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# LATIN AMERICAN
## Law & Business Report

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Special Interview

# Andean Region Gets Boost from Exports

## An Interview with JP Morgan's Luis Oganes

**Colombia has made a remarkable turnaround in the last two years. Alvaro Uribe, elected president by a landslide in May, 2002, has taken the offensive in Colombia's battle against the largest guerrilla force in Latin America, the FARC (Revolutionary Armed Forces of Colombia). Since becoming president, Mr. Uribe, who studied at Harvard and Oxford, has survived three assassination attempts by the FARC. Mr. Uribe's efforts have brought calm, confidence and security back to Bogotá.**

**With the insurgency under control, the Colombian economy had been expected to grow by over 4 percent in 2004, led by exports and construction. But new economic figures released on November 30 showed that growth in the third quarter was well under expectations.**

**Ecuador and Peru share Colombia's border, and some of its economic growth. Growth in Peru is still concentrated in the mining sector, and both Ecuador and Peru depend heavily on exports to fuel the economy.**

**The three Andean countries are partners with the United States in a program that is intended to replace the drug trade with jobs in the formal economy. To encourage economic development, the U.S. has exempted many Andean imports from duties.**

**In order to learn about the opportunities, risks and potential of the three Andean economies, *LALBR* spoke with Luis Oganes, Co-head of Latin America Sovereign Strategy and Economics at JP Morgan & Co.**

### Growth in Colombia Spurred by Exports

***LALBR: Colombia's economy had been growing at 4 percent but there was a downturn in the third quarter. Why?***

**Oganes:** The external environment has been quite supportive for Colombia's growth. Fifty percent of Colombia's exports go to the U.S. and the U.S. economy has been growing. Global economic growth has translated into increased Colombian exports. Another factor has been the improvement in confidence locally and this is because of the progress made by the security strategy of President [Alvaro] Uribe. This increased confidence has spurred private investment in Colombia. So there is both an external demand driver and a domestic driver which is higher private investment. However, in the third quarter there was a surprising downturn in mining and agriculture. In the case of mining, the drop in oil output explains most of the reduction, while agriculture was hit by a strike of transportation workers—which should not repeat itself in the fourth quarter. In any case, the weak third quarter figure has forced us to revise our GDP growth forecast for 2004 as a whole to 3.2 percent from the previous 4 percent. This rate still assumes a reacceleration of growth in the fourth quarter of 4.5 percent relative to the third quarter.

***There are fears that the strengthening Colombian peso could reduce sales in overseas markets, but this has not happened yet.***

***LALBR: What would happen to Colombia's economy if there is a downturn in its export markets?***

**Oganes:** Growth will decline. Growth is quite sensitive to global demand.

***LALBR: How much of the Colombian economic growth comes from exports?***

**Oganes:** Out of the 3.2 percent growth that we now forecast for this year, exports are contributing with 1.8 percent.

### Concerns Over a Stronger Peso

***LALBR: In order to maintain its sales of goods overseas, Colombia needs to keep the peso from getting stronger. Already this year the peso has appreciated by 11 percent against the dollar. Does the Colombian Central Bank have the funds to intervene and keep the peso from rising?***

**Oganes:** The exchange rate has become a very sensitive issue. As a result of improvements in trade accounts and increased capital inflows from FDI, from remittances and portfolio investors, etc., the currency has been appreciating steadily throughout the year. There are fears that at some

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Tax Advisory

# 2005 Mexican Tax Reform Approved

by Carlos Gradwohl and John Salerno

**On November 13, 2004, the Mexican Congress approved the 2005 tax reform bill, which was submitted by the Mexican Executive Branch on September 8, 2004. The final tax reform law, which contains a number of important changes from the bill that was originally introduced, will in most cases become effective on January 1, 2005.**

The following is a summary of the key provisions of the tax reform law. The Act has not yet been published in the Mexican Official Gazette (Diario Oficial de la Federación), thus this summary should be reviewed in light of the official text once published.

The Mexican corporate income tax rate will be gradually reduced from its current rate of 33 percent to 28 percent over a three-year period, as follows: 30 percent in 2005, 29 percent in 2006 and 28 percent in 2007 and future years. This reduction will also apply to individuals.

Mexican corporations are required to distribute 10 percent of their taxable income to employees as profit sharing. Beginning in 2005, profit sharing will be deductible for Mexican income tax purposes when paid.

### Consolidated Groups

As from January 1, 2005, Mexican consolidated groups may consolidate up to 100 percent of the taxable income or loss of group members, based on the top Mexican holding company's shareholdings in its Mexican subsidiaries. Certain transition rules may apply. This percentage has been increased from 60 percent under current law.

The acquisition of inventory will no longer be deductible for income tax purposes. Instead, taxpayers will be required to deduct the cost of sales in the year in which income related to the sale of goods is earned. The tax reform law contains specific rules regarding the calculation of the cost of sales, as well as special transition rules that may apply.

It is important to mention that taxpayers that deduct purchases of inventories as of December 31, 2004, will have the option of reversing those inventories over a four to twelve-year transition period that would be determined based on the company's inventory turnover.

Mexican corporate taxpayers will be able to claim indirect foreign tax credits in connection with dividends distributed by second-tier foreign subsidiaries to the extent that certain specific requirements are satisfied. This rule was formerly addressed in a tax decree, and has now been codified.

