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Hemispheric Trade Liberalization: Implications for the Local Private Sector

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**HEMISPHERIC TRADE LIBERALIZATION:
IMPLICATIONS FOR THE LOCAL PRIVATE SECTOR**

I. INTRODUCTION

In recent years most Latin American governments reversed the direction and objectives of their economic policies -- from import substitution, expanding state controls and ownership over the economy to trade and investment liberalization, de-regulation and privatization. The private sector rather than the governments is now expected to be the main driving force for economic development, with the state playing at best the role of catalyst and regulator.

Trade liberalization throughout the Western Hemisphere is gaining momentum. It is a major element in far-reaching economic policy reforms adopted by governments searching for ways to reactivate their economies. Trade liberalization is advancing along three parallel roads:

a) All Latin American countries have started individually and unilaterally to lower tariff barriers substantially on global imports and to eliminate quotas, import licensing and some forms of indirect trade restrictions. Governments have dismantled

foreign exchange controls and multiple exchange rate systems. The general policy thrust is to incorporate external trade into the concept of a free market economy where supply and demand rather than government decisions are allowed to determine the trade pattern.

b) Virtually all Latin American and Caribbean countries have entered into sub-regional agreements to liberate trade among member countries from all direct restrictions by 1996.

c) Most Latin American and Caribbean countries would like to negotiate a free trade agreement with the United States or enter NAFTA.

The main premise of the analysis presented in this Report is that the local private sector has to benefit from trade liberalization in order for the free trade concept to take root and become irreversible. The local private sector has to embark upon wide-ranging adjustments in order to make a successful transition from operating under protection and state controls to unrestricted trade and free competition. This analysis will show how the local private sector can prepare to operate successfully under trade liberalization and what specifically can be done at individual company level; working through local business associations; and pressuring the government for economic reforms

and infrastructure improvements to help companies achieve greater efficiency and become more competitive.

Support for trade liberalization is based on the assumption that it will serve as catalyst for reactivating the economy. Support will quickly turn into opposition, however, if trade liberalization is perceived to create bankruptcies, unemployment, income loss, and balance of payments deficits. This means that the future success and durability of trade liberalization and free trade agreements will depend on the local private sector benefiting from liberalized trade; otherwise, Latin American governments will come under pressure to abrogate free trade commitments and return to state intervention designed to restrict and manipulate the flow of external trade, payments, and investments.

For trade liberalization to prove successful and durable, it is not sufficient to shift government policies from emphasis on import substitution to export promotion. Such macroeconomic policies need to be accompanied by measures having the effect of lowering the unit operating costs and raising the efficiency of private firms to international standards via investments in plant modernization, technical training to upgrade worker productivity, better understanding of United States and other foreign market requirements, further government reforms that help lower company operating costs, and improved access to capital markets at international financial cost levels.

Under a government program of progressive trade liberalization and eventual free trade, private local firms will face their competitors from the United States or neighboring countries increasingly without protection, subsidies, or incentives. Price, quality, reliability, servicing, supply sourcing, credit, transportation, and other related factors will determine which companies will be successful in the markets being merged into one market by the removal of trade barriers.

Faced with trade liberalization, company managements will seek answers to questions vital for their business:

a) How will their own government's trade liberalization program affect their business? What adjustments does the company have to make? How can supply costs be lowered? What opportunities will open up for expanding the business? Should joint ventures with foreign partners be pursued for access to capital, technology, or markets abroad?

b) Similar issues apply to free trade agreements. How will the terms of a free trade agreement affect the company's business? How will the company have to operate differently? How can it lower its unit operating costs through economies of scale?

This study outlines how a local private company can analyze the cost structures of its product lines and compare them to the price of competing imports under free market conditions. A comparative cost analysis helps decisions how to re-structure a

company's business operations with the objective of surviving and benefiting from trade liberalization. The discussion here identifies areas for cost reduction at the company level and for internal re-organization with a view to improve competitiveness under conditions of free trade. Industrial modernization and how to organize a program for worker training to upgrade productivity are discussed in some detail. An emphasis on marketing and how to improve the export support services at embassies abroad are outlined.

Local private sector organizations can play a central role in organizing their member firms to pressure for government reforms and infrastructure improvements that would reduce the operating costs for local private firms and help them become more competitive. Private sector organizations can influence government negotiating agendas for sub-regional free trade agreements and pressure for private sector representations at the negotiating table in some cases. This report singles out several economic policy areas where the private sector has a major interest in advocating further reforms: budget reform and interest rate policy, an exchange rate system, reform of investment policies and local financial markets, and financial strengthening of local firms -- all designed to permit local private firms to adjust to free market conditions, to benefit from trade liberalization in order to support the movement toward a hemispheric free market.

The emphasis of this report has deliberately been placed on the competitive impact of imports under free trade conditions on local private firms in their own previously protected domestic market. It is clear that the large majority of Latin American private firms will feel the competitive impact of free trade in their own domestic market. Those that export are likely to export even more and benefit more when member countries in a free trade agreement reduce their trade barriers. The main concern should be focused on what happens in the domestic market when trade barriers fall. If more and more local private companies face difficulties in competing against imports, political pressures will force a radical change in commitments to free trade. This would happen in the United States and anywhere else in the world. The Latin American private sector, however, has become used to operate behind protective barriers in the form of tariffs or subsidies or tax incentives or evasion or lack of anti-monopoly legislation or various other indirect trade barriers. Even a 10% tariff provides effective protection if combined with such indirect trade barriers. Most Latin American companies need to carry out wide ranging adjustments to be able to face competition from imports effectively in their home market under conditions of free trade. The objective of this study is to point out some of the steps that can be taken to improve the ability of domestic companies to compete when faced with removal of protective trade barriers.

