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What a US economic slowdown will mean for Asia and Latin America

Our regular table at the end of this report, which compares the economic performance of the significant countries in Latin America with the bigger economies of Asia, shows that almost all of them have been growing well. This is essentially the result of strong demand, pepped up by easy liquidity, in the US. Both Latin America and Asia are major suppliers to the US, so if the US economy turns down, both regions will suffer.

On most views of the business cycle the US economy is probably overdue a recession. The chances of a recession happening this year are rising. Even cautiously optimistic independent forecasters such as Swiss Re now reckon that the chance of a recession (not just slower growth) is 35% in the US this year, up from 30% in January. Swiss Re still expects only slower growth, but is clearly worried by the disappointing economic data coming out of the US in February and March.

The US Federal Reserve Board itself emphasised how uncertain the economic outlook in the US now is. At its March meeting, the Fed implicitly acknowledged that the economy was in difficulty, edging away from the language it previously used.

The financial markets immediately jumped to the conclusion that the Fed was now as likely to lower interest rates as to raise them. Previously the assumption in the markets had been that the Fed was more likely to raise rates than lower them.

The Fed actually left the overnight federal funds rate at 5.25%, where it has been since last June. The only difference was in the language the Fed used to describe its view of what it was most likely to do next with interest rates. The Fed altered the words it used but it is far from clear that their meaning had changed.

The stock and bond markets' euphoria on 21 March, on the news of what the Fed had done, looks irrational. One point the Fed was absolutely clear about was that the risk of higher inflation in the US economy had not vanished. It said in its statement: "The [Federal Open Markets] committee's predominant policy concern remains the risk that inflation will fail to moderate as expected." What the markets are ignoring is that stagflation (slow growth and high inflation) is now a distinct prospect for the US economy.

Growth in the US fluctuated between 2%-2.6% in the final three quarters of 2006. This was a significantly slower rate of growth than in 2004 and 2005. The consensus forecast for growth in the first quarter of 2007 is 2%. Despite the slowing rate of growth, inflation continues to run higher than the Fed's unofficial "comfort zone" of between 1% and 2% a year, and wages are climbing faster than productivity.

“The problem for the financial markets is that the superior returns of private equity funds, in the current economic conditions, are tempting more traditional investors to invest more in LBO funds.”

Liquidity and monetary policy

The big problem for economic policymakers in the US is that the economy has not reacted to higher interest rates as they expected. The marching up of interest rates under Alan Greenspan, the last Fed chairman, was supposed to steer the economy away from inflation without wrecking it on recession. The Fed's problem, clearly, is that both risks remain.

What may be the problem is that the Fed, and monetary economists, have underestimated the effect that liquidity, and especially the leverage that financial markets now provide, has on the real economy. Private equity deals, which have been one the main reason for the M&A boom of the past couple of years, depend on cheap debt to work. Leveraged buyout (LBO) funds borrow heavily to buy their target companies: usually debt is three or four times their equity investment. In bold deals it can be as high as five or six.

This leverage is injected into the economy when the deal goes through. The holders of the shares in the target company are being paid three or four times what they are worth to a pure cash buyer. The LBO funds get the maths to work by seducing bankers, who are easily lulled into believing that this time it is different. They overlent first to Latin America, causing the 1980s debt crises, and then to Asia in the 1990s. The LBO funds prefer to value companies on earnings before interest, tax, depreciation and amortisation (ebitda), a formula which relies on underlying economic conditions remaining constant: this formula would produce horrible overvaluations if inflation and interest rates were to rise because the formula ignores them.

The problem for the financial markets is that the superior returns of private equity funds, in the current economic conditions, are tempting more traditional investors to invest more in LBO funds. The more hard cash the LBO funds have the more they can borrow. This is probably where the financial bubble in the world equity markets lies. Only a major smash in the private equity market will prick the bubble.

A smash is almost inevitable for two reasons. First the LBO funds are paying more and more for companies. This means that any adverse change to their assumptions costs them damagingly large amounts of money. The second reason is that the LBO funds have to sell the companies they have taken over back to stockmarket investors in order to cash their profits.

The pressure on the LBO funds to sell investments will rise if inflation and interest rates rise. A glimmer of what might happen came from recent worries in the US about subprime lending, following the run-up in US interest rates in the past couple of years. Stockmarket investors dumped shares in companies (mostly banks) that had been boasting about their success in the subprime area. What also happened, as usual in debt crises, is that the financial system yanked credit lines from companies involved in the sector. This jumpy behaviour exacerbated the Latin American debt crisis and will probably make the coming LBO crisis a major economic event.

The benefit of jumpiness, however, is that it crystallises a crisis and enables it to be purged, though probably not quickly. US banks took four years, in the 1980s, before they felt confident enough to start writing off their Latin American debts. Credit to Latin America never recovered and the continent has been growing slowly for almost 20 years. Now most governments across the region prefer to tap their domestic bonds markets rather than rely on the vagaries of the international capital markets.

The question for Latin America and Asia is how long US banks will take before they recover their nerve in lending to already over-extended US consumers and financial sector companies (also known as LBO funds).

What the trend means

One of the most noticeable features of 2006 and 2007 has been the jump in food prices around the world. In most countries, food prices are now rising much faster than overall inflation. This is an early indication of the pressure that the US's dash to replace oil with ethanol will place on world food supplies. Some reputable environmentalists argue that President George W Bush's enthusiasm for ethanol as a fuel will increase food prices, and possibly starvation, across the world.

In Latin America, the rise in food prices has become acute and prompted political action. In Mexico, for example, food prices rose by 6.3% in 2006, or more than 50% faster than the overall increase in inflation (4.05%). A further rise in food prices in January prompted the government to try to fix the prices of staple foods. Even before President Bush's dash for ethanol, food prices were rising because of China's demand for more meat, which means that stockfarmers have to buy more grain to feed their growing herds of animals.

The dash for ethanol is not confined to the US: around the world governments have accepted environmentalists' arguments that ethanol, biodiesel and other green fuels do less environmental damage than traditional diesel and petrol. The rise in international oil prices has given further impetus to this change: diluting fuel with alcohol distilled from either maize or sugar can reduce energy costs.

The development of biofuels has major implications for both Asia and Latin America. Asia, and particularly China, is the fastest growing market for fuel in the world. China is already the world's third biggest vehicle market, with sales of 7m vehicles in 2006. Only the US and Japan are bigger.

Brazil is already the world's biggest distiller and exporter of ethanol, producing about 37% of the world's total output, and is in pole position to become the world's dominant producer of bio-fuels. The issue of biofuel has jumped right up the international agenda and was one of the main issues discussed at the summit between President George W Bush of the US and President Lula da Silva of Brazil in early March.

Interestingly, while governments claim that alcohol-based fuels are environmentally superior, environmentalists are starting to argue that a switch to growing crops for alcohol to power vehicles (or even aeroplanes) will condemn more of the world's poor to starvation. These environmentalists argue that farmers can either grow food crops or fuel crops. Farmers cannot do both, they claim. Forestry, and cellulosic ethanol, may be the way forward, since trees tend not to use land and water that is needed to grow food (see article at the end of this feature).

On which side China (and to a lesser extent India) come down in this argument will have major strategic implications. So far China has focused on ensuring that it can feed its people. A major switch by China to biofuels will, inevitably, push up world food prices. That is good news for South America's farmers, but bad news for Mexico and Central America, which are net importers of food.

