyoto Agreement on Climate Change to "buy" unused carbon emission quotas from companies that are exceeding their Kyoto targets.

Cervecería Nacional is investing US\$5m to clean up its production processes: the environment ministry says that this investment should yield a Kyoto quota which can be sold to dirtier companies in Europe.

Fixed income markets in Latin America of which

	<i>stock</i>		<i>short term</i>	<i>long term</i>	<i>corporate</i>
	US\$bn	% GDP	US\$bn	US\$bn	US\$bn
Argentina	60	33	5	44	11
Brazil	583	74	227	318	39
Chile	40	35	9	17	13
Colombia	42	32	31	6	5
Mexico	159	21	52	89	17
Peru	8	10	1	4	2
Venezuela	7	5	3	4	0
Total	898	41	329	482	87
US	9,043	72	1,475	4873	2,695
China	1,100	100	na	na	na

source: BIS, June 2006; LAAR

Mexico and China vie for WHO's top job

Mexico and China competed hard for the right to run the World Health Organization for the next five years. The competition, won by Margaret Chan, on 8 November, exemplifies the difference in approach the two countries are taking on healthcare. As developing economies, both China and Mexico face huge healthcare challenges. Arguably, Mexico's health-care policy has been one of that country's least trumpeted successes. Not only has life expectancy gone up to a respectable 75 years for men at birth, but government policies to extend healthcare to the poorer members of society have been a huge (and electorally popular) success.

"China's healthcare spending is negligible. Combined spending on health, education, welfare, and pensions, at all levels of the Chinese government came to only about 3.5% of GDP, according to figures cited by Lardy (National Bureau of Statistics of China 2005, 278). So the Chinese government has considerable scope to increase its own consumption expenditures without raising taxes on households."

The architect of Mexico's reforms, Julio Frenk, lost out in the race for the WHO's top job for the second time. What he has achieved in Mexico may, however, turn out to be the template for healthcare programmes in developing economies. Healthcare is likely to be one of the great social and economic challenges of the next 10 years. Not only there is the threat of pandemics, but around the world people are living longer putting new demands on economies and healthcare systems.

For China, increasing public consumption of healthcare could be one way to deal with the huge economic imbalance created by the US\$1 trillion in foreign exchange reserves. In Taiwan, Nicholas Lardy from the Institute for International Economics in Washington noted recently, the introduction of national health insurance in Taiwan boosted average household spending there by more than 4%. The Taiwanese became less fearful about what would happen if they fell ill so they felt they could afford to spend more rather than save. "The ultimate purpose of economic growth everywhere is improvements in human welfare," Lardy wrote recently in an IIF report. "By this standard, China is falling far below potential."

China's healthcare spending is negligible. Combined spending on health, education, welfare, and pensions, at all levels of the Chinese government came to only about 3.5% of GDP, according to figures cited by Lardy (National Bureau of Statistics of China 2005, 278). So the Chinese government has considerable scope to increase its own consumption expenditures without raising taxes on households.

The government could simply reduce its own investment expenditures and reallocate the funds to consumption. Lardy argues that a reduction in the government's direct investment and cutting its capital transfers would free up resources to increase government consumption-i.e., outlays for health, education, welfare, and pensions. That would contribute significantly to a rebalancing of the structure of demand, away from investment and toward consumption.

An increase in household consumption as a share of GDP also could contribute significantly to the transition to a more domestic consumption-driven growth path. That, in turn, requires a reduction in the saving rate of households, which has increased significantly since the 1980s and has been running at about 25% of disposable income since 2000. By contrast, in the US in 2005 households spent more than their disposable income, i.e., the saving rate was slightly negative.

Why do people save? One motivation, Lardy argues in his IIF paper, is clearly precautionary. People save to cope with life's uncertainties such as illness, unemployment, or injury. In China, as the government and enterprises have reduced the support they provide, this expenditure has become

“The other two significant motivations for households to save are: for retirement and for the education of their children. This is particularly true in China because the basic government pension scheme is extremely limited and government expenditures on education are modest.”

an individual responsibility. In urban areas only about half the population, for example, is covered by basic health insurance and in rural areas less than a fifth of the population is covered by a cooperative health insurance programme initiated on a trial basis in 2002.

As the share of health expenditures paid directly by the government or borne by enterprises has waned, the share of total health outlays borne by individuals on an out-of-pocket basis increased from around 20% in 1978 to more than 55% by 2003, Lardy points out. As a consequence, many households save to cover potential future medical expenses. Indeed, the reduction in the share of health expenditures provided through the government and by employers is probably a key reason that household saving as a share of disposable income increased significantly in the 1990s.

The other two significant motivations for households to save are: for retirement and for the education of their children. This is particularly true in China because the basic government pension scheme is extremely limited and government expenditures on education are modest. In 2005 the pension scheme covered 131.2 million workers, only 17% of those employed, plus 43.7 million retirees. Moreover, a worker must contribute for a minimum of 15 years before he or she is entitled to draw any benefits at retirement. And the basic pension scheme is designed to provide a pension equal to only 20% of average local wages, independent of a worker's lifetime earnings.