Lack of preparation by the local private sector to effectively respond to changes created by their own government's import liberalization program can delay or even jeopardize the movement toward hemispheric free trade. Import liberalization is causing many local companies to embark on some of the internal corporate reforms suggested in this report to be able to face growing competition from imports. Even more local companies oppose trade liberalization often even before import tariff rates have been reduced to a level where they stop providing effective protection.

II. EXECUTIVE SUMMARY.

Discussions on trade liberalization in the Western Hemisphere have largely focused on macro-economic policy decisions, removal of trade barriers, on exports, transnational companies, major industries, or employment effects. This Report directs attention to the adjustments to be made by the vast majority of Latin American firms serving primarily the domestic market as they face the effects of progressive trade liberalization on their operations.

The Latin American private sector must survive and benefit from trade liberalization in order for the free trade concept to become an irreversible policy objective in Latin American countries. Support for free trade is based on the assumption that it will stimulate the economy and help achieve sustainable economic development. Support will quickly turn into opposition if trade liberalization is perceived to create bankruptcies, unemployment, income loss, and balance of payments deficits, and benefits only foreign investors or the other trade partner countries. Latin American governments will then come under pressure to abrogate trade commitments and return to state intervention designed to restrict and manipulate the flow of external trade, payments, and investments as well as internal costs and prices.

For trade liberalization to prove successful and durable, it is not sufficient to remove tariff barriers and quantitative import restrictions and to shift policies from import

substitution to export promotion. These and related macro-economic policy reforms need to be accompanied by other measures that will work to lower company unit operating costs and raise efficiency levels of local firms to international standards. This will depend upon whether individual firms undertake wide-ranging adjustments necessary to make a successful transition from operating under protection and state controls to a new mode of operations geared to free trade and competition against unrestricted imports. With trade liberalization local companies in many cases will no longer control domestic market conditions, but imports and international cost and price levels will determine prices, quality, and other conditions at which the local company's products will be sold.

To prepare to operate successfully in a free market, Latin American companies should start analyzing how they will be affected by trade liberalization and develop strategies of how to overcome their competitive weaknesses as well as how to take advantage of new opportunities that will be created by trade liberalization and free trade agreements.

As a first step, a company can calculate how its "bottom line" will be affected if it had to sell its products at prevailing international price levels without government protection, subsidies or incentives. While regional free trade is never fully implemented immediately, it cannot be predicted how far and how fast trade liberalization will proceed in the future. It takes considerable time to undertake the diverse adjustments

and reforms for a local company to become competitive against unrestricted imports. Corporate re-structuring, therefore, should start as the government starts taking the first steps of trade liberalization.

A second step for a company is to examine in detail the cost structure of each of the company's product lines and compare its aggregate cost structure (excluding the effects of subsidies and incentives) with the c.i.f. price of competing or potential competing products that will enjoy unrestricted entry as trade liberalization proceeds. A detailed cost comparison allows a company to identify and to analyze the strengths and weaknesses of its operations and to determine what to do with individual product lines in the future.

After identifying and analyzing the causes for specific cost and price differences compared to imported products, the company is in a position to select and to implement strategies for reducing individual cost elements in order to bring total costs down to international levels. There are many ways of reducing unit costs.

Latin American companies can discover new ways of cutting costs or raising productivity by analyzing foreign competitors, particularly those that are exporting successfully. One can look at their management structure, marketing organization, cost structure, sourcing of inputs, distribution set-up, facility utilization, corporate budget components, financing costs, worker training programs, and many other elements to learn how to

operate successfully without protection and subsidies.

Tariffs and other protective measures have allowed local companies to operate with a "margin of inefficiency", that is, at costs above international levels. As trade restrictions are reduced, this "margin of inefficiency" shrinks and local companies are forced to find ways to reduce their inefficiencies or absorb them in the form of decreased profits or bankruptcy.

This type of cost analysis and adjustment strategies helps a company to develop new insights that enable it to select from a number of options which strategy is the most viable for operating under trade liberalization. Depending on the results of the cost analysis and reforms, a company might decide to

a) continue production and expand exporting to the free trade partner countries; or

b) discontinue production of some lines and switch to importing similar products previously produced for which the company already has a distribution network in its home market; or

c) seek some form of partnership in production and/or distribution with a company from the other free trade country or a third country to benefit from economies of scale or access to each other's market, technology, capital, or raw materials.

There are various other options available to a company for planning to operate successfully under open market conditions. In a closed market it is often profitable to diversify and to expand a company's range of product lines; in an open market specialization is necessary to meet competitive pressures from

imports. A protected market encourages creation of monopolies; an open market, strategies to reduce unit costs to meet pressure from imports.

Latin American governments that want their trade liberalization policies to be successful and durable should be concerned that their own private sector responds to pressures from imports by aggressively cutting costs rather than defensively seeking protection.

Industrial and agricultural modernization via investments in new technology, worker training to raise productivity, improved supply sourcing and product marketing, and sweeping operating reforms are some of the positive responses to competitive pressures from imports. Plant modernization should be accompanied by revamping a company's internal administrative structure and management decision-making process. Important may also be the introduction of an improved management information system for quick response to changing competitive conditions.

Worker training to upgrade the technical capability and the productivity of a company's work force should be a key component for a company to adjust to trade liberalization. Increasing labor productivity clearly translates into lower unit costs and improved profitability and permits payment of higher real wages, thereby reducing labor opposition to trade liberalization.

Private sector associations in Latin America have already played an effective role in some instances in organizing local companies to develop policy agendas and pressure to influence

negotiations of sub-regional free trade agreements. There is room for these associations to play a still more effective role and to seek participation in trade negotiations.

Private sector organizations can also propose agendas to advance economic policy reforms and infrastructure improvements that will help firms to reduce their operating costs to compete more successfully against imports. It is obvious that to survive and prosper under trade liberalization, private companies need reliable telecommunications, electricity, mail service, low cost transportation, modern ports, adequate storage facilities, and security in handling goods. To succeed, they also need further government reforms in trade, financial markets, exchange rates, and other areas affecting the cost of doing business. An on-going training program is needed for commercial attaches of Latin American embassies to improve their effectiveness in assisting companies to export to the markets where these embassies are located.