Technology as well

Brazil sees biofuels as a key element in its industrial development. Until or unless electric cars make a breakthrough, Brazil has the world's best technology for alternative-fuel vehicles. Brazil launched its flex-fuel vehicles in

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2003. In 2006, 70% of the 2.2m vehicles built in Brazil used flex-fuel engines. Flex-fuel engines run on any mix of petrol and alcohol. What is interesting is how many flex-fuel cars there are in other parts of the world. In the heart of the hitherto petrol-guzzling US, even Texas has flex-fuel cars. The state has 450,000 flex-fuel vehicles, able to run on an 85:15 ethanol-petrol mix.

Brazil is also developing biodiesel. This is a fuel that dilutes diesel with vegetable oils. Any vegetable oil can be used: soya is popular but castor oil is now coming into vogue. In Bahia, where 90% of Brazil's castor oil is grown, increasing acreage is being used to grow castor oil for biodiesel.

In Europe and North America the same sort of thing is happening: in Britain new crops such as borage are being grown simply for the biodiesel market. In the US, President George W Bush's commitment in January's State of the Union speech to US energy self-sufficiency through boosting its production of ethanol, mostly distilled from high fructose corn-syrup (but sometimes from sorghum), prompted an increase in maize prices. President Bush called for a fivefold increase in biofuel production, including ethanol.

In Europe, butanol, which is distilled from wheat, is becoming popular. The European Union has guaranteed (a comparatively high) price for wheat provided it is distilled into butanol, which is encouraging farmers to sow more wheat. Bio-butanol, a crop-based fuel, will be marketed later this year by DuPont, a US chemicals company and BP, one of the world's biggest energy companies. Some energy commentators claim that butanol is the best biofuel currently available, because, unlike ethanol, it has as much energy per gallon as petrol.

The US still has a long way to go to reach President Bush's goal of fuel self-sufficiency. In August 2006 fewer than 1,000 of the US's 169,000 petrol stations sold E-85, the 85% ethanol 15% petrol mix that is the greenest fuel on offer in the US. Although E-85 benefits from a tax credit of US\$0.51 a gallon, consumers are reluctant to use ethanol because it provides only 75% of the energy of ordinary petrol. The attractiveness of E-85 depends on the price of pure petrol. When oil and petrol prices rise, E-85 becomes more attractive.

At the beginning of March the American Automobile Association reported average petrol prices were back at US\$2.16 per gallon as the crude oil price headed over US\$60 a barrel. The rise makes E-85 competitive with pure petrol again and should encourage more ethanol plants. In the US, ethanol already has, by law, to be blended into petrol in Houston and Dallas in Texas and the same rules will soon apply in Florida, Georgia and North and South Carolina.

Brazil's technology

The Brazilian government and the Brazilian ethanol industry aim to export the country's technological know-how acquired on the back of over 30 years of ethanol research and development. This would, once and for all, do away with the country's stigma of being mainly an exporter of commodities. Brazil is already recognised as the world's leading authority on ethanol and is eager to maintain this position. Its flex-fuel technology is central to this plan: the Brazilian vehicle industry has the patented technology to adapt petrol-only engines so they can also run on ethanol.

Not only that, Brazil is also on the verge of producing ethanol-fuelled small jets on an industrial scale. Embraer, the third-largest airplane manufacturer in the world, has adapted its light aircraft Ipanema to run on ethanol. The plane's engine is now awaiting safety certification. The country is also a frontrunner developer of biodiesel produced from vegetable oils, particularly soya-derivate oil, to be mixed with oil-based diesel. Brazil's energy

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giant, Petrobras, plans to add as much as 18% biodiesel in the petroleum refining process that produces conventional diesel. The company forecast consumption of 840m litres of the product this year with a mix of just 2% biodiesel.

Another pioneering Brazilian initiative is the production of cellulosic ethanol from sugar-cane waste, or *bagaço*. Scientists say cellulose ethanol is more environmentally friendly than other sorts of ethanol, not least because it does not require the use of extra land to grow crops. For Brazil this technology is considered of "strategic importance". Some experts suggest that cellulosic ethanol could become the most important source for power generation in Brazil, behind hydroelectricity and natural gas. Brazil is already seeking technology to retool gas-fired power plants so they can burn ethanol.

All these technologies are of interest to Asia, especially China, and to other parts of Latin America. If Brazilian energy technology does become one of the world's standards, Asian dependence on US technologies (apart from weapon technologies) will diminish. Geopolitically, if Brazilian ethanol technology represents the next wave of economic development, the strategic importance of the Middle East will also diminish.

State of the Union

What happens in the US will be crucial to the development of biofuels. President Bush called, in his State of the Union address, for the nation to use 35bn gallons of biofuels, including ethanol, by 2017, a level that far exceeds the Environmental Protection Agency's target of 7.5bn gallons by 2012. (Last year, the US used 5.4bn gallons, with ethanol used chiefly as a petrol additive.)

According to the Energy Information Administration (EIA) and the Renewable Fuels Association (RFA), production of ethanol in 2006 was 4.86bn gallons. That represented an increase of 24.3% on 2005. US demand for ethanol increased even faster, rising by 33% on 2005.

Oil men doubt that the US will hit Bush's ambitious biofuels targets. They point out that petrol demand is still growing at around 1.6% a year, despite the inroads flex-fuel has made. The oilmen argue that as maize prices rise the profits to be made from producing ethanol shrink. This squeeze, they claim, will deter investors from backing the construction of more ethanol plants. Even so, six new ethanol plants are under construction in Texas alone.

The global implications of the US switch

Lester Brown, the founder of the Earth Policy Institute (EPI), an environmental think-tank in Washington DC, said that by 2008 ethanol plants could be consuming half of the US corn crop. The US Department of Agriculture has projected that ethanol plants will require 60m tons of the 2008 grain harvest, but Brown claims that the plants will actually need more than twice that amount - 139m tons. In 2004/05, the latest year for which official statistics are available, the US harvested just under 300m tonnes (295m tons) of corn. Of that 20% went to make ethanol.

The US Energy Secretary, Samuel Bodman, admitted in early March that because of constraints on farmland and the need for corn in the food supply, corn-based ethanol can supply only 15bn gallons of ethanol, less than half of the 35bn gallons of renewable and alternative fuels President Bush set as a goal by 2017 in his State of the Union speech in January.

The risk is that the demand for ethanol will push up corn prices and thus raise the price of foods in the US. As corn is used as feed for most meats and also in processed foods, a rise in corn prices has a pronounced knock-on effect across the economy.

“Together, Brazil and the US are responsible for 70% of worldwide ethanol production.”

Brown from the EPI argues that what is beginning to emerge is an "epic competition between people who own automobiles...and the [world's] other 2bn people who are spending half their income on food already. If grain prices climb to the highest levels we've ever seen, it could create urban food riots in many poorer countries," including Mexico, Indonesia, and Egypt, and lead to political instability, Brown argued. He and the EPI are calling for a moratorium on federal permits for more ethanol plants.

So why not increase imports?

The obvious solution to the problem facing the US is to increase imports of ethanol. The obvious place to increase imports from is Brazil. Currently Brazil has to triangulate its ethanol exports to the US through the Caribbean to get around US import tariffs.

The US's Latin Americanists argue that by increasing direct imports of ethanol from Brazil, the US will achieve two strategic goals. First it will reduce US energy dependence on oil from the Middle East and, second, it will encourage Latin Americans to become better disposed to the US. There are two problems. The first is that congress will have to approve any changes to the ethanol import tariff. The second is that with so much money being invested in expanding domestic (US) ethanol production, there are some very big bets being placed against any reduction in the import tariff.