*Beginning in 2005, profit sharing will be deductible for Mexican income tax purposes when paid.*

### Thin Capitalization Rules

Interest accrued on loans will be deductible to the extent that the Mexican company's total debt with related parties and foreign unrelated parties does not exceed three times its stockholders' equity (for financial statement purposes). This rule will be phased in on a proportional basis over a five-year period to the extent

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## The Fine Print

# New Rules for Brazilian Investment Funds

by Fernando J. Prado Ferreira and Kenneth Antunes Ferreira

### Introduction and History

The Brazilian Securities Commission (CVM) issued Ruling No. 409 on August 18, 2004, which provides for the creation, management and operation of Brazilian investment funds (Funds) and sets out the respective reporting requirements.

Ruling 409/04 is the outcome of extensive work developed by CVM and market participants to consolidate the rules applying to Funds, which were until then regulated by CVM (securities investment funds) and the Central Bank of Brazil (financial investment funds), among other events.

This CVM consolidation of rules via Ruling 409/04 was made possible by Laws Nos. 10303 of October 31, 2001 and 10411 of February 26, 2002, which had amended Law No. 6385 of December 7, 1976, to treat as securities any investment fund shares or other collective investment contracts or instruments, thus vesting CVM with authority to issue rules on Funds.

During the transitional period until issuance of Ruling 409/04, the Central Bank and CVM issued Joint Decision No. 10 of May 2, 2002, and entered into an agreement on July 5, 2002, to define how inspection activities concerning some Funds would migrate from the Central Bank to CVM. On February 27, 2004, CVM issued Ruling 405, by which the Funds then regulated by the Central Bank would have to send information to the CVM input system on the Internet, in lieu of the Central Bank information system.

On March 17, 2004, a draft Ruling was submitted for public opinion and comments, and the resulting text materialized into Ruling 409/04. Ruling 409/04 has offered significant breakthroughs, as financial investment funds (FIFs)—which account for a significant majority of the Funds market—have more flexible rules when compared to securities investment funds (FITVMs). With the advent of Ruling 409/04, FIFs and FITVMs will follow the same patterns of regulation and supervision.

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However, Ruling 409/04 will not apply to a number of investment funds that are already subject to specific regulation, such as Real Property Investment Funds, Receivables Investment Funds, Private Equity Funds, or Mutual Funds for Investment in Shares under Incentive.

### Major Features of Funds and Changes Brought about by Ruling 409/04

***Definition***

Article 2 of Ruling 409/04 defines Funds as the pooling of capital and resources for investment in securities or other assets available in the securities and financial markets.

Funds may be organized as closed-end or open-end. Shares in a closed-end Fund are redeemable only when its duration expires. Shares in an open-end Fund are redeemable at any time.

***The new ruling clarifies the duties of the Fund administrator, as well as spelling out prohibited activities.***

There are also exclusive Funds to be held by a single shareholder, which would in theory go against the idea of a pool of resources. In practice, however, this legal inconsistency has no significant consequences.

### Classification of Funds

Ruling 409/04 has unified the regulation of Funds, which are now classified into distinct categories depending on the type of assets they invest in, as follows:

- *short-term fund*—investments are made only in federal debt bonds offering fixed income or pegged to the Selic benchmark rate variation, or in other securities pegged to price-index variation, maturing within a maximum period of 375 days and with an average portfolio term not exceeding 60 days;
- *indexed fund*—the Fund performance is directly related to the assets in which it invests;

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## Public Offerings

# Prior and Future Public Offerings of Tax-Exempt Securities by Argentine Issuers

by María Fernanda Farall

The Argentine securities commission (Comisión Nacional de Valores—CNV) and the Argentine tax agency (Administración Federal de Ingresos Públicos—AFIP) issued a joint resolution regarding the public offering of certain securities (Joint Resolution) on September 9.[1] This Joint Resolution outlines the requirements that the public offering of corporate debt securities known as *obligaciones negociables* and of securities issued by certain financial trusts must meet for these securities to be exempted from certain taxes.[2] This article examines the offering of corporate debt securities by Argentine issuers prior to the Joint Resolution, the tax audits resulting from these offerings and new requirements imposed by the Joint Resolution.

### Use of Debt Securities by Argentine Companies in the 90s

Beginning in the early 1990s, the issuance and sale of debt securities has been one of the most widely used means of financing by Argentine companies. The wide use of debt securities has been due to the tax benefits given, which are not enjoyed by other traditional corporate means of financing, such as loans. These tax benefits mainly consist of an income tax exemption on interest received and profits from the sale of debt securities and a value added tax exemption on services relating to the issuance, subscription, placement, and transfer of debt securities.[3] Additionally, issuers may deduct interest payments made to the holders of debt securities and expenses and costs incurred in connection with the issuance and placement of debt securities, for income tax purposes.[4]

In order to receive tax benefits, the issuer must meet the requirements of the law. Among other requirements, debt securities must be placed through a public offering approved by the CNV. And the funds from the offering must be applied in specific ways to qualify (for example, the proceeds can be invested in assets inside Argentina, or the proceeds can refinance debt and pay for capital contributions to affiliated entities).