In conclusion, it should be emphasized that trade liberalization and free trade will succeed and become irreversible only if the private local sector survives and benefits; otherwise, pressures will force a return to protectionism in Latin American countries. To benefit, the local private sector needs to thoroughly revamp its operations and to push for further economic reforms and infrastructure improvements that will help reduce corporate operating costs and enhance the ability to compete.

III. HOW TO ADJUST FROM PROTECTION TO OPEN MARKETS.

Analysis of Corporate Cost Structure

To adjust to a government program of import liberalization or a free trade agreement, a local company should start by analyzing how it will be affected by trade liberalization and then develop strategies how to overcome its competitive weaknesses as well as how to take advantage of new opportunities created by trade liberalization.

Trade liberalization means that direct and indirect restraints on imports and other measures to protect against imports are being progressively reduced or eliminated and that, therefore, domestic companies need to find ways to operate successfully without protection and incentives.

After protection has been dismantled and free trade is established with partner countries, imports rather than domestic products generally determine prices, quality, styles, packaging, credit terms and other market conditions. Local companies will need to meet international standards to remain competitive against imports. These assumptions should be the basis for a company to calculate what the price level will be for its individual product lines under free market conditions.

A local company should compare the unit cost level of each

of its diverse products with the CIF prices for competing imports free of duties and other trade restraints. The result of such a calculation shows the "margin of inefficiency" or the margin of protection that needs to be eliminated for the local company to be able to survive and compete under future conditions of free trade.

Corporate managements will have to re-think their strategies and re-structure the operation of their company in some areas, as protection and subsidies are progressively being lifted and international price levels, quality standards, financing terms, and supply conditions increasingly come to determine operating success or failure.

A company can calculate the likely impact of trade liberalization or free trade on its corporate "bottom line." Under free trade the government will no longer interfere to shield the local company from competition by imposing import barriers or subsidizing the cost of inputs or offering tax incentives or financing on preferred terms. The company needs to assess what will happen to its "bottom line" if government incentives and protection are lifted and international prices and quality standards determine sales volume and profits. In other words, it has to be calculated how the company's operating results will be affected if it had to sell all of its products at home and abroad at prevailing international price levels, while receiving no government subsidies or incentives.

These calculations will show management what can happen to its business if it takes no action while protection is eliminated. Obviously, trade liberalization is a gradual process and not all indirect trade barriers may be lifted at the end of the transition period under a free trade agreement. As it cannot be predicted how far and how fast trade liberalization will proceed and as it takes time to carry out necessary corporate changes and reforms, it is important to start preparation early for operating under free trade conditions.

A second step in the corporate adjustment process should be to analyze the strengths and weaknesses of the company for competing without protection or incentives at home and abroad. The company should examine in detail the cost structure of each of its product lines. It should compare the aggregate unit costs (excluding subsidies and incentives) of each of its product categories with the international c.i.f. price of the competing imported product that would enjoy unrestricted entry under a free trade agreement. The company should carry out such a cost comparison for each of its products. The cost build-up for each product has to include not only direct manufacturing and selling costs, but also on a prorated basis all administrative costs, other fixed costs, advertising, transportation, telecommunications, and other selling costs, borrowing expenses, fees and commissions, and taxes paid.

A detailed cost build-up for each product and a comparison of total unit costs with corresponding import prices enables a company to identify products that will have difficulty competing under free trade conditions as well as products that have export potential. Products with unit costs substantially higher than the landed price of competing imports have to be analyzed further in order to identify the factors within the cost structure responsible for the wide cost disparity.

There can be many reasons for cost disparities between a domestic and an imported product, excluding protection, subsidies, incentives, price supports, and similar trade distortions. The local company may be at a disadvantage due to high cost raw materials or other inputs, small scale production, antiquated machinery, plant lay-out or production methods, high cost of credit, inefficient inventory maintenance, high cost internal transport or inadequate storage facilities, high cost public services, excessive, restrictive government regulations, unreliable electricity, mail, or telecommunication services, high cost energy, low labor productivity, burdensome labor fringe benefits, an excessive labor force, a high ratio of administrative to factory personnel, or any number of other factors.

After completing a product-by-product cost comparison with imports and after identifying the various causes for major cost

disparities, the company can start targeting individual cost elements for reduction or elimination in order to bring total costs down to international levels. Successful cost re-alignment will enable the company to continue to operate profitably after protection and incentives have been eliminated. Obviously, other factors unrelated to the cost cutting can emerge that will also impact on the company's results.

Cost savings can be achieved by reducing or eliminating excess expenditure and uneconomic activities, but also by raising productivity of the workforce, of employed capital and land. The cost of inputs can be reduced by making changes in the sourcing of inputs. Reform or re-structuring of parts of the business can result in raising efficiency and lowering unit costs of production or distribution. There are many ways, of course, to reduce unit costs.

Protection against imports allowed a company to maintain domestic prices above international price levels. This protective margin absorbed the excess costs and thus preserved the viability of the local company. Under free trade this situation for a local company is no longer tenable. Every inefficiency or excess cost affects a company's competitiveness and has to be absorbed by a decrease in profitability, because the cost of imports, and not the local company determines the going market price in most cases. Under free trade, even the smallest unnecessary or excess

costs -- if a hundred of them are aggregated -- become a component in making a local company non-competitive vis-a-vis its foreign competitors.

A local company can discover new ways to cut costs or raise productivity by analyzing its foreign competitors: their management structure, marketing organization, cost structure, sourcing of inputs, facility utilization, distribution system, financing costs, re-investment policy, marketing strategy, selection of distributors, technology employed, and generally pinpointing the competitors' strengths and weaknesses compared to one's own company.