Eduardo Pereira de Carvalho, a former Brazilian agriculture and finance minister, has touted the idea of a partnership between Brazil and the US in ethanol to the US Senate's foreign relations committee. Pereira now heads the Sindicato Agroindustrial de Açúcar do São Paulo. Fascinatingly Richard Lugar, the Republican senator from corn-belt Indiana and chair of the Senate's foreign relations committee, is also keen on a Brazil-US deal.

Some stats

Together, Brazil and the US are responsible for 70% of worldwide ethanol production. Brazilians, however, can produce ethanol from sugarcane more cheaply than US can distil ethanol from maize. Luis Gusti, a former president of Venezuela's state-owned oil company PDVSA, now a senior adviser to the US Center for Strategic and International Studies, claims that Brazil's sugar based technology is five times more efficient at converting sugar cane into ethanol than US maize-based technology. In 2006 Brazil's ethanol exports reached US\$1.6bn, more than double the 2005 figure. This result was achieved thanks to national production of 14.75bn litres.

Brazil is the only country in the world with a sizeable untapped agricultural area: Amazonia. This means Brazil could earn enormous economic rewards as the world seeks cleaner alternatives to oil-based fuels. According to Brazilian experts, global demand for ethanol would be 7.5 times greater than Brazil's current output if the world agreed to dilute petrol with a 10% admixture of ethanol. Such a mixture would, Brazilian exports say, have major benefits for CO2 emissions. In Brazil, even conventional petrol engines already run on a 75% to 25% petrol-ethanol mix.

Brazil is, therefore, well placed to cash in on the rising importance of biofuels, especially ethanol. The cashing-in will be political and strategic as well as financial. The Brazilian foreign ministry, Itamaraty, is well-aware of the political and trade opportunities afforded by the country's advanced biofuel industry. Brazil is now selling ethanol to Japan and negotiations to supply ethanol to the fuel-thirsty Indian and Chinese markets are well advanced. Indeed, the three countries seem keen to invest large sums of money to develop Brazilian biofuel technology further.

“The implications of a clash between motorists and cooks for arable land is certainly good news for South America.”

In regional terms the Itamaraty hopes to reinforce Brazil's - still unfulfilled - leadership role by embarking on an aggressive biofuel diplomatic mission.

The Itamaraty expects to increase Brazil's influence in Latin America by promoting ethanol and biodiesel production in the region using Brazilian-acquired technology. The plan aims to weaken the position of any challenger for the leading regional position, chiefly oil-rich Venezuela, by allowing smaller countries to assert their energy independence thanks to Brazilian generosity. For that to happen, however, Brazil needs the US on its side.

Brazil's problem is that although it has the technology, the biofuel industry lacks the resources necessary to scale-up to supply ethanol and the associated technology to meet the potential demand from the world market. The backing of Japan, India, China, or even of the Europeans, even put together, will be insufficient to make ethanol a viable global alternative. So Brazil is delighted by the recent change of US energy policy.

The biggest obstacle to a future Brazil-US ethanol partnership is the high tariffs the US levies on Brazilian-produced ethanol. The tariffs can be dodged by triangulating Brazilian ethanol through countries that have duty-free agreements with the US.

This is not, however, an acceptable solution for the Brazilian government. Another problem is whether Brazil and other potential large-scale producers can really supply enough ethanol without undermining the global commodities' market and making the price of food more expensive worldwide.

Despite being recognised as a renewable source of energy, the production of sugar-cane ethanol carries environmental problems of its own. Environmentalists are concerned that increasing global demand for the product will lead to the expansion of the area currently cultivated in Brazil, of some 5m hectares, by 75% in the next 10 years and threaten the Amazon rainforest in the same way the soya boom did a few years back.

There is actually some evidence to suggest that Brazil's arable farmers are switching to strategies to increase yields rather than acreage. In 2006, Brazil's arable acreage actually fell (see below) even though the crop size increased.

Also, the traditional way of harvesting the cane stalks, which entails burning the leaves to make manual labour easier (and therefore cheaper), sends millions of tons of CO₂ into the atmosphere. Supporters of the ethanol industry, however, claim that new technologies will reverse these effects. The use of sugar-cane bagaço to produce cellulose ethanol would make the burning of the leaves pointless. A switch to cellulosic ethanol would lead to greater ethanol output from the more or less the same acreage.

Soya

The implications of a clash between motorists and cooks for arable land is certainly good news for South America. The continent is beginning to rival North America as the world's breadbasket. Brazil is the world's second biggest soya producer, after the US, and Argentina is the third.

Put together, their production is about 30% higher than US production. Both Brazil and Argentina expect that their harvests, which are in, to be bumper ones. Like maize, soya is used to feed animals. China is now the world's biggest consumer of soya products.

For 2007 the Brazilian agriculture ministry is forecasting that the grain and oilseeds harvest will rise by a further 6% to around 124m t, which would

“Brazilian farmers calculate that the grains harvest, which has already begun, will earn them about 23% more, in cash terms, than the 2006 harvest.”

beat the previous record of 123.6m t set in 2003. In 2006 the grains crop was 116.6m t, according to official figures. This was 3.6% up on 2005's harvest.

Brazilian farmers expect the soya crop to weigh in at 55 t this year, about 5% more than the 2006 crop. What is interesting is that the acreage sown with soya is falling: in 2007 the soya acreage will be down by about 8% at 20.3m hectares. But with the rise in prices, Brazilian farmers can expect to see a R\$25bn increase in their incomes from soya. The maize crop is likely to be 1% higher at around 42.5m t. In 2008 Brazilian farmers expect to grow around 45.5m t of maize.

What is crucial for farmers, and for the rest of the Brazilian economy, is that the dollar prices of grains are rising faster than the Real is appreciating against the dollar. Soya and maize prices, in particular, have surged in the past year as the US uses increasing amounts of maize to make biodiesel.

Brazilian farmers point out that soya prices are now the highest since 2002 and about 50% higher than at the beginning of 2006. Brazilian farmers argue that the US drive to increase the amount of alcohol it produces from maize will keep soya prices high.

What US farmers are doing is replacing soya acreage with maize, yet the international demand for soya for both animal and human consumption is actually increasing because of the growing prosperity of China. Chinese stockfarmers are importing more soya to feed their animals and meet the growing demand for meat.

Brazilian farmers calculate that the grains harvest, which has already begun, will earn them about 23% more, in cash terms, than the 2006 harvest. The higher farmgate prices will leave farmers with an extra R\$12bn or so in their bank accounts. The farm-machinery industry is confident that farmers will use this windfall to buy new equipment. This investment should again help to increase farmers' productivity.

Interestingly, the acreage of arable land actually fell in Brazil in 2006 to 45.5m hectares from 47.7m in 2005. Brazilian agronomists say that marginal farmers were affected by the strength of the Real against the dollar, which squeezed their profitability. The increase in output, however, suggests that bigger Brazilian farmers are becoming more productive.

Argentine farmers are equally bullish. They believe that the 2006/07 harvest will set a new record at over 90m t. The estimate comes from the Secretaría de Agricultura y Ganadería and was published on 21 January.

If the ministry's forecasts are met the harvest will be 14% up on the 2005/06 harvest and 6% bigger than the previous record, set in 2004/2005. It is also worth noting that 10 years ago the harvest in Argentina came to just 45m t.