If an issuer fails to comply, all tax benefits are automatically lost. Additionally, the issuer will be liable for the resulting income tax and value added tax plus any accrued interest on such taxes, as well as penalties. This could be financially devastating to issuers depending on

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## Public Offerings (from page 6)

the size of the offering. Distressed companies that are in debt restructuring negotiations or proceedings would be particularly hard hit if the tax benefits were lost.

### What Went Wrong

Commencing in early 2000, the AFIP began scrutinizing several debt securities offerings. It questioned whether issuers were simulating a public offering to take advantage of the statutory tax benefits when, in reality, such issuers were simply selling debt securities to a small group of investors or even obtaining or refinancing a loan from one or a small group of financial institutions.

One of these tax investigations resulted in a 2002 opinion from the AFIP that established the position of this agency with respect to what constitutes a public offering.[5] The AFIP ruled that the mere authorization of the offering by the CNV would not be sufficient for the offering to be a public one. Rather, the issuer should make the securities available to the general public. Whether the general public had access to debt securities would be a question of fact to be determined on a case-by-case basis, the AFIP ruled.

***A new regulation clarifies how public offerings can qualify for tax exempt status.***

The AFIP is continuing to actively investigate recent issuances, and some of the investigations have generated controversies over whether the AFIP is taking too narrow a view in defining a "public offering."

Under the Argentine securities regulations, a public offering is an offer to the general public or to a sector or specific groups.[6] Many of these offerings have been approved by the CNV and placed in the U.S. through Rule 144A, which applies to resales of certain unregistered securities to qualified institutional buyers.[7] These offerings appear to have met the statutory definition of a public offering but nonetheless failed the AFIP standard.

### What the Future Brings: The Joint Resolution

In an effort to answer some of the questions that had been raised by these tax audits, the CNV and the AFIP issued the Joint Resolution. The Joint Resolution applies to public offerings made after September 15, 2004.

*Safe Harbor—The Book-Building System*

The Joint Resolution provides a safe harbor—the so-called "book-building system." Securities offered under the book-building system would be automatically deemed offered through a public offering and, thus, would be tax exempt.

The book-building system requires issuers to record non-binding purchase offers from potential investors, which will be used to determine the sale price and the amount of debt securities to be offered. This record must be electronic and kept in Argentina. It must also be accessible to the CNV. Issuers must also:

- publish the final version of the prospectus in accordance with the applicable Argentine securities regulations;
- invite the public to make bids for the securities for at least nine days; and
- record all communications expressing an interest to purchase identifying the potential investors, date and time of the communication, amount of securities to be purchased and any other relevant information.

*Other Public Offerings*

The placement of debt securities through means other than the book-building system, including international private placements (e.g., Rule 144A), will meet the statutory tax exemptions so long as the principles of transparency and equal treatment of investors are, in the opinion of the CNV, guaranteed. In the case of international private placements, the issuer or the placement agent is also required to carry out "effective placement efforts," which must be described in detail in the prospectus.

*Restructurings*

In the event of a debt restructuring, new securities issued in exchange for outstanding tax-exempt securities will also be tax exempt so long as the holders of the old securities are the purchasers of the new securities. (Previously, it was not clear whether the tax benefits of debt securities issued in connection with a refinancing or exchange would be lost.)

*Disclosure, Reporting and Recordkeeping Obligations*

In the case of international offerings, issuers must file with the CNV all information about the offering made available in the foreign markets.[8] Additionally, all issuers must describe in detail in the prospectus how the proceeds of the debt offering will be used. For instance, if the proceeds will be used for acquisition purposes, the issuer must summarize the businesses to be acquired. If the proceeds will be used to cancel an existing bridge loan, information about the creditor, amount of principal and interest owed, interest rate and use of the loan proceeds must be provided.

Following the completion of the offering, issuers must also report to the CNV the manner in which the proceeds have been used. Previously, issuers were required only to file with the CNV a sworn statement certifying that the proceeds had been used. This has been changed by the Joint Resolution, which now imposes stricter reporting obligations upon issuers, regardless of

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## Public Offerings (from page 7)

whether the securities are placed through the book-building system or otherwise. Now issuers must file with the CNV a sworn statement certifying that the proceeds from the securities offering were used in the manner stated in the offering within 10 days from the use of the proceeds if used all at once together with a report issued by an independent public accountant certifying as to such use. If the issuer uses the proceeds in stages, then this filing must be made within 10 days from each use.

*It remains to be seen how useful the safe harbor introduced by the Joint Resolution will prove to be in practice.*

Issuers must also keep records of the debt securities offering in order to maintain the tax benefits. Documentation from the placement agent evidencing that the placement agent has placed the securities through a public offering as well as a statement from the placement agent showing its experience and skills are some of the records that issuers must maintain.

### An Assessment of the Joint Resolution

While the Joint Resolution clarified certain aspects of public offerings of tax-exempt debt securities, it fell short of answering some important questions, in particular for international debt offerings. While not automatically deemed private offerings, international debt offerings, however, will be subject to the scrutiny of the CNV to determine whether the principles of equal treatment of investors and transparency have been respected if the safe harbor was not used. It is uncertain what this will entail. It also remains to be seen how useful the safe harbor introduced by the Joint Resolution will prove to be in practice. It is also unlikely that the Joint Resolution will have any impact upon the ongoing tax audits, which will likely be continued by the AFIP.