Boosting Welfare

To be fair, the government in China is trying to boost the living standards of poorer people. The government has eliminated farmer taxes, raised minimum salaries and increased spending on social welfare and education. The more the government improves these services, the less incentive there will be for the Chinese to save, economists argue. China's gross savings rate, at about 45% of GDP, is double the world average.

“Households in China save a lot because they have no confidence in the social safety net,” Richard Bush, a director at the Brookings Institution in Washington, said. “They don't believe there will be money for pensions, for healthcare for education so they don't spend to the degree that a country at that level of development should.” In October, China's ruling Communist Party renewed its pledge to build a “harmonious society,” a slogan used to underline the push to improve welfare. “The initiative to build a harmonious society via increased spending on education, health and the social safety net should further increase households' disposable income for spending,” said Ma Jun, an economist at Deutsche Bank.

The Mexican experience

The current health-system reform, designed and implemented by Frenk, focuses on the 50m uninsured Mexicans who had been excluded from participating in social insurance schemes for more than 60 years. The reform established the System of Social Protection in Health (SSPH), which introduces new financial rules for public health and community-based services, as well as for personal health care. The latter is funded through the Seguro Popular (Popular Health Insurance). The following analysis draws heavily on a paper, prepared by Frenk and his colleagues, and published in a British medical journal, *The Lancet*.

Seguro Popular is mostly funded by the federal government, though state governments also chip in and there is a small means-tested insurance premium element. The poorest 20% of families are exempt from any contribution.

The people eligible for Seguro Popular are everybody who is not covered by the Instituto Mexicano del Seguridad Social (IMSS) or the Instituto de

“ In 2000, Mexico was spending only 5.6% of its gross domestic product (GDP)-about US\$350 per head-on health care, which was well below the average level in Latin America (almost 7%). ”

Seguridad y Servicios Sociales de los Trabajadores del Estado, (ISSSTE) which covers public-sector employees and their families. The IMSS covers workers in the formal economy. Some of the more powerful trade unions, notably, the oilworkers also have their own healthcare programmes for members.

Most of the households eligible for Seguro Popular are poor and many are headed by women. The law establishing the new system was passed in April, 2003, and came into effect on January 1, 2004, with the goal of achieving universal health insurance coverage by 2010.

Until the arrival of Seguro Popular, the uninsured population could only access state and federally run health-service facilities by paying for them. Although the fees were means-tested and heavily subsidised, they still took a huge bite out of poor people's incomes. In addition, state and federal clinics and hospitals were poorly managed and often suffered from shortages of medicines.

The Seguro Popular programme is free at the point of delivery and is funded through payroll contributions by the employer and the employee, with an additional federal allocation financed from general taxation.

Outside this, there is still a poorly regulated group of private providers. They serve uninsured families who have some capacity to pay and the insured population who are dissatisfied with the quality of public social security services.

As of 2000, before the reform, IMSS covered all private-sector salaried workers and their families, accounting for about 40% of the nearly 100m inhabitants of Mexico. ISSSTE covered an additional 7%, and private insurance covered the (richest) 3% or 4% of the population. Thus, about 50% of the population was left without access to any form of prepaid health insurance, including about 2.5 million families from the poorest segments of the population, who received only very basic community and preventive health interventions included in the poverty alleviation programme, Oportunidades, which was run by the Secretaría de Desarrollo Social.

In 2000, the country was spending only 5.6% of its gross domestic product (GDP)-about US\$350 per head-on health care, which was well below the average level in Latin America (almost 7%). Although the uninsured accounted for 55% of the population in 2002, they received 34% of public funding for health, which translates into an average level of public per-head spending 2.3 times higher for the insured than for the uninsured. Further, federal expenditure per head across the 32 states was five times higher in the state with the highest expenditure than in the one with the lowest. Differences in state per-head contributions to health care in the same year were even more dramatic, being 115 times higher in the state with the highest expenditure than in that with the lowest. Finally, investment in equipment and new facilities represented no more than 2% of total federal spending for the uninsured.

One of the key outcomes of the 2003 reform was to change these shortcomings. The changes included explicit rules for financial transfers from the federal to the state level, priority setting through a package of essential services, and certification of health infrastructure.

The Mexican experience offers potentially relevant lessons to other countries. Most developing countries face the combination of a rapid epidemiological transition (ie moving from dealing with transferable whether infectious or contagious diseases and diseases and complications around child-

"The Mexican reform benefited from the notion that health is an aspiration of all political forces and can thus generate broad agreements and help enhance social cohesion. The strong emphasis on democratic principles—transparency, accountability, and the empowerment of citizens—also helped to gather support and consolidate much-needed public participation in all issues related to health care."

birth to confronting non-transferable diseases such as cancer and heart problems) with an underfunded and overwhelmed health-care system that is unable to respond accordingly.

The Mexican reform is based on the principle that healthcare is not a commodity nor a privilege, but a social right. The fulfilment of this right can improve the health conditions of the population, the human capital of individuals and households, and the poverty situation of the country. This reasoning is especially appealing given the democratisation process in many developing countries and economies in transition.