The agriculture ministry reckons that in 2007 food and grain exports will bring in US\$ 24.67bn. This will be 24% more than in 2006. Argentina is now the world third biggest producer of soya.

The Bolsa de Comercio de Rosario forecasts that grain and soya exports in 2006 came to US\$14.5bn, up 15% on 2005. The bulk of Argentina's soya crop is crushed to produce soya oil which is then exported as a manufactured, rather than agricultural, product.

The ministry is expecting production of 45m t of soya; 20m t of maize ; 15m t of wheat; 5m t of sunflowers ; 3m t of sorghum and 1m t of both rice and malting barley.

"The big problem with cellulosic ethanol is that the technology to produce it is currently expensive and untested on any scale."

The Venezuelan conundrum

One peculiar side effect of the US enthusiasm for ethanol has been to tempt Venezuela to enter the same market. It is going into partnership with Cuba, once a major sugar producer, to develop ethanol as a fuel additive. The Cubans, like the Brazilians, want to use cane waste to produce ethanol. On 28 February Venezuela's oil and energy minister, Rafael Ramírez, signed an economic cooperation agreement with the Cuban minister for foreign investment, Marta Lomas, in Havana.

The main result of the Seventh Joint Cuban-Venezuelan Commission, was an agreement to build 11 ethanol plants to reinvigorate Cuba's declining sugar industry by using pulp to make cleaner fuel. Although Raúl Castro attended the signing ceremony, he did not speak. Before the meeting Ramírez had an audience with Raúl's brother, Fidel, who gave his first live interview since falling ill in July 2006, speaking to President Hugo Chávez on the latter's *Aló, Presidente!* radio show on 27 February.

Essentially, however, Venezuela and Chávez want hydrocarbons to remain the world's most important source of energy. High oil prices provide Chávez with the revenues to finance his geopolitical ambitions. A major fall in oil prices would cripple Chávez as a political rival in Latin America to the US. The geopolitical problem for the US is that an international fall in oil prices would cause problems for countries where the US has major strategic interests, such as Mexico and Saudi Arabia.

Mexico, despite being the US's second biggest oil supplier after Canada, is a net importer of petrol. The Interamerican Development Bank (IDB) reckons that Mexico could save US\$2bn a year and create 400,000 new jobs in agriculture if Mexico switched to demanding that all petrol was diluted by 10% with ethanol.

CELLULOSIC ETHANOL

Better than sugar and corn?

The great advantage of cellulosic ethanol, whether it is distilled from sugarcane waste (bagaço, as the Brazilians do and Cubans hope to do) or timber, is that it will not lead to farmers using arable land to grow crops for fuel. Timberland is usually at best marginal agricultural land, so the choice between growing food or fuel crops does not arise. The land can support neither.

The big problem with cellulosic ethanol is that the technology to produce it is currently expensive and untested on any scale. The Brazilians lead in the technology to produce cellulosic ethanol from *bagaço*, but the US is more interested in developing technologies to distil ethanol from wood chips and agricultural waste.

In early March the US Energy Department announced that it would provide up to US\$385m to back six bio-refinery projects that would produce cellulosic ethanol, a type of ethanol that can be made from nonfood crops and agricultural waste. The money will be disbursed over the next four years and are another feature of President Bush's goals of making the cost of cellulosic ethanol competitive with gasoline by 2012 and of reducing America's petrol consumption by 20% over the next 10 years.

Currently, cellulosic ethanol is still twice as expensive to produce as corn-based ethanol. For that reason, no company has yet to construct a commercial-scale cellulosic plant. Mike Muston, executive vice president of Broin Companies, which will build one of the new plants, told the New York

“The great advantage of cellulosic ethanol is that it should produce a multiple of the energy needed to create it.”

Times that Broin could produce cellulosic ethanol for between US\$2.25-\$2.50 a gallon and expected to cut those costs to under US\$2 a gallon when it started its plant around 2010. The government wants to get costs down to US\$1 a gallon. At such a price, cellulosic ethanol would be able to compete with any other biofuel. Altogether the six plants should cost more than US\$1.2bn to build and should produce more than 120m gallons of cellulosic ethanol a year. The plants will use a range of raw materials ranging from thick grasses (known as switch grass) to straw and wood chips.

The big and expensive problem in producing cellulosic ethanol is synthesising the enzymes needed to turn the cellulose in trees into alcohol. Ethanol is most easily distilled from sugar-rich products such as sugarcane, grapes and barley. In trees, the carbohydrates which are the precursors of sugar are locked inside the walls of the plant cells.

Some of the search for enzymes capable of breaking down tree cellulose is taking place in unusual places. The Economist recently reported that some researchers are looking for enzymes inside the stomachs of wood-eating termites. At the US's Oak Ridge National Laboratory the Bioconversion Science and Technology group is working with bacteria that may have the capability to attack plant cellulose and convert it directly into ethanol.

The great advantage of cellulosic ethanol is that it should produce a multiple of the energy needed to create it. With corn-based ethanol, the energy produced from the ethanol is only about 30% greater than the energy needed to create it. No one is quite sure how much more energy cellulosic ethanol produces: guesses vary from a conservative two to three times (Oak Ridge) to an almost unbelievable 16 times (The Economist).

Heavily wooded countries are looking hard at cellulosic ethanol: New Zealand, which spends over US\$2.5bn a year on imports of hydrocarbons, reckons that it could become self-sufficient in fuel if it developed a cheaper system for producing cellulosic ethanol. Sweden is another country interested in turning trees into ethanol. While New Zealand believes that willows are best suited as a raw material, Sweden prefers poplars. Another choice is eucalyptus. It is fast growing and has been successfully genetically modified so that trees all grow to standard size and shape which means that processing them can be industrialised.

The US appears to be most keen on poplar as a feedstock for cellulosic ethanol. The hybrid poplar is the first energy crop to have its genome sequenced, and scientists are pretty confident that they know which single gene controls lignin structure. Lignin structure controls a tree's rate of growth, which is invariably slow but strong. Scientists claim that they can tell the tree to grow faster, and weaker. A tree with less lignin would have more cellulose and therefore produce more ethanol.

The US reckons that to meet President Bush's 2017 target it will need to be collecting around 1bn tons of biomass. Probably between 350m and 400m tons will come from dedicated energy crops. Of this, probably about two-thirds will come from woody feedstocks. The rest will come from switch grass. The other 600m-650m tons would come from corn residue (known as stover) and household waste.

Tennessee, home to Al Gore, a former US vice president who is now a major figure in the campaign to reverse global warming, is investing heavily in research into cellulosic ethanol. The University of Tennessee is working on plans to build a pilot biorefinery to produce 5m gallons of cellulosic ethanol. The pilot plant is part of the Tennessee Biofuels Initiative, which envisions 10 biorefineries across the state, producing 1bn gallons of cellulosic ethanol.

Brazil's agricultural exports

Brazil's agricultural exports doubled between 2002 and 2006, rising from US\$24.8bn to US\$49.8bn, the agriculture minister, Luis Carlos Guedes, pointed out. The biggest increases were in sugar and alcohol, which saw exports rise by 243%. Meat exports were up by 170%; coffee by 143%; grains by 123% and fruits by 91%.

Guedes argued that what was really impressive was the agricultural industry's resilience in the face of problems such as drought; the weakness of the dollar against the Real (over the past four years the Real has appreciated by 40% against the dollar) and the volatility of international prices for agricultural products.