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[1] Joint Resolution No. 470/2004 and 1738/2004 published in the Argentine Official Gazette of September 14, 2004. It went into effect on September 15, 2004.
[2] Law No. 23,576 as amended by Law No. 23,962 governs the debt securities known as *obligaciones negociables* (ON Act).
[3] Section 36 bis of the ON Act.
[4] Section 37 of the ON Act.
[5] AFIP-DGI Opinion No. 16/2002 (AFIP-DGI Dictamen No. 12/2002) dated January 25, 2002.
[6] Section 16 of Law No. 17,811.
[7] Rule 144A placements are typically the first entry of Argentine issuers into the U.S. market. For an analysis of Rule 144A and other issues for non-U.S. companies that are considering entering the U.S. capital market or already have securities trading in the U.S., please see the publication titled *Foreign Private Issuers of Equity Securities in the United States—Disclosure and Reporting Obligations* authored by Jones Day attorneys Kevin D. Cramer, Steven D. Guynn, Gary T. Johnson, Richard M. Kosnik, J. Eric Maki and David P. Porter, which is available at jonesday.com with the permission of its publisher R.R. Donnelley.
[8] For instance, issuers placing securities in the U.S. using Rule 144A must meet certain information requirements in the U.S. See the Jones Day publication mentioned in FN 7 above. ❑

# New Law Grants Tax Incentives for Industrial Investments

by Leandro Passarella

### A Tax Policy to Encourage Investments

In September, Law No. 25,924[1] entered into effect to provide "temporary" tax incentives to encourage certain capital expenditures. The incentives allow the use of input VAT to pay other federal tax liabilities (or receive a refund) and accelerate the depreciation of qualifying assets. The benefits apply only to investments in fixed assets (excluding motor vehicles) used in "industrial activity" or to fixed assets used in public utility infrastructure projects by "Argentine companies," which would include an Argentine branch of a foreign company.

***New Regulations***

On September 6, the executive branch issued regulations to specify additional requirements to qualify for the incentives. One general requirement relates to time, as a taxpayer must use the incentives within a three-year period (expiring October 1, 2007); hence, the statute's reference to "temporary." Further, the benefits are not self-determined but rather must be applied for by the taxpayer.

Congress has budgeted AR$1 billion (approximately $330 million (U.S.)) per year to fund the investment incentives in capital assets. This budget will be allocated between VAT credits and refunds (AR$700 million) and accelerated depreciation (AR$300 million). Export projects involving qualifying assets may benefit simultaneously from both incentives. Capital expenditures made toward public utility infrastructure projects, however, are not subject to these limits.

Further highlights of the new regulations include:

- *VAT credit or refund.* To receive VAT credit, the input VAT must be accrued through purchases or imports of capital assets used in industrial activities or for infrastructure construction services. The input VAT, to the extent not recovered from the taxpayer's own VAT sales, may be credited against other tax liabilities three months after accrual.[2] If the taxpayer does not have any VAT output to offset, the input VAT will be refunded.
- *15 percent rule.* A minimum capital expenditure threshold applies to qualify for benefits. Thus, as a general rule, a taxpayer may apply for incentives after 15 percent of the projected investment is made during the law's specified three-year period. Capital assets purchased before the enactment of the law will benefit from the incentives if less than 10 percent of the investment project has been executed.
- *Continuity of interest.* The benefits are conditioned on the taxpayer's holding the assets for at least three years. If during this time the assets are disposed under a non-taxable exchange for new assets, the benefits would be carried over, as long as the new assets are comparable in value to the old assets.

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### A Carrot and a Stick

The new regulations link the benefits for investments in public utility infrastructure to a public bidding and approval process. The regulations require the Ministry of Economy to solicit benefits applicants at least twice a year. If the budgeted incentives available (see above) at the time of the call are not fully allocated, they will be carried over to the next call. The government's first call for bids was October 29th.

The policy objectives of the new regulations are revealed in the new regulations. Applicants will be considered based on four factors, each of which is assigned a relative weight expressed as a percentage. Thus, the stated criteria are: payroll increase (30 percent), net exports (25 percent), use of Argentine inputs (30 percent) and increase in exports (15 percent). Even more telling, the rules exclude applicants with pending legal actions in order to permit inflation adjustments to their financial statements prepared for tax purposes. Applicants with claims pending would have to withdraw those actions and pay any pending and disputed income tax before applying for the benefits, though fines will not be assessed. The new regulations effectively force applicants to compare the potential benefits of withdrawing a tax inflation adjustment action with the savings from the incentives.

> ***Argentine branches of foreign companies will not be able to apply for the benefits of this regime.***

Under the new regulations, the Argentine tax authorities will have five years to audit an applicant's fulfillment of its applied-for investment project. If noncompliant, the benefits will be canceled and the taxpayer fined up to 100 percent of the amount of unpaid taxes.

### Tax Incentives for Software Industry

As reported in the October 31 *LALBR*, p. 6, the Argentine Congress enacted Law No. 25,922,[3] which pro-

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# Tax Incentives (from page 9)

vides tax breaks to software companies engaged in the manufacture, design, development, production and implementation of software systems and its user's manuals. The new regime also exempts from Central Bank exchange controls, payments to import hardware and other IT components. Surprisingly, Argentine branches of foreign companies will not be able to apply for the benefits of this regime. The creation of Fonsoft, a fund to finance software companies in Argentina, may be the reason for the exclusion.