This analysis enables a company to determine which of several broad options to choose as the most viable strategy to operate under future free trade.

If the calculations show that the company's own unit costs, after eliminating protection and incentives, are in line with international price levels, then the company may be well positioned to compete against imports and seek to develop exports to the markets of free trade partner countries.

In the past, local companies have organized their production and marketing under high levels of protection. This has often resulted in high cost production of small volumes of a large

variety of products. Faced with an opening of markets at home and abroad, some local companies may be able to reduce their unit costs to international levels by specializing in fewer products and by exporting in order to achieve large volumes and thus benefiting from economies of scale.

Selecting which products to discontinue and in which to expand may be quite different when planning to operate under free trade rather than under protection. When the domestic market is protected, a local company may be able to raise selling prices for its products when profits come under cost pressures. This is usually not possible under free trade where domestic market price levels are generally determined by imports, not by local producers. A local company, therefore, should compare its total unit costs of each product line with the price for competing imports. The company should consider discontinuing those of its product lines where the cost disparity with imports is the greatest -- after all feasible cost reductions have been carried out. The local company should concentrate continued production of those products where its aggregate unit costs are closest to or below the landed price of competing imports. By expanding production and developing exports the company can further lower the unit costs for these remaining products by taking advantage of economies of scale.

Some companies may find the optimum strategy to discontinue

some or all of their own production and switching to import corresponding products from the free trade partner countries. The local company can utilize its own distribution network to market these imports in its home market. Becoming the marketing agent for a strong former competitor is preferable to being bankrupted by competition. A company may want to start importing and distributing locally those product lines which it decided to discontinue.

An analysis of the local company's cost structure under free trade might reveal the best strategy to be to form a joint venture with a strong competitor, supplier, or distributor in the free trade partner country in order to benefit from economies of scale and specialization and access to each other's markets, technology, or capital.

Management needs to devise a comprehensive strategy how to manage successfully the transition from operating in the domestic market protected against imports to selling successfully in a free market. The options will revolve around

- a) specialization
- b) shifting from production to importing
- c) expansion into exporting
- d) joint venture for financial, technological strengthening and/or better access to foreign markets.

Many local companies will need to re-design their corporate structure to emphasize the marketing function; to improve their management information system for quick response to changing competitive conditions; and to become competitive in price, quality, volume, credit, styling, packaging, delivery, and other responses to market changes.

Programs to Cut Costs

A move from protection to trade liberalization requires local companies increasingly to meet internationally competitive standards of doing business in order to survive intensifying competition from imports in its internal market or to expand exports. As trade restrictions are being reduced, more and more local companies will encounter increased pressures from competing imports. To meet competition from imports effectively when protection is lifted, local companies need to be innovative and responsive to market preferences by offering customers new products of better quality, more attractively designed and packaged, at lower cost. The response should be aggressively competitive oriented to cutting costs and improving quality rather than defensively seeking protection. The attitude should be to operate successfully under trade liberalization rather than to apply political pressures to undermine free trade.

A negative case of undermining trade liberalization occurred this year in Guatemala with chicken leg imports from the United

States. Consumer preferences in the United States for other chicken parts resulted in a depressed market price for chicken legs. The low U.S. FOB price became attractive to start exporting chicken legs to Guatemala, particularly after Guatemala reduced import duties. Continued protection for local grain producers, however, has kept the cost of feedstock high in Guatemala. In addition, local chicken producers have not been innovative but have always offered only whole chickens on the local market. Faced with consumer preference for the low-priced, high quality U.S. product, Guatemalan chicken producers applied pressures on their own government to introduce onerous health inspections only for imported chicken legs with intent to restrict imports. Domestic production or other food imports are not subjected to similar health testing. As trade liberalization advances and pressures from imports adversely affect more industries, demands will increase to employ countervailing administrative and other non-tariff trade barriers in lieu of tariffs and quotas.

Faced with a general trend of import liberalization, local companies need to focus attention on reducing costs and improving efficiency. There are many components to a company's operating and non-operating costs and all of them should be analyzed with a view to cut costs. Management should think of protection as an inefficiency margin that permitted the company to operate profitably at costs above international levels. Removal of this protective margin requires cutting costs down to prevailing

international levels which are the CIF prices of competing imports free of tariffs and taxes. Under a free trade agreement with the United States, local companies will face competition from imports by U.S. producers that employ the latest technological advances to increase productivity of their high-cost labor. Local companies need to seek ways to reduce, to save, or to offset high-cost inputs in their production process.

Trade liberalization produces pressures on companies to specialize in order to become more efficient, more competitive, operating at lower unit costs. This situation is the reverse of protection. Under a policy of import substitution, new opportunities opened up for adding product lines for which imports were being limited or eliminated altogether. Under free trade, companies need to lower their costs, improve their efficiency, and specialize where they have a comparative advantage in order to be able to sell profitably at the imported price level.

Industrial and Agricultural Modernization

In Latin America protection and inflation have acted as disincentives to invest in modern technology and to replace obsolete plant and equipment. Nationalistic positions on the transfer of technology and failure to adequately protect intellectual property rights have contributed to the neglect to

carry out industrial and agricultural modernization or "reconversion industrial." In many cases, high interest rates or credit shortages were additional impediments to investments in plant modernization or for taking other steps to improve efficiency. Faced with budget deficits, governments or state companies often preempted local credit markets or drove up interest rates for the private sector. High rates of inflation encouraged speculative, short-term investments in preference to longer term productive investments in plant and equipment.

Under trade liberalization, local companies are faced with competition from imported products made with the latest technology. Now Latin American countries recognize the need for industrial modernization. The proposed strategies for doing so, however, may not always produce the desired results.