In 2006 exports of sugar and alcohol increased by 57% to US\$6.2bn. Ethanol exports were worth US\$1.6bn in 2006, up 31% on 2005's figure. Brazil's technology in distilling sugar cane into alcohol led to 12 new distilleries opening in 2006. In 2007 the ministry expects another 16 distilleries to open.

Brazil is the biggest beef and chicken exporter in the world and despite an outbreak of foot and mouth in Mato Grosso do Sul and Paraná, beef exports increased by 6% in 2006 to US\$8.6bn.

THE YUAN PROBLEM

The attractions of corporate America

An ambiguous comment from the governor of the People's Bank of China, the central bank, at the IDB meeting in Guatemala in mid March suggested that China might be about to stop buying US dollars. The recycling of the Chinese trade surplus into US debt has kept US interest rates low. Our view is that if China changes its reserves policy it is likely to stay in the dollar, but will buy US companies rather than US government securities.

What Zhou Xiaochuan said was that China did "not intend to go further and accumulate reserves". In the first two months of 2007, the central bank has had to recycle US\$40bn of Chinese export receipts back into US dollar securities. Most economists reckon that this recycling has kept the value of the US dollar well above what US economic fundamentals (a vast and growing current account deficit and a substantial fiscal deficit) would indicate. So if China stops buying US Treasuries, the dollar will sink. More importantly, in the short term at least, US interest rates will rise.

What makes a sudden Chinese move out of the dollar unlikely is that it already has a huge stock of US Treasury bonds. China has almost US\$1 trillion in reserves. No-one knows how much of these reserves are in dollars, or in T-bonds, but a substantial portion must be. The consensus guess is 70%.

The chairman of the US Federal Reserve Board, Ben Bernanke, said in late March, in a written answer to a letter to him from Senator Richard Shelby, an Alabama Republican, that China's accumulation of US debt is not a problem for the US or for the Fed's conduct of monetary policy.

Bernanke wrote: "Because foreign holdings of US Treasury securities represent only a small part of total US credit market debt outstanding, US credit markets should be able to absorb without great difficulty any shift of foreign allocations...And even if such a shift were to put undesired upward pressure on US interest rates, the Federal Reserve has the capacity to operate in domestic money markets to maintain interest rates at a level consistent with our economic goals."

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Bernanke's letter, dated March 16, followed questions from Shelby after Bernanke's semi-annual monetary policy testimony before the Senate Banking Committee on 14 February.

China held US\$353.6bn in US Treasury securities in January, second only to Japan, according to government data published in March 2007. It is quite possible that China is disguising the scale of its holdings by buying through proxies.

Many US politicians worry about the amount of US debt held by foreigners, and some say that it constitutes a national security risk. The US Treasury Secretary Henry Paulson said in February that the issue was "not high up" on his list of concerns." Paulson added: "It is a good sign that investors are attracted to US assets."

Shelby is the most senior Republican on the Senate Banking Committee. He said in his letter that the committee has "a great degree of interest" in China's foreign-exchange tactics. Bernanke told him that although it is difficult to predict where the Chinese yuan currency would settle if it were allowed to trade completely freely in currency markets, it would be fair to conclude that the yuan is currently undervalued.

Bernanke's remark echoed a statement he included in the text of a speech he gave in December in Beijing, when he said China's currency was undervalued and provided a subsidy to Chinese exporters. Bernanke said in his letter that the Chinese monetary authorities have been resisting upward pressure on the value of the yuan in foreign exchange markets by purchasing dollars, and perhaps other foreign currencies. Bernanke reckoned that such purchases came to US\$1 trillion.

Bernanke is not certain the accumulation of reserves has created excess liquidity in China's banking system. China can drain liquidity from the system by issuing bonds and bills or raising bank reserve requirements.

So what might China do?

If China were to diversify, it might well buy more yen securities. Such a move, however, would be seen as hostile by Japan, since it would push up the yen and thus price Japanese goods out of the US market. A higher yen would wreck the carry trade (borrowing yen to buy higher yielding currencies) that has provided investors, both Japanese and international, with easy profits.

Some economists argue that Japan's central bank is supporting the carry trade by keeping Japanese interest rates deliberately low. The central bank is doing this to keep the one buoyant part of the Japanese economy, exports, competitive.

Our longstanding view is that China is unlikely to move out of the dollar, but it may well move out of US government securities and into US equities. What China may do, as Arab investors did when they were busy recycling their oil surpluses in the 1970s and 1980s, is buy up international companies. The Arabs took substantial stakes in German chemicals companies and Italian vehicle companies such as Fiat.

Chinese buying may be more targeted than the Arab buying a generation ago. What the Chinese may do is try to buy large enough stakes in US companies so that these companies buy Chinese or outsource production to China rather than other cheap labour locations. The Chinese, almost certainly, will not try to buy ownership of US companies, just significant stakes. The deep US suspicion of China as an economic competitor was clear from

"By the end of 2006 Springs Global was shifting production from the US to Brazil."

the failure of China's National Oversea Oil Corporation (CNOOC) to take over Unocal in 2005.

Arguably, Latin American companies have shown the way. As early as 1999 Coteminas, a Brazilian textile company linked up with a US textile company, Springs Industries. In 2001, the connection became closer. In 2005 Springs merged with Coteminas, to form Springs Global S.A. The deal produced the largest home-furnishings manufacturer in the world and was clearly designed to deal with competition from China.

Springs Global started life with revenues of US\$2.4bn. Each partner contributed businesses to the merger. In the US Springs, renamed Springs Global US Inc, continued to operate from Fort Mill, where Springs was founded in 1887. The HQ of Springs Global, however, is in Brazil. Springs has been in partnership with Coteminas since 2001, when it was taken private by a group of investors who backed the Bowles family.

Springs owns the Wamsutta brands of towels and sheets. The merged company started life with annual sales of US\$2.4bn and employed 25,000 people in six countries. Apart from Brazil and the US, the merged company had operations in Canada, Mexico, Argentina and Turkey.

By the end of 2006 Springs Global was shifting production from the US to Brazil. In October 2006 Springs Global US announced that it was shedding 465 production jobs in South Carolina. That was about a third of the workforce at a plant which processes bedding fabrics and makes sheets and pillowcases.

Crandall Bowles, co-chairman of Springs Global, and the previous head of Springs Industries explained then: "Our strategy has been to use reliable service as a competitive advantage, and we are doing that by converting domestic facilities to smaller and highly flexible operations that react quickly to changing demand. It is increasingly difficult to make products competitively in the US due to severe pricing pressures from Asian competitors, which is why we must shift more capacity to our low-cost and modern facilities in South America. After this capacity is in place, Springs Global will be not only the world's largest producer of home textiles, but also one of the most competitive manufacturers globally."

Springs and Coteminas have other operations that will be excluded from the merger. Coteminas has a big denim business and Springs has floor tile and window-blind business. Springs also recently sold off its textile research operation to the managers of that business.

Coteminas was set up Brazil's vice president José Alencar. It makes bed linen, bath towels, dressing gowns, wedding dresses, T shirts and socks. It has brands such as Artex, Santista, Paládio Calfat and Garcia for bed linen, tablecloths and bath towels. Springs contributed brands such as Wamsutta, Springmaid, Regal, and Dundee. Coteminas' main clothing brands are Attitude and Jamm. It also has a large business, supplying retailers with their own brand goods. Coteminas has 11 plants in the states of Minas Gerais, Santa Catarina, Paraiba and Rio Grande do Norte.