This regime broadly defines software, although it does not include software developed for purposes of internal use. To benefit from the tax breaks, companies will have three years to comply with a recognized industry standard for quality control of software products. Benefiting companies must also keep separate accounting records if they engage in other activities, so as to allocate the benefits to the specific activity. The amount reserved by the government to fund the benefits will be specified annually in the Federal Budget and apportioned by the Secretary of Industry, Trade and Small- and Medium-Size Businesses.

Unlike the tax benefits for investments in fixed assets, the software regime does not penalize noncompliance with a software project, other than preclude a taxpayer from reapplying for the special tax breaks. Nonetheless, neither the legislators nor the regulators has clarified how the tax incentives interact with an earlier law that qualified investment in software companies for tax exemptions and deferrals but which required the provincial governments to adopt specific regulations to put them into effect.[4] Moreover, we continue to seek a response from the provinces and the city of Buenos Aires to our urging that they implement similar tax breaks to bring the promotion of the software industry to a coherent, unified standard. For now, this binary request is still being processed.

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[1]Published on September 6, 2004.
[2]For assets purchased through leases, the incentive applies three months after the purchase option is exercised.
[3]Published on September 9, 2004.
[4]See Law 25,856 discussed in "Argensoft: Will Your Software Soon Be Made in Argentina?" (Argentine Business Law Watch, January 23, 2004). ❑

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# ICSID Arbitration Cases against Argentina Revisited

by Carlos E. Alfaro and Agustin Marra

At present there are approximately thirty cases filed against Argentina as a result of the measures taken by the government due to the Argentine currency crisis.

The pesification that converted into pesos all the payment obligations denominated in foreign currency and froze public services' tariffs have had serious implications not only for investors awarded with concession contracts but also for all investors that trusted in an economic stability, and a legal framework that was later substantially changed. Many of these investments were made under the umbrella of Bilateral Investment Treaties (BITs) which provided arbitration as the valid mechanism to solve any arising dispute.

Many investors brought claims against Argentine federal and provincial governments before the International Center for Settlement of Investment Disputes (ICSID). Currently, there are over 29 arbitration cases filed before ICSID against Argentina.

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The following is a list of all the cases filed with the ICSID taking into account the different subject matter involved:

- *Water area:* (1) Compañía de Aguas del Aconquija S.A. and Vivendi Universal; (2) Azurix Corp.; (3) Saur International; (4) Aguas Provinciales de Santa Fe S.A., Suez, Sociedad General de Aguas de Barcelona S.A., and Interagua Servicios Integrales de Agua S.A.; (5) Aguas Cordobesas S.A., Suez, and Sociedad General de Aguas de Barcelona; (6) Aguas Argentinas S.A., Suez, Sociedad General de Aguas de Barcelona S.A., and Vivendi Universal S.A.
- *Gas area:* (7) Enron Corporation and Ponderosa Assets L.P.; (8) CMS Gas Transmission Company; (9) LG&E Energy Corporation, LG&E Capital Corporation and LG&E International Inc.; (10) Sempra Energy International; (11) Camuzzi International S.A.; (12) Gas Natural SDG S.A.; (13) Total S.A.
- *Oil area:* (14) Pioneer Natural Resources Company, Pioneer Natural Resources (Argentina) S.A. and Pioneer Natural Resources (Tierra del Fuego) S.A.; (15) Pan American Energy LLC and BP Argentina Exploration Company; (16) El Paso Energy International Company; (17) BP America Production Company and others; (18) Wintershall Aktiengesellschaft
- *Electricity area:* (19) AES Corporation; (20) Camuzzi International S.A.; (21) Enersis S.A.; (22) Electricidad Argentina S.A. and EDF International S.A.; (23) EDF International S.A., SAUR International S.A., and Léon Participaciones Argentinas S.A.

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## Arbitration (from page 10)

- *Informatic services:* (24) Siemens A. G.; (25) Unisys Corporation
- *Motor vehicle enterprise:* (26) Metalpar S.A. and Buen Aire S.A.
- *Telecommunications area:* (27) Telefónica S.A.
- *Leasing area:* (28) CIT Group Inc.
- *Insurance area:* (29) Continental Casualty Company

The Argentine government has threatened to investigate whether the companies that entered into concession agreements complied with the investments called for in the contracts. The government's objective is to force companies to withdraw the claim under arbitration if they want to renegotiate their contracts.

ICSID runs the risk of becoming a tool to force negotiations or to improve one party standing. The number of cases may also produce a backlash for the future. Countries will be less willing to accept submitting to arbitration. ❑

BRAZIL

## Judicial Reform

# Brazil's Clogged Court Dockets to be Eased by Constitutional Amendment

by Scott Studebaker

The Brazilian congress has passed a judicial reform bill that supporters say will significantly speed up the clogged Brazilian court system. The system has been plagued by lengthy appeals, which mean that complicated cases can take a decade to be resolved. The amendment itself took even longer than most court cases. The senate gave final approval to the bill on November 17, some 13 years after the bill was first introduced.