El Salvador provides an example. El Salvador's small industrial firms developed under a regional Central American policy of import substitution protected by high external tariffs. The local firms were, therefore, often not exposed to external competition. Individual plants suffered from diseconomies of scale by producing a variety of products in small volume, often with obsolete or inefficient equipment. Many plants are out of phase with the government's current free market policies geared to trade liberalization, renewed regional integration, price and exchange and interest rate de-controls, promotion of exports and

investment. Many Salvadorean private companies fear a move toward free trade with the United States or with Mexico at this time and some prefer also a slowdown in the government's drive to establish a market economy. They want to retain incentives, subsidies, and price supports. Similar cautious or negative attitudes are also found among the private sector in Guatemala, Panama, Colombia, and elsewhere.

It is now generally recognized that Salvadorean industrial firms have to improve their efficiency and ability to compete in order to survive as trade barriers are being lifted and in order to benefit from future free trade agreements with Mexico and the United States. The Ministry of Economy, therefore, developed a plan for the "Formulation of an Industrial Policy and Program of Industrial Reconversion" aimed at modernizing El Salvador's small industries and preparing them to become exposed to competition at home and abroad.

The program as originally outlined by the government, however, appeared to contradict free market principles. Under the Ministry's proposal, the government rather than the private sector were to take charge of modernizing the privately owned firms. The government was to introduce fiscal and other incentives, impose a price policy, develop investment programs, and hire outside consultants as so-called "sectorialistas" to develop a program of modernization for each industry which the

government was to approve. A cumbersome new bureaucratic machinery in the form of six commissions and committees had been proposed for this program. The "Comision Consultativa" alone was to be composed of the top executive from thirteen diverse organizations ranging from the Ministry of Economy to the universities. The result would have been an array of conferences producing a mountain of paperwork but little tangible progress with modernization.

Better results can be achieved by encouraging and organizing the private sector, working through its local business associations, to take the initiative in developing its own program of modernization for each industry, after gaining a clear understanding and accepting the importance to prepare for future free trade. The local private sector would then be responsible for the results achieved from efficiency investments, and wrong decisions would affect profits and could not be blamed on the government.

Plant modernization should be accompanied by revamping a company's internal organization, including corporate departments and management organization to clearly define operations along functional and/or product lines with separate profit centers, budgets, production, sales and export targets, regular management reviews of results achieved, and greater attention and effort in the marketing end of the business.

Industrial modernization is a lengthy process and requires extensive financing and/or foreign investment. Financing strategies of similar reform efforts that have proven successful in other countries can be examined. To finance sound modernization plans and programs, proposals can be presented to appropriate international financial institutions.

A major adjustment effort is specifically needed in agriculture and the agribusiness industry in Latin America and the Caribbean to prepare to survive and to benefit from free trade. Modernization in agriculture is necessary to prevent massive unemployment and income decline in rural areas among small, inefficient farmers producing such staple products as corn, wheat, rice or sorghum, which United States or other large-scale growers can produce and sell far more efficiently.

Latin American or Caribbean countries would not hesitate to abrogate free trade agreements if their major agricultural sectors were to be threatened with extinction by free trade. Consumers, however, should not be deprived of lower food prices and higher quality as a result of competition under free trade. The problems to adjust agriculture to trade liberalization are difficult, and agriculture is the source of perhaps the greatest opposition to effective trade liberalization.

Panama exemplifies the resistance to trade liberalization in agriculture. Panama probably has the highest duties on

agricultural imports (up to nearly 100%) of any country in Latin America and the Caribbean. This has permitted a lack of competition, inefficient methods of production, high margins, poor packaging and low quality of some basic food products, particularly some vegetables and fruits sold in supermarkets. There has also been pressure from some private sector groups against Panama joining sub-regional trade groups unless protection on many agricultural products can be preserved. Panama has come under strong pressure, however, from AID and the World Bank to adopt open market policies. It has been slow and reluctant to implement trade liberalization commitments with an initial goal of reducing all duties to a maximum 60% ad valorem for industrial and 90% for agricultural and agroindustrial products. While this target has been largely attained for industrial products, key agricultural products remain protected well in excess of the agreed maximum. In the meantime, Panama has made a new commitment to lower the maximum duties to 50% -- still a very high level compared to the rest of Latin America.

It may prove useful to examine all major causes for the high costs and inefficiency in agriculture and apply new approaches to solve these problems taken from experiences elsewhere that have proven workable in cutting costs and raising efficiency. Problems of land tenure and population pressures on land make it particularly difficult in Latin America to modernize agriculture and to achieve economies of scale and levels of specialization that capitalize on the comparative advantage of the region.

Emphasis on Marketing

Latin American exports have grown to exceed \$120 billion per year. Obviously, many Latin American companies are successful with exporting. Many other local companies, however, have long been accustomed to operate behind protective tariff walls which permitted the exercise of monopoly or oligopoly power in local markets. Local companies were usually not exposed to cutthroat international competition, but rather to changing government regulations.

In countries with high inflation or extensive government controls, the government would set prices and, in some cases, even wage rates and profit margins. In such a controlled business environment, market forces played a subsidiary role in the success or failure of a business. Local managements, therefore, generally paid little attention to the marketing function of their business. Companies often expected distributors or wholesalers to arrive at their factory gate to enquire about product availability, price, and delivery schedule. Many small and medium-sized companies have not had a separate marketing, sales, or export department with its own director or manager, budget, sales or export targets.

In a free trade environment, as two or more markets are being merged, or under unilateral trade liberalization, local

companies are increasingly exposed to competition from imports. the market place. To survive, they need to pay increased attention to the marketing function of their business. Management attitudes and the mode of company operations have to change from a strategy of "trying to sell what is being produced" to "producing what sells well." This implies greater operating flexibility in many ways and more responsiveness to consumer preferences. Smaller companies in Latin America in particular are sometimes unaware of what sells well abroad and whether markets abroad are willing to accept the products they produce. They need to study their competitor strategies and their markets abroad and be able to adjust designs, packaging, size, colors, styles, and prices offered in order to remain competitive.