Grupo México

Another example of a Latin American company buying up a US competitor is Grupo México, the world's third-biggest mining company. It bought Asarco, a US copper mining company, in 1999 for US\$2.25bn. The deal is now coming good, thanks to the strength of copper prices since 2002. The problem was that in the first couple of years, copper prices faded as the US economy went into a mild recession.

"The takeover of Asarco, whose main asset was the Southern Peru Copper Corporation, distracted managers from the core Mexican business."

Apart from the vagaries of the copper price, Grupo México ran into legal problems in trying to reshuffle its assets. The big problem facing the firm was the level of debt at its two operating subsidiaries.

This problem has now been eased, following two debt reschedulings. As a lot of the lending to the group was secured against copper production, the restructuring allowed the company to improve its working capital position.

The takeover of Asarco, whose main asset was the Southern Peru Copper Corporation, distracted managers from the core Mexican business, which revolved around two mines, Cananea and La Caridad. Copper production at La Caridad dipped to 110,000t in 2002 from 161,000t in 2001.

In 2006, the group was back on track. Consolidated sales grew 23.4% to an all time record of US\$6.37bn. The rise in copper prices meant that the company made windfall profits. It noted that its cost of sales increased by just 8% to US\$2.6bn.

This meant that its profits before interest, tax, depreciation and amortisation (ebitda) were up 41% at US\$3.64bn. Net profits were up 43% at US\$1.5bn.

THE YUAN

Where next?

China's foreign ministry took another swipe at US criticism of its yuan policy. China said that the US should not pressure China to revalue its currency, or blame China for what it calls internal US economic problems. The rebuke comes after US senators announced plans to introduce legislation aimed at forcing the yuan higher. The senators blame the cheap yuan for American job losses and an increasing US trade deficit.

Many US lawmakers and manufacturers believe China deliberately undervalues its currency by up to 40% to make its products cheaper to buy abroad. The US trade deficit with China hit US\$232.5bn 2006. What the senators are preparing is a bill that would impose punitive tariffs on Chinese products that benefit from "exchange rate misalignment."

The Senate measure is bipartisan. A New York Democrat, Charles Schumer, and a South Carolina Republican, Lindsey Graham, relaunched a proposal at the end of March. The senators, and US manufacturers, claim that China's cheap yuan policy is costing millions of US citizens their jobs. Last year the senators sought to introduce a bill to impose a 27.5% tariff on all imports from China unless the Chinese government allowed the dollar to fall against the yuan. The senators dropped the bill after visiting China to discuss the matter with Chinese officials.

Graham and Schumer say the bill they are now drawing up will meet World Trade Organization rules and will go the Senate before the summer.

In 2005 China dropped the yuan's fixed peg with the US dollar, replacing it with a link to a basket of currencies. The yuan has appreciated by about 5% against the dollar since the change. There is ample evidence that China's central bank controls the yuan, which never approaches its 0.3% daily margin for manoeuvre against the dollar. It is hardly an accident the yuan touched 7.85 to the dollar last November, exactly one year after the central bank set a rate of 7.85 to the dollar for the one-year swaps introduced in November 2005.

“The consensus view in the international capital markets is that China will tighten monetary policy only modestly in the next six months.”

The Chinese government said that China will continue to reform the exchange rate, but at a "rational" and "stable" rate so as not to affect economies in the region or the world. It is far from clear what this policy actually means.

The independent view

The consensus view in the international capital markets is that China will tighten monetary policy only modestly in the next six months, perhaps allowing the yuan to appreciate by between 3% and 4% the dollar. This will, almost certainly, not be enough to head off the legislators.

The view that monetary policy will be modestly tightened derives from statements by Chinese Premier Wen Jiabao, who has admitted, finally, that China's economic growth is "unstable, unbalanced, uncoordinated and unsustainable". Wen offered his damning assessment on 16 March at the National People's Congress, the rubber-stamp parliament which the government tends to use as an occasion to laud its own achievements (especially regarding the economy). Until Wen's outburst the meeting had been dominated by China's new property law - a vaguely worded but symbolically important recognition of private ownership - and the unification of the tax system for foreign and domestic businesses.

But the premier's concerns overshadowed these reforms. "China's investment growth is too high, lending growth too fast, liquidity excessive, and trade and international payments very unbalanced. Energy efficiency and environmental protection issues haven't been properly resolved," Wen said. The premier also admitted that corruption was rampant and that the government had failed to achieve its targets for improving rural healthcare.

After the economy grew a "surprisingly fast" 10.7% in 2006, it is likely that policymakers will be equally concerned by figures for the first quarter of 2007 are produced. Economic data for the first two months provide no evidence that the government has been trying to slow down the economy. Industrial production, for example, rose 18.5% year-on-year in January and February, versus a 16.6% growth in 2006. The supply of narrow money M1 increased 21% in February and lending is also accelerating: the volume of outstanding bank loans jumped 17.2% to US\$3.04 trillion.

The day after Wen Jiabao's comments the central bank raised interest rates for the third time in a year in a bid to rein in investment and quell inflationary pressures. However, the 27 basis points (hundredths of a percentage point) rise will have a minimal effect in slowing the considerable momentum that the economy has acquired.

Exports are still booming. In the first two months of the year, exports rose by 52% to US\$82.1bn while imports were up just 13.1% at US\$58.3bn. For the trade surplus to fall below last year's level (US\$177.5bn), imports should increase by 25% this year while export growth drops to 20%. The US reckons that its trade deficit with China increased by 19% in the first two months to US\$21.3bn.

China's priority

The key issue for China is creating jobs. It took the fastest growth rate for more than a decade to create 11.8m new jobs and keep the unemployment rate at 4.1% in 2006. The ministry of labour and social security has warned that even a similar performance this year would not be enough to prevent the rate rising to 4.6%.

Even a moderate increase in unemployment is likely to have a major impact on social stability, particularly in China's big cities. So no government is likely to adopt policies that will produce such an outcome.

Too destabilising

Influential US economists such as Fred Bergsten argue forcefully that China's current account surplus is one of the most destabilising factors in the international economic outlook. This article is based on Bergsten's testimony to the US Senate Banking & Urban Affairs Committee in February 2007.

"About one quarter of all of China's economic growth in the past two years has stemmed from the continued sharp rise in its trade surplus."

China's global current account surplus soared to about US\$250bn in 2006, about 9% of its GDP. China has become by far the largest surplus country in the world, recently passing Japan and far ahead of all others. Its foreign exchange reserves have also passed Japan's to become the largest in the world and now exceed US\$1 trillion, an enormous waste of resources for a country where most of the huge population remains very poor.

China's role in the global imbalances is even greater than these numbers might suggest. A substantial increase in the value of the Chinese currency is an essential component of reducing the imbalances but China has blocked any significant rise in the yuan by intervening massively in the foreign exchange markets, buying US\$15bn to US\$20bn per month for several years to hold its currency down.

Since 2005, China has let the yuan rise marginally against the dollar but, since China continues to link its exchange rate to the dollar and the dollar has fallen against virtually all other currencies, the average exchange rate of the yuan is weaker now than in 2001 when China's current account surplus accounted for a modest 1% of its GDP.

The importance of trade

About one quarter of all of China's economic growth in the past two years has stemmed from the continued sharp rise in its trade surplus. China is thus overtly exporting unemployment to other countries and apparently sees its currency undervaluation as an off-budget export and job subsidy that, at least to date, has avoided effective international sanction.