### Binding Precedents

While the amendment contains many provisions, the mechanism that will have the greatest practical importance is the use of "judicial directives" by the Supreme Court. Under the provisions, the Brazilian supreme court can issue directives that will bind lower courts to decide similar cases in the same way. To be binding, directives must be approved by at least eight of the 11 supreme court justices. Directives approved by less than eight justices will not be binding. "Judicial directives will reduce the number of cases that are filed," says Georges Fischer, Senior Partner at Fischer & Forster Advogados in São Paulo, who represents many foreign firms in Brazil. "Many lawyers will advise their clients not to go to court when a directive will make it very unlikely that they can win."

Previously, decisions of the supreme court applied only to the particular parties before the court. Crowded court dockets are a serious problem in many Brazilian states, such as the industrial state of São Paulo, where cases take an average of seven to 10 years to be resolved.

This lack of precedent setting cases has caused confusion and misunderstanding of Brazil's court system. In 1990, for example, the government of Fernando Collor de Mello locked up bank deposits for 18 months in an effort to combat inflation. The action caused hardships as patients suddenly found themselves without funds to pay for medical care or homes. Businesses were unable to pay suppliers. Many large depositors went to court to force banks to hand over their deposits. Some plaintiffs won, some lost, but the supreme court decisions against the government action never compelled lower courts to rule in a similar way.

***Crowded court dockets are a serious problem in many Brazilian states, such as the industrial state of São Paulo, where cases take an average of seven to 10 years to be resolved.***

The Brazilian government opposed the measure approved by the senate because it feared that one court directive against the government could permit millions of citizens to successfully file claims, particularly in disagreements over taxes and disputes over severance pay for public workers.

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# Clogged Courts (from page 11)

### Clearing Supreme Court Docket

The amendment will also relieve the court docket of the Brazil's highest court by giving the Supreme Court the discretion to choose the cases it will hear, similar to the *writ of certiorari* process used by the U.S. Supreme Court. Under the previous system, the court was burdened with often trivial appeals from defendants from lower courts. Under the amendment, the Supreme Court should give priority to hearing cases where a decision will have widespread effects, as opposed to narrow questions of law.

The amendment establishes a new National Council of Justice, an independent entity that will have the power to investigate judicial impropriety and fine or suspend judges. While the council will not have the ability to fire judges, it can control judicial budgets. The national council will be made up of judges, prosecutors and prominent members of the bar.

The most important change will be the increased certainty that the new procedures will bring to potential litigants, says lawyer Fischer. "Most of my clients complain of high levels of uncertainty in Brazil," he said. "This measure will help." ❑

# Recent Antitrust Developments

by Francisco Todorov, Cristiane de Oliveira Coelho and Paula Azevêdo

### SEAE Suggests Restrictions to Approval of Brasil Telecom/iG Acquisition

The Secretariat of Economic Surveillance (SEAE) issued an opinion suggesting restrictions to the approval of the transaction by which Brasil Telecom is acquiring 63 percent of Internet Group do Brasil (iG). Upon the closing of this transaction, Brasil Telecom will control 73 percent of iG's shares.

SEAE argued that, although the transaction will not lead to market closing, it might result in vertical restrictions. In order to avoid these consequences, the Secretariat suggested that the transaction be approved under the condition that Brasil Telecom gives iG's competitors equal access to telecommunications infrastructure that enables Internet connection, especially regarding the "income share" (i.e., division between the telecom operator and the provider of revenue generated by the use of telecommunications infrastructure by users). According to SEAE, this condition should be imposed for a three-year period, after which the Brazilian Competition Commission (CADE) should decide whether the restriction is to be maintained.

The same recommendation has already been made by SEAE in the review of Brasil Telecom's acquisition of iBest, a company active in the same market as iG. The Secretariat concluded, in both cases, that the Access Providers—iBest and iG—might benefit from their association with Brasil Telecom, which would result in market distortions that might reduce the number of competitors, affecting competition and end-users.

Although the transaction between Brasil Telecom and iBest is still being reviewed by CADE, SEAE has taken into account the horizontal concentration caused by both transactions—iBest and iG—and concluded that there would be no anticompetitive effects due to the great number of competitors in the relevant market of service providers. — *by Cristiane de Oliveira Coelho*

### CADE Exempts Bank Transaction from Fine

On October 27th, the Brazilian Competition Commission (CADE) approved a joint venture between Mellon Bank and ABN AMRO Bank, affirming its jurisdiction over merger control filings involving financial institutions and their understanding regarding the need to submit these transactions for their review.

CADE decided, however, not to fine the banks for tardy filing of the notification, since the jurisdiction conflict was exculpatory.

In effect, CADE has had a different opinion than the Secretariat of Economic Law (SDE) and the Secretariat of Economic Surveillance (SEAE), believing that it does not have to follow the opinion by the Federal General Attorney's office that determined that the analysis of mergers between financial institutions falls within the Central Bank's jurisdiction.

There is currently a bill in Congress regarding the jurisdiction for analysis of mergers between financial institutions. According to the bill, the jurisdiction relating to CADE and the Central Bank will be defined in a more precise manner, where CADE will analyze less complex mergers that do not present systemic risks.