Some Latin American companies are more preoccupied with production than with marketing. Asian competitors who are successful with exporting maintain large marketing budgets, know their foreign markets, study consumer preferences, carefully select their foreign distributors, spend large sums on advertising abroad, and minimize their freight and inventory costs. The result has been that Asian exporters are often more successful than Latin American exporters in penetrating the United States market in many product categories with low duty levels.

Contrary to widely held opinion, the United States and

Western Europe are relatively open to most imports, with low duties, but highly competitive supply and market conditions. High quality and advanced technology are chief characteristics for more and more products that sell well in these markets. Intense, costly advertising is directed at consumers who are exposed to a wide range of choices and geared to rapidly changing tastes and styles.

In such a situation, a Latin American company needs to search for and identify its market niche for meeting specific customer needs. To build up its identity in a specific market, a company can map out a strategy design to capitalize on factors that affect the market potential, such as the importance of providing financing to local distributors or efficient product servicing that can be offered with the sale of the products. Three marketing factors have been cited as key to the success of many companies operating in highly competitive markets:

- a) reliable, speedy customer servicing of products sold;
- b) intensive promotion and advertising efforts; and
- c) a sound distributor network.

IV. THE ROLE OF PRIVATE SECTOR ORGANIZATIONS.

Private sector associations in Latin America can play an effective role in organizing local companies to develop industry positions addressing government plans and programs of trade liberalization or negotiating agendas for framework agreements or sub-regional free trade agreements. Private sector associations, such as FUSADES in El Salvador, COHEP in Honduras, FEDECAMARAS in Colombia or FEDEPRICAP, the umbrella private sector organization for Central America, can organize their member companies into industry or product specific committees along the lines developed by Mexico when preparing for the NAFTA negotiations. Each industry-specific committee would work out an agenda related to the trade issues of its industry or product group. The positions emerging from this effort can then be presented by the business association to its own government to become part of the agenda of negotiating topics. Frequent communication on many issues, of course, exists between local business associations and their government. The effort proposed here would focus on private sector issues related to trade liberalization.

Agendas or positions prepared by the same industry in the different member countries of a sub-regional trade grouping, such as the Andean Pact or the Central American Common Market, can be harmonized and co-ordinated by a regional organization, such as SIECA or FEDEPRICAP, to achieve collaboration among the private

sector in a sub-regional group of countries preparing for a free trade agreement with Mexico or the United States.

Joint public/private sector councils can be formed in a Latin American or Caribbean country designed to plan and to program preparations for a free trade agreement, including government economic policy reforms and infrastructure improvements that would help lower local company operating costs and enhance the ability to compete in open markets.

Local private sector organizations should try to actively participate and be represented in the trade and investment councils formed for discussing trade issues under framework agreements or in negotiations of sub-regional free trade agreements. The local private sector has a vital interest in the outcome of these negotiations and wants to ensure that its interests and agendas related to trade liberalization are on the table being negotiated.

Smaller local companies in the same industry but producing complementary or differentiated products can be organized by trade associations into "export committees" following the Chilean model. These smaller firms can jointly develop a sales catalogue and share export marketing costs, including the cost of a salesman abroad, advertising and market research, and other

marketing costs. They could share warehousing abroad and offer a broader range of products for export.

Companies in the same industry but in the different countries of a sub-regional free trade area could consider forming joint regional export marketing or trading companies. Japan and Brazil have developed successful trading companies.

Technical Training to Upgrade Worker Productivity

Success with trade liberalization depends not only on modernizing plant and equipment, reducing costs and restructuring the company. Employing more advanced machinery and equipment, including computerized equipment, requires a work force able to operate, to service, and to repair such equipment. Training to upgrade the technical capability and the productivity of a company's work force should be a key component if a company wants to operate successfully under trade liberalization. Increasing productivity as measured by the output volume per worker clearly translates into lower unit costs and improved profits. It permits payment of higher real wages, allaying criticism that free market policies do not lead to social improvements.

Executives in Latin American countries need to know how their competitors abroad are reducing costs and increasing productivity. Many Latin American and Caribbean enterprises do not yet pay sufficient attention to the technical training of

their work force. Information on what has been done can be provided by the World Bank, the IDB, and foreign academic institutions. Workshops for local private sector executives can be organized to alert them of the benefits of devoting time, effort, and money for worker technical training as an essential part of the company's competitive strategy for operating under free trade conditions. Experts who have conducted worker training programs can present a range of diverse options available to worker training and point out the different results attained as well as their relevance for specific industries in a Latin American country.

Technical training workshops designed to upgrade the work force in an industry can be organized by private sector organizations in cooperation with other entities, such as a labor union federation and the Ministry of Education or Labor. These workshops should lead to the creation of an ongoing technical training program for workers. The details and financing of an ongoing worker training program can be planned and programmed at the workshop by local business executives working together with representatives of the country's Ministry of Education and of Labor, the labor union movement, and international lending institutions.

Other aspects of raising productivity, such as how to raise worker motivation, initiative, work discipline, and general,

national educational standards of workers can also be addressed at these workshops. The overall objective should be how to organize the work force to help the company compete more effectively at home and abroad under conditions of trade liberalization.

Export Support Services by Embassies.

The export drive by many Latin American countries is handicapped by lack of effective support services rendered by their own embassies, consulates, and trade offices abroad. Local private sector associations should propose to their government an on-going program of training commercial attaches of the embassies abroad to efficiently collect regularly relevant market intelligence, relay it speedily to appropriate private sector organizations, promote actively the country's own products abroad, inform appropriate firms at home about future dates of trade fairs and public tender offers, and compile and update a local directory of importers, distributors and suppliers and arrange contacts for visiting businessmen from the home country.