By keeping its own currency undervalued, China has also deterred a number of other Asian countries from letting their currencies rise very much against the dollar for fear of losing competitive position against China. Hence China's currency policy has taken much of Asia out of the international adjustment process. This is critical because Asia accounts for about half the global surpluses that are the counterparts of the US current account deficit. Asia has accumulated the great bulk of the increase in global reserves in recent years and is essential to the needed correction of the exchange rate of the dollar because it makes up about 40% of the dollar's trade-weighted index. The most obvious Asian candidates for sizable currency appreciation in addition to China are Japan, Taiwan, Singapore and Malaysia.

The international implications

These global imbalances are unsustainable for both international financial and US domestic political reasons. On the international side, the US must now attract about US\$8bn of capital from the rest of the world every working day to finance its current account deficit and its own foreign investment outflows. Even a modest reduction of this inflow, let alone its cessation or a selloff of the US\$14 trillion of dollar claims on the US now held around the world, could initiate a precipitous decline in the dollar. The global imbalances probably represent the single largest current threat to the continued growth and stability of the US and world economies.

"It is essential to reduce the US and Chinese imbalances by substantial amounts in as orderly a manner as possible."

Acute trade policy pressures of this type, threatening the basic thrust of US trade policy and thus the openness of the global trading system, prompted drastic policy reversals by the Reagan Administration, to drive the dollar down by more than 30% via the Plaza Agreement in the middle 1980s, and by the Nixon Administration, to impose an import surcharge and take the dollar off gold to achieve a cumulative devaluation of more than 20% in the early 1970s.

It is thus essential to reduce the US and Chinese imbalances by substantial amounts in as orderly a manner as possible. The goal of US adjustment should be to cut the current account deficit to around 3% of GDP, about half its present level, at which point the ratio of US foreign debt to GDP would eventually stabilise and should be sustainable.

China needs to adopt policies to promote policies to reduce its uniquely high national saving rate by increasing domestic consumption. China can do this most easily through higher government spending on health care, pensions and education.

Such new government programs are needed for purely internal reasons anyway because of the unrest in China that has resulted from the demise of state-owned enterprises that provided these benefits in previous times. They would reduce the precautionary motive for household saving in China and boost private as well as government demand, contributing importantly to the needed international adjustment.

Large changes in exchange rates will also have to be a major component of the adjustment process. A change in China's currency policy, in both the short and longer runs, is in fact by far the single most important issue in US-China economic relations. An increase of at least 20% in the average value of the yuan against all other currencies, which would imply an appreciation of about 40% against the dollar, and sizable appreciations against the dollar of other key Asian currencies will be required to achieve an orderly correction of the global imbalances.

Such a change could be phased in over several years to ease the transitional impact on China. It could be accomplished either by a series of step-level revaluations, like the 2.1% change of July 2005 against the dollar, but of much larger magnitudes and with a substantial initial "revaluation" of at least 10 to 15%. An increase of 40% in the yuan and other Asian currencies against the dollar would reduce the US global current account deficit by about \$150bn.

Over the longer run, China should adopt a more flexible exchange rate that will respond primarily to market forces. These forces would clearly have pushed the yuan to much higher levels by now in the absence of China's official intervention. There is some justification, however, for China's fears that an abrupt move to a freely floating exchange rate now, particularly if accompanied by abolition of its controls on financial outflows, could trigger capital flight and jeopardize its economy in view of the fragility of its banking system.

Full-scale reform of China's exchange-rate system will have to await completion of the reform of its banking system, which will take at least several more years. Hence the adoption of a flexible exchange rate regime in China, essential to avoid re-creation of the present imbalances in the future, can be only a second stage in the resolution of the currency problem and the immediate need is for a substantial increase in the price of the yuan (especially against the dollar).

Mexico annoys China

Relations between China and Mexico have become difficult. The most recent (end March) contretemps was over Mexico's apparent interest in buying jet fighters from Taiwan.

China's twitchiness about Mexico's and Chile's interest in buying jets which are surplus to Taiwan's military needs follows a decision by Mexico to cite China before the World Trade Organization over the subsidies China offers to its manufacturers. On the other hand, China was pleased that in January Mexico forced a jet carrying Taiwan's president to Nicaragua to take a detour over the Pacific rather than overflying Mexico.

Mexico is not the only Latin American country interested in Taiwan's elderly F-5Es. Chile, which in 1970 was the first Latin American country to open an embassy in Beijing, is also interested in the Taiwanese jets, as are Paraguay and Guatemala, both of which still recognise the government in Taipei as the legitimate government of the whole of China. Outside Latin America, the Philippines is also interested in buying the jets.

China's official news agency, Xinhua, claimed that Taiwan's hawking of the US-made jets was an effort at diplomacy through weapons' sales. Taiwan wants to sell the jets to make room in its hangars for more-modern jets. China claims that Taiwan has become the world's biggest arm purchaser "in the last few years" and accuses it of habitually trying to export arms through "non-official channels".

China pointed out that in 1997 Taiwan sold Panama a dozen F-5Es and threw in a couple of UH-1Hs to make the deal more attractive. Early in 2007, Taiwan gave Nicaragua several F-5Es to get President Chen Shui-bian's visit to that country off to a good start.

WTO

Mexico announced at the end of February that it would back a call by the US for the WTO to investigate the subsidies China provides to its manufacturers on a range of products including steel, computers and clothes.

Mexico said that it wanted to set up a series of talks under the auspices of the WTO to discuss these subsidies. The US government, under pressure from congress, called for a WTO review of China's subsidies on 2 February. It is likely that the WTO will treat Mexico's and the US's complaints as one if China does not modify its policy within the next two months.

If the WTO takes up the case, the next stage will be to pick a disputes' settlements panel which will have nine months to decide whether China's subsidies are legal or not. Most complaints take at least nine months to resolve.

The European Union, Australia and Japan have also complained to the WTO about the level of China's subsidies, but they have only said that they want to be recognised as third parties. Mexico is the first country to have allied itself with the US on this issue.

Mexico is particularly concerned that it is being pushed out of the US market for manufactured goods by cheaper competition from China. According to figures from the US Department of Commerce, China moved further ahead of Mexico as the US second biggest source of imports in 2006. Canada is the US biggest supplier.

"China's official news agency, Xinhua, claimed that Taiwan's hawking of the US-made jets was an effort at diplomacy through weapons' sales."

Countries which recognise Taipei rather than Beijing

Belize (1989)
Burkina Faso (1994)
Costa Rica (1959)
Dominican Republic (1957)
El Salvador (1961)
Gambia (1995)
Guatemala (1960)
Haiti (1956)
Vatican City (The Holy See) (1942)
Honduras (1965)
Kiribati (2003)
Malawi (1966)
Marshall Islands (1998)
Nauru (1980-2002, 2005)
Nicaragua (1990)
Palau (1999)
Panama (1954)
Paraguay (1957)
Saint Kitts and Nevis (1983)
Saint Vincent and the Grenadines (1981)
São Tomé and Príncipe (1997)
Swaziland (1968)
Solomon Islands (1983)
Tuvalu (1979)

Note: The date in brackets is when they first recognised Taipei as the capital of China.

China is facing a slew of complaints to the WTO. The US and European Union recently complained about China's subsidies on car parts.

Steel

Separately, Mexico decided to continue with its anti-dumping duties on Chinese-made steel valves for at least another five years. The duty stands at 125.9% and was first imposed in 2001. The duty will be reviewed again in February 2011.