For now, the uncertainty concerning the jurisdictional conflict remains. Notwithstanding, CADE has revealed to the market that unless there is a clear understanding regarding jurisdictional issues, companies that present merger

*Continued on page 13*

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# Antitrust (from page 12)

control filings tardily will probably not suffer legal penalties. — *by Paula Azevêdo*

### Antitrust Immunity for Airlines Proposed

News reports have recently indicated that the Brazilian government is studying the possibility of granting antitrust immunity for mergers and acquisitions in the commercial aviation sector in Brazil. According to this proposal, for a period of five years such mergers and acquisitions would not have to be submitted for approval of the Brazilian Competition Commission (CADE). This change would take place through an amendment to the current Bill, under review by Congress, that creates the new aviation regulatory agency—ANAC.

Currently, mergers in the airline sector need to be approved by CADE, since the Brazilian competition law is applicable to all sectors of the economy (in the absence of an express exemption). At the moment, the Secretariat of Economic Law of the Ministry of Justice (which issues an advisory opinion on mergers under review at CADE) is reviewing a code sharing agreement between the two largest airlines—TAM and VARIG—after a proposed merger between the companies did not materialize. The Secretariat of Economic Surveillance of the Ministry of Finance (which also issues advisory opinions) has already stated that the code sharing agreement should not be approved. If the proposed immunity goes forward, it would seem that the code sharing agreement might not need a formal approval by CADE.

Recently, CADE imposed penalties on VARIG, TAM, VASP and Transbrasil (which no longer operates) in an investigation of cartel practices in the Rio de Janeiro-São Paulo route, the most important in Brazil (see below). It is not yet known whether the proposed immunity would also cover investigations of anticompetitive agreements and behavior, or whether the new regulatory agency would be in charge of analyzing such cases. It is also not yet known whether the proposed change will in fact be sent to Congress for approval, or whether such approval would be given. — *by Francisco Todorov*

### CADE Determines Removal of Term “Employee” from Non-Competition Clause

During the October 27th session, the Brazilian Competition Commission (CADE) determined that the term “employee” be removed from a non-competition clause set forth in the merger agreement entered into by and between JMS do Brasil Participações Ltda. and J. Malucelli Seguradora S.A.

According to CADE, a clause restraining one “employee” from working for a competitor’s company may infringe the Brazilian Constitution since it would represent a breach in labor freedom. Since CADE affirmed its responsibility for assuring both the Constitutional principle of open competition and the social values of labor, it determined the removal of the term “employee” even though the current drafting would not bring about anticompetitive effects.

Even though similar decisions have been issued in other cases, CADE has already decided differently in the past by affirming its lack of jurisdiction over clauses that do not relate to market regulation, and sent the case to the Public Prosecution Office for Labor Rights for examination. — *by Cristiane Coelho* ❑

# Investment Funds (from page 5)

- *fixed-income fund*—at least 80 percent of the Fund portfolio must be invested in fixed-income assets directly, or in related synthetic securities via derivatives transactions;
- *stock fund*—at least 67 percent of the portfolio must be invested in stocks traded on securities exchange or organized OTC market;
- *foreign exchange fund*—at least 80 percent of the Fund portfolio must be invested in foreign exchange-related assets directly, or in related synthetic securities via derivatives transactions;
- *foreign debt fund*—at least 80 percent of the Fund assets must be invested in sovereign debt bonds, and up to 20 percent of the Fund’s net equity may be invested in other credit instruments transacted in the international markets; and
- *multiportfolio fund*—the investment portfolio of this hedge fund must encompass several risks, without a special commitment to concentrate on specific or distinct factors.

### Administration

Ruling 409/04 has also clarified the duties, prohibitions and responsibilities of the Fund administrator. Until then, these tasks and duties had been defined—sometimes in a conflicting manner—in scattering regulations. The Fund administration was oftentimes confused with the Fund portfolio management. CVM has properly defined each of these roles.

Under Ruling 409/04, the Fund administration encompasses a set of services directly or indirectly relating to the Fund operation and maintenance. These services may be provided by the administrator itself or subcontracted with third parties.

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# Investment Funds (from page 13)

For its part, portfolio management includes the ability to buy or sell securities that make up the Fund portfolio. This activity is performed by a person accredited with CVM to act as a portfolio manager. Accordingly, this accreditation with CVM allows a person to trade in portfolio assets and administer the Fund itself (e.g., to keep and update the Fund books; to exercise the rights attaching to the Fund assets; to monitor third-party services; and so forth).

Under Ruling 409/04, the agreements entered into between the administrator and third parties for the performance of securities management, treasury, control, processing and custodial services, as well as for share issuance and redemption bookkeeping, must contain a clause expressly providing for joint and several liability of the Fund administrator and third parties for any losses caused to the Fund shareholders on account of any acts that run contrary to prevailing laws and regulations.

Market players have stood up against this determination on the argument that CVM could not have availed itself of a Ruling to establish this joint and several liability, which can only be determined by law or contract.

### Administration Fees

Administration fees are also worthy of note. Ruling 409/04 provides not only for administration fees, but also for compensation of the services charged to the Fund separately.

According to Ruling 409/04, the administrator may also charge a performance fee on certain conditions. In the draft text of Ruling 409/04, this performance fee could only be charged to Funds that met certain minimum asset and investment requirements. CVM properly struck these requirements from the final text, as the performance fee primarily relates to the Fund's risk policy (not to investment values).

### Allocation of Fund Shares

The Fund shares should be allocated in accordance with the Fund characteristics or target investors, i.e., whether it is a closed-end or open-end fund, or else solely intended for qualified investors. Allocation of shares in an open-end fund is not conditional on prior registration with CVM. However, allocation of closed-end fund shares is dependent on registration with CVM.