A database and information system produced by embassies of the U.S. and other advanced countries can serve as a model. A databank, continuously updated, can include lists of importers and distributors by product categories, sources for raw

materials, components and other inputs used by the industries of the home country, credit terms, international price changes, and many other data useful for exporters or importers.

Arrangements can also be made to hook up with international databanks. "Dialogue", for example, provides access to about 500 other databanks. "Data-Star" collects and updates tapes on detailed trading activities in every country. There are literally hundreds of electronic bulletin boards published daily by diverse public and private agencies that list all the information an exporter or importer would need. Access to accurate, relevant information becomes vital for correct business decisions under free trade conditions.

Influence on Government Policies and Programs

The ability of local companies to compete against imports after trade barriers have been reduced or eliminated can be seriously impaired by the lack of an adequate, modern infrastructure and by the absence of some important economic policy reforms. Local business associations can organize their private member companies in identifying the obstacles to compete caused by their own government and develop proposals for change. In the past, import restrictions could counterbalance the higher costs of an inefficient infrastructure and burdensome government controls.

The lowering of import barriers and phasing out subsidies can be accompanied by eliminating an overvaluation of the exchange rate. In this way, the local private sector is not fully exposed to competitive pressures from imports stemming from the lowering of tariff rates or subsidies. Basically healthy local companies can be saved from bankruptcy by giving them thus more time to adjust to the new competitive environment. At the same time, a more realistic exchange rate is established that helps stimulate new export development.

Government policy reforms affecting the local financial markets, interest and exchange rates, labor laws, technology

transfer, and foreign investment regulations can also impact on the competitiveness of local private companies.

Infrastructure

Deficient infrastructure and unreliable public services can substantially raise the costs of doing business for private companies. The additional costs can seriously impair the competitiveness of local companies when they face competition in domestic and foreign markets from companies in more advanced countries that have at their disposal low cost efficient public services and a modern infrastructure. Higher costs caused by inadequate infrastructure and public services affect the ability to compete against imports when import barriers, incentives, and subsidies are reduced and no longer provide a protective margin for local companies.

Internal transport and storage, ports and airports, postal service and telephones, electricity, customs, and many other areas need to operate reliably and effectively when local companies face foreign competition under diminishing margins of protection. Ports and the internal transport system need to operate efficiently, at low cost, and with adequate handling capacity. Estimates show that telecommunication costs per product manufactured and sold by Latin American companies are three to ten times higher than for companies in the United States. After

privatization and de-regulation, costs tend to drop and service improves.

Any one of these inefficiencies in the infrastructure may add only marginally to the costs of doing business; however, when all these small additional costs are aggregated, the total can prove to be the decisive element affecting the survival of a company exposed to cutthroat competition from foreign competitors not facing such additional cost burdens. Studies can be commissioned by private sector organization that will identify and measure these many forms of inefficiencies caused by factors external to the private sector. Their competitive impact under trade liberalization should be analyzed. The result should be used by private sector organizations to press for further economic reforms and public investments in the areas identified in order to help the private sector to lower its costs and become more efficient. This would enhance private sector support for trade liberalization. It would advance sub-regional trade agreements and a country's readiness to negotiate a free trade agreement with the United States.

Not all infrastructure has to be developed, owned, and operated by the public sector, but it can act as catalyst for encouraging the private sector to invest in some infrastructure that will also benefit its own business. For example, adequate, modern storage facilities at ports, airports, kans railway

terminals are needed for efficient, reliable, low cost exporting and importing. The government can encourage private investment in storage facilities through accelerated depreciation, investment tax credits or low cost loans.

Local private sector organizations should strive to improve their effectiveness in influencing or participating in government policy decisions that affect trade and investment. Local business associations should invite their government to consult with them on trade and investment policy changes. These associations should respond constructively to proposed changes in policies and regulations affecting external trade or the competitiveness of the local private sector.

The private sector should insist that trade liberalization be accompanied by further economic policy reforms and infrastructure improvements that will help private firms reduce their costs and compete against imports.

Privatization

Privatization should be planned so that it leads to more reliable, more efficient, better maintained, and lower cost public services that translate into important unit cost savings for companies engaged in exporting or competing against imports. A change from state monopolies to private monopolies should be

accompanied by setting up sound regulatory or supervisory mechanisms to prevent monopolistic abuses, encourage investments, and pass on cost savings to customers. Proceeds from privatization can be earmarked for government investments in infrastructure.

Budget Reform and Interest Rate Policy

The local private sector should advocate specific, clearly defined budget reforms that would help make companies more competitive and financially stronger. One of the goals of budget reform should be to shift the emphasis from current administrative expenditures to infrastructure investments.

The private sector should strongly support a balanced budget for two reasons: a) To cover deficits, governments compete for capital available in the local market by raising interest rates on private sector loans or siphon off funds in other ways from the banking sector that would otherwise be available to the private sector. b) Deficits are also covered through money expansion by the Central Bank resulting in inflation. Inflation discourages new investments and leads to postponing replacement of obsolete equipment.

Many local firms have difficulties generating their own capital or obtaining adequate, low cost, long-term financing for plant modernization and expansion. High rates of inflation

dictate maintenance of negative working capital, high debt-equity ratios, and maximum distribution of corporate earnings rather than re-investment. Inflation produces a preference for short-term speculative financial transactions rather than long-term productive investments. Local managers pay more attention to production than to marketing and customer servicing. Under inflationary pressures, they are more concerned with securing supplies and raising prices than expanding volume. While these modes of operation work for companies when they face problems caused by inflation, these same methods lead to bankruptcies when companies face competitive pressures from liberalized imports. Operating strategies that are viable under inflation generally do not work under conditions of free trade.