The Mexican reforms use the WHO framework for health system performance, standardised methods (eg, household income and expenditure surveys), and analytical tools (eg, national health accounts). The investment in human resources over a period of two decades made it possible to adapt knowledge generated worldwide and to gather evidence in support of a major transformation of the health system. This evidence empowered Mexican policymakers in their discussions both with the Ministry of Finance and with Congress, and guided the design, implementation, and evaluation of the reform.

The Mexican reform benefited from the notion that health is an aspiration of all political forces and can thus generate broad agreements and help enhance social cohesion. The strong emphasis on democratic principles—transparency, accountability, and the empowerment of citizens—also helped to gather support and consolidate much-needed public participation in all issues related to health care. The early involvement of key stakeholders was essential once the necessary changes were acknowledged and policy options had been identified. Finally, phase-in was organised with a gradual approach, which provided the time necessary to generate political acceptance and to develop a local supply response.

Seguro Popular was implemented on the basis of prioritising population groups, states, and localities to provide the right balance of a rapid, perceivable, and progressive supply response that has focused on the poor. Further, the roll-out of the Seguro Popular was undertaken with a selection of municipalities and states to serve the poorest, but also to do so without any political bias. As a result of substantial effort to increase awareness through evidence, the reform managed to be recognised as an objective shared by all political parties and all regions, which greatly facilitated the annual negotiation with Congress for the annual budget allocations necessary to meet affiliation targets.

New Head of WHO

Chan, who comes from Hong Kong, is the second woman to head the WHO after Gro Harlem Brundtland, who ran the organisation from 1998-2003. She is 59 and is an expert in dealing with infectious diseases. She is on record as saying that healthcare should occupy a central position in social and economic policy.

In her final presentation to the 193 members of the WHO she said that "good health promotes social development and economic productivity besides contributing to political stability and security."

She studied medicine at the University of Western Ontario, Canada and joined the Hong Kong public health department in 1978. In 1994 she became health minister for Hong Kong and retained that position when the colony returned to Chinese rule in 1997.

In that role Chan had to deal with the first outbreak of bird flu in 1997 and subsequent outbreaks of Sars which killed hundreds of people between 2002 and 2003. In 2003 Chan left Hong Kong to join the WHO where she became assistant director general responsible for infectious diseases.

"China and Argentina still lead in the growth stakes. Our confidence that Brazil would top 4% growth this year looks like being confounded. In Asia, growth in India is forging ahead."

COMPARATIVE DATA

Real interest rates in this group of emerging economies are turning positive. It is interesting that the only developed economy in Asia, Japan, has negative rates, where inflation is higher than short term rates. China's rates are now positive. In Latin America, Brazil's double-digit real interest rates are shrinking: nominal rates are coming down but inflation is still not rising. In Mexico, by contrast, nominal rates are struck at 7% but inflation is rising.

China and Argentina still lead in the growth stakes. Our confidence that Brazil would top 4% growth this year looks like being confounded. In Asia, growth in India is forging ahead.

Comparative data	GDP growth		Consumer price index		GDP US\$bn	Real interest rates	Exchange rate local currency vs US\$	
	% change year-on-year	quarter	% change	12 months to	2003	%	% change in past year	rate on 08/11/06
China	10.4	Q3	1.5	Sep	9,412	1.3	2.7	7.87
Hong Kong	5.2	Q2	2.1	Sep	233	1.6	0.0	7.8
India	8.9	Q2	6.8	Sep	3,633	-0.5	2.4	44.7
Indonesia	5.2	Q2	3.3	Sep	977	4.1	8.4	9,110
Japan	1.5	Q2	0.6	Sep	3,910	-0.25	4.1	79.3
Malaysia	5.9	Q2	3.3	Sep	291	0.5	3.7	3.54
Philippines	5.5	Q2	5.4	Oct	414	0.7	8.7	49.9
Singapore	7.1	Q3	0.4	Sep	123	3.0	8.0	1.56
South Korea	4.6	Q31	2.1	Oct	994	2.5	10.63	935
Taiwan	4.6	Q2	-1.2	Oct	632	3.0	0.2	32.9
Thailand	4.9	Q3	2.8	Oct	555	2.5	10.6	36.8
Argentina	7.9	Q2	10.5	Oct	534	-0.4	-3.3	3.07
Brazil	1.2	Q2	3.7	Sep	1,576	9.9	1.0	2.15
Chile	4.5	Q2	2.1	Oct	193	3.0	1.5	533
Colombia	6.0	Q2	4.2	Oct	337	2.3	0.0	2,278
Mexico	4.7	Q2	4.1	Sep	1,072	2.9	-1.8	10.9
Peru	9.2	Aug	1.9	Oct	167	2.5	4.1	3.22
Venezuela	9.2	Q2	15.5	Oct	164	-5.1	1.0	2,989*
US	2.9	Q3	2.1	Sep	12,227	3.2		

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