If a closed-end fund is solely targeted at qualified investors, the corresponding registration for allocation of shares will be deemed granted on the date of submission of the documents set out in Ruling 409/04. If a closed-end fund is not intended for qualified investors only, allocation of its shares must be preceded by registration of the public offering circular as per CVM Ruling No. 400 of December 29, 2003.

### Distribution for the Account and at the Order of Clients

Under Ruling 409/04, a Fund may retain securities dealerships to subscribe for or acquire Fund shares for the account and at the order of their respective clients. These institutions must create a supplemental record of shareholders for each Fund, identifying each of the holders of record per code (to be reported to the Fund administrator).

Special bookkeeping of Fund shares should be effected in the proper record of Fund shareholders, identifying the name of the dealership institution and stating the code by which the holder of record is entered in the supplemental record.

### Illiquidity

One of the breakthroughs of Ruling 409/04 refers to the exceptional illiquidity of Fund portfolio assets.

When this illiquid status is detected, CVM authorizes the Fund administrator to declare the Fund closed for proper redemption, and an extraordinary general meeting of the Fund shareholders must be held to resolve replacement of the Fund administrator and/or manager; on reopening or permanent closing of the Fund for redemption; and on the possibility of redeeming shares in bonds and securities.

This general meeting may even approve the spin-off or winding-up of the Fund.

### Written Resolution in lieu of General Meetings

One of the major practical problems faced by Fund administrations related to general meetings, given the difficulty in bringing shareholders together. Ruling 409/04 allowed the Fund administrators and shareholders—if so expressly determined in the Fund rules—to adopt a written resolution in lieu of general meetings, thus dispensing with general meetings of shareholders.

### Transition

Investment funds in operation on the date of publication of Ruling 409/04 must conform to its rules until December 31, 2004, if such funds are regulated by CVM Ruling No. 302 of May 5, 1999, and by Central Bank Circulars Nos. 2616 of September 18, 1995, and 2714 of August 28, 1996.

### Conclusion

The interpretation and effective implementation of these new rules and concepts introduced by Ruling 409/04 will consolidate as concrete cases are discussed among market players and CVM.

Following up on these developments is a key factor for a better understanding of these issues. ❑

# CADE Maintains Veto to Nestlé Purchase of Garoto

by Priscila Castello Branco

On September 5th, 2004, the Brazilian Competition Commission (CADE), in a 3 to 2 majority decision, denied approval to the request for reconsideration of the previous decision of the Commission itself blocking the acquisition of Garoto by Nestlé. In February, 2004, CADE blocked the Nestlé/Garoto transaction under the argument that the acquisition would lead to the creation of market power in two segments: chocolates in general (including chocolate bars, candy bars, chocolate boxes and Easter chocolate eggs) and chocolate syrups. Nestlé, when of the presentation of its request for reconsideration of the decision in April, 2004, offered to sell assets and brands corresponding to approximately 10 percent of the market of chocolates in general and of 20 percent of the segment of chocolate syrups. CADE would then approve this altered structure of the transaction.

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Two out of the three new CADE commissioners, which had not taken part in the February decision, voted for the approval of the transaction, affirming that the company that would be created with the brands and assets would be able to effectively compete in the affected markets and that, therefore, competition would not be damaged. Commissioners Luiz Alberto Esteves Scaloppe and Luiz Carlos Thadeu Delorme Prado also affirmed that companies should be allowed to freely operate in the market with as little intervention as possible from CADE.

Notwithstanding the two votes mentioned above, Commissioners Roberto Augusto Castellanos Pfeiffer and Luis Fernando Rigato Vasconcellos understood that the sale of brands and assets proposed by Nestlé would not allow for the effective operation of a competitor in the affected segments, since the market structure—which operates with high idle capacity—would make it difficult for a new player to compete. Mr. Pfeiffer and Mr. Vasconcellos followed a previous vote with the same conclusion by former Commissioner Thompson Andrade (which was also counted for purposes of determination of the final result).

It is now expected that Nestlé will appeal against CADE's decision at the Federal Court. It has also stated that CADE exceeded its period for review of the transaction, which should result in an approval without restrictions of the transaction. It is also expected that Nestlé will seek an injunction suspending the effects of CADE's order of divestment before a final Judicial decision. ❑

# Interest Rates Hiked but Economy Still Growing

by Edwin Taylor

Brazil's industrial production showed signs of slowing in September but remained at a record pace for the year, according to numbers released by the Brazilian Institute of Geography and Statistics (IBGE).

In September, total national industrial output remained unchanged versus August. Compared with September, 2003, however, production expanded 7.6 percent. Although this was down from August's year-on-year expansion of 13.4 percent, output for the year through September was still up 9 percent. It is expected that production will end the year with an 8 percent growth over 2003, breaking Brazil's previous record of 7.6 percent set in 1994 at the start of the Real Plan economic adjustment program.

Edwin Taylor is a *LALBR* special correspondent in Rio de Janeiro.

IBGE analyst Sílvio Sales said September's stability versus August did not represent a reversal of the year's recovery but merely a pause after the rapid growth of the first semester. "Judging by the indicators for employment, industrial wages and capacity utilization, September's result does not point to a decline for industry. Quite the contrary," said