The Exchange Rate

Controlled exchange rates are usually not flexible enough to reflect relative price changes among trading countries. Exchange controls tend to result in an over- or undervalued exchange rate that acts to distort foreign trade. Controlled exchange rates affect relative prices in foreign trade and, therefore, influence and interfere with competitive free market forces. An overvalued exchange rate impedes the growth of non-traditional exports and produces a negative trade balance. It invites growing opposition to trade liberalization and a return to protectionism. A fixed exchange rate when domestic inflation is well above international levels will also produce overvaluation of the exchange rate with the same consequences of slowing exports and affecting the trade balance negatively. A fixed exchange rate that becomes increasingly overvalued can lead to capital flight forcing the government into a corrective major devaluation.

An exchange rate problem of this type has recently emerged in several Latin American countries with potentially negative consequences for trade liberalization and free trade. In several countries, Central Banks are keeping the exchange rate fixed and/or overvalued to keep the local currency costs of external debt service low and for cheap imports to help restrain inflationary pressures. Real domestic interest rates are kept positive in relation to domestic inflation. With a fixed or

overvalued exchange rate, domestic interest rates measured in dollar terms become very attractive to foreign lenders, stimulating large inflows of short-term private foreign capital, including return of flight capital.

The result is a large supply of foreign exchange acting to keep the exchange rate overvalued which then serves as an obstacle to the development and growth of non-traditional exports. An overvalued exchange rate can thus stimulate a large capital surplus and a large and growing trade deficit while maintaining the balance of payments in equilibrium. This situation can be destabilized by some political event or an expectation of a major devaluation, causing suddenly a large outflow of short-term foreign capital, general loss of confidence, and a major devaluation and/or re-imposition of exchange controls and/or return to import restrictions and export subsidies.

Private sector organizations can point out the negative trade effects of these exchange rate policies and insist that their own government fine-tune its budgetary, interest rate, and exchange rate policies to prevent the relationship between domestic interest rates and the exchange rate from encouraging capital inflows at the expense of non-traditional export development.

Countries that face a growing trade deficit may resort to devaluations to restrict imports, causing an impact similar to tariffs. A member country in a sub-regional free trade agreement should not be allowed to employ devaluations to restrict imports from the other member countries.

Reform of Investment Policies

Private local and foreign investment is essential for future free trade development. Conditions should be improved for foreign and local investment to become more responsive to new investment opportunities that may be created by trade liberalization and to the necessity of many local companies to modernize and to strengthen their business financially in order to survive and benefit from free trade. To prepare for free trade may require raising additional capital or a foreign partner who brings new capital.

All major constraints to local and foreign investment should be identified and proposals advanced for removing these constraints. An open door to foreign investment will result in joint ventures and other forms of partnerships and cooperation that will help local private firms to obtain capital for modernization, access to improved technology and to markets abroad.

The local private sector should advocate effective protection of intellectual property rights by their own government. Inadequate protection of trademarks, inventions, and other forms of intellectual property rights is a barrier to attracting foreign investments, licensing agreements, and other forms of technology transfer. It often discourages foreign firms from entering into partnerships with local companies. It can hinder the process of industrial modernization by barring access to state-of-the-art technology which is needed for local companies to remain competitive when faced by pressures from imports. Mexico's law on protection of intellectual property rights can be used as guideline for drafting legislative reform proposals in this area in other countries. Regulatory reform would help advance a country toward negotiation of a free trade agreement with the United States.

Financial Strengthening of Local Firms

Long periods of high inflation in many Latin American countries in the past provided an incentive for local firms to maintain a high debt-equity ratio by distributing all corporate earnings to the shareholders and borrowing to finance expansions and working capital requirements. Highly leveraged companies are very vulnerable to bankruptcy when profits and sales decline and/or interest rates increase. Exempting the re-invested portion of corporate earnings from income taxes, at least for a defined period of years until financial stability is restored, would

serve as a powerful incentive to reduce a firm's debt-equity ratio and thereby strengthen it financially to better survive periods of declining profitability dictated by increased competition from imports under trade liberalization.

Local Financial Markets

High rates of inflation, large public sector deficits, the debt crisis, unstable interest rate policies, and restrictive government regulations have combined to act as constraints on the emergence of local financial markets in Latin America to become effective vehicles for facilitating investment and trade growth. Expanding local financial markets and easier access to these markets by local firms at reasonable cost are crucial for free trade and private sector development in Latin America and the Caribbean.

To be able to compete under free trade conditions, local companies must have access to diverse credit facilities at international cost levels. Various foreign trade financing sources are available, but Latin American companies are often not well informed about the existence of these financial sources or about the techniques how to utilize and become eligible for external financing, particularly from government programs or international financial institutions. It is important to know what loan information is required by these agencies and how to

prepare, package, and present it. In some cases, the first step is to develop corporate information required to assess risks by agencies that offer insurance and guarantees. Once this is obtained, a company can become eligible for external financing.

Financial sector reform should aim to encourage local financial institutions to emphasize financing production and exports. Conditions should be created for local financial institutions to compete for customers by offering a more complete set of services that could include insurance, brokerage, underwriting, pre-export, acceptance, and various other forms of financing. Consideration could be given to establishing U.S. Eximbank-type services of offering credit lines to foreign importers in order to help own exporters to be competitive. Credit lines to a number of foreign importers can be "bundled" together in order to reduce risks for the issuing agency.

The Central Banks of member countries in sub-regional trade agreements could work out joint "special risk sharing arrangements" to help their export firms access to international credit at reasonable cost.

V. CONCLUSION

The local private sector has to benefit for hemispheric free trade to take roots and to advance. Protectionism will return if the local private sector does not gain from free trade.

To survive under trade liberalization and to benefit from free trade, the individual Latin American firm needs to revamp its own operations. Local private sector organizations should influence the negotiating agenda of free trade agreements and advocate effectively for further economic reforms and infrastructure improvements that will help the private sector to reduce its costs and compete against liberalized imports.