The duty applies to all valves with a diameter of between half and a quarter of an inch. These products are heavily used in the capital goods, oil, electricity and metal-bashing industries.

The economy ministry, which consulted Mexican companies over the issue before imposing the duty, said that it believed that removing the duty would lead to China dumping more of its products on the Mexican market. The Mexican ministry said that there was sufficient evidence to suggest that China's exports of these products were at prices significantly below what Mexican and other companies charged for them. The Mexican ministry conceded that China's exports of these products were marginal, and that any increase in their exportation to Mexico would have a harmful effect on the national economy.

The flight of Taiwan's president

President Chen Shui-bian of Taiwan accused China of lobbying Mexico to ensure that his aeroplane carrying him back from Managua to Los Angeles did not cross Mexican airspace. Chen was in Managua for the inauguration of President Daniel Ortega on 10 January.

A direct line from Managua to Los Angeles would mean that most of the journey would be over Mexican airspace. Taiwan claims that Mexico kow-towed to China and forced Chen's plane to fly west and out over the Pacific before flying north to the US. Chen had to stop in Los Angeles to refuel the plane.

China had tried to prevent Chen going to Nicaragua and had expressed its displeasure at Chen's 17 hour visit to San Francisco on the way out.

Despite the election of Daniel Ortega, a leftwinger, as president, Nicaragua had shown little sign of wishing to switch its diplomatic representation from Taipei to Beijing. There are 24 countries around the world that recognise Taiwan as the legitimate government of China. Of these 24 countries, 13 are in Latin America and the Caribbean.

LAAR BRIEFS

Ecuador: Hutchinson Whampoa, a Hong Kong-based ports company, won the concession to manage Manta, the second largest port in Ecuador, in February. Rightwing US commentators assert that Hutchinson Whampoa is a Chinese company. Through Hutchinson, these commentators claim that China controls a number of strategic ports in Latin America including those at each end of the Panama Canal, the Buenos Aires Container Terminal in Argentina, the international terminal at one of the most important ports on Mexico's Pacific coast, a large port on Mexico's Atlantic coast, and two ports in the Bahamas. Hutchinson Whampoa denies that it is a front for China and argues that it is an international, commercially driven ports company which happens to be based in Hong Kong. Hutchinson has agreed to spend US\$460m on upgrading the Manta port. The concession for the Manta port lasts for 30 years.

China and the Mexican border: China's ambassador to the US, Zhou Wenzhong, made an official visit to the US border with Mexico at the end of March.

His trip was designed to underline how interested China is in the border area. Manuel Ochoa, vice president of binational [US-Mexico] development for the El Paso Regional Economic Development Corp, said that several Chinese companies were interested in setting up in the area. Zhou spoke to El Paso businessmen about US-China economic relations. China is the US's second-largest trading partner behind Canada.

Trucks: The US is again stalling on allowing Mexican trucks greater access to the US. In February the US government had said that it would "soon" allow 100 Mexican haulage companies beyond the current 20 mile zone on the US side of the border. The US government said that this would happen as part of a pilot project.

The Senate appropriations committee, however, denied the pilot project the money for the pilot scheme on 22 March. The committee ruled that the pilot project should be delayed until the government had allowed more time for public debate. Protectionists such as Joan Claybrook, president of Public Citizen, argued that the Bush administration was in too much of a hurry to open up the border without considering the security issues.

The US Department of Transportation said that it would do all it could to meet the senators' reservations and that the pilot project would show that Mexican haulage companies brought real benefits to the US economy without compromising US security. It noted that the proportion of Mexican trucks failing to meet US safety standards had fallen from 59% in 1990 to 21% now.

What is worrying for Mexican policymakers is that the hostility to the pilot project was led by three Democrat senators, Byron Dorgan, (North Dakota); Dianne Feinstein (California) and Patty Murray (Washington). Dorgan claimed that the US was prepared to open up its roads to Mexican trucks before Mexico opened its roads to US trucks.

The Senate's block on the initiative was supported by the International Brotherhood of Teamsters. The teamsters claimed that the senators were supporting their doubts about the safety of Mexican trucks. The pilot project was due to start in mid-April and was scheduled to last for a year.

Under Nafta, which came into force on 1 January 1994, both countries should have allowed trucks from both countries free access to their roads from 2000.

Drugs: On 16 March the federal government announced that it had seized US\$205m in cash from a gang involved in the meta-amphetamine trade. The US embassy subsequently claimed that the seizure had followed information provided by the US Drug Enforcement Administration.

The key point about the meta-amphetamine trade is that it does not involve South America: the chemicals used to make the drugs are imported from Asia. It seems that Asian gangs are tapping into the Mexican drug gangs' distribution muscle in the US. The pseudo-ephedrine seized in Mexico City on 16 March apparently came from India. The Mexican police said that the gangsters had set up a chemicals company, Unimed, in Mexico City to manufacture the meta-amphetamines. The company was operating in Lomas de Chapultepec, one of the smartest areas of Mexico City. Two of those arrested were Chinese.

Venezuela and Taiwan are the only two economies in the table that have negative real interest rates: Argentina's real rate is zero which again underlines how different its economic policies are from the other economies in the Southern Cone. Its economic policies are much more aligned with Venezuela's: the US is only just beginning to realise that Argentina is not the reliable ally it once was.

COMPARATIVE DATA

Only two of the currencies we monitor in this table have fallen against the US dollar in the past 12 months. The weakness of the Venezuelan Bolivar is far from unexpected. The poor performance of the Taiwanese dollar is more surprising. It is also worth noting that the Bolivar is on the rebound: a month ago it was more than 40% down against the dollar, year-on-year

The Bolivar is rebounding because the heterodox economic policies of President Hugo Chávez are having their desired effect. Inflation fell heavily (consumer prices actually fell by 0.7% in March 2007) as the government cut value added taxes and focused its economic policies on curbing inflation. Our inflation data uses February's figures.

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			% change in past year	rate on 28/03/07
China	10.7	Q4	2.7	Feb	9,412	0.2	3.7	7.73
Hong Kong	7.0	Q4	0.8	Feb	233	3.4	0.1	7.8
India	8.6	Q4	6.7	Feb	3,633	1.2	3.1	43.0
Indonesia	6.1	Q4	6.3	Feb	977	2.6	0.0	9,150
Japan	2.3	Q4	0.0	Jan	3,910	0.6	1.6	116
Malaysia	5.7	Q4	3.1	Feb	291	3.1	6.4	3.46
Pakistan	6.6	2006	7.4	Feb	105	2.5	0.0	60.6
Singapore	6.6	Q3	0.6	Feb	123	2.4	6.0	1.52
South Korea	4.0	Q4	2.2	Feb	994	2.7	3.6	939
Taiwan	4.0	Q4	1.7	Feb	632	0.1	-4.6	33.1
Thailand	4.2	Q4	2.3	Feb	555	2.2	10.0	35.0
Argentina	8.6	Q4	9.6	Feb	534	0.0	-1.0	3.11
Brazil	3.8	Q4	3.0	Feb	1,576	9.7	6.7	2.08
Chile	4.3	Q4	2.7	Feb	193	2.3	-1.0	541
Colombia	8.0	Q4	5.3	Feb	337	2.3	4.9	2,173
Mexico	4.3	Q4	4.1	Feb	1,072	2.9	0.0	11.1
Venezuela	11.8	Q4	20.4	Feb	164	-10.1	-27.0	3,258*
US	3.1	Q4	2.4	Feb	12,227	2.8		

Sources- 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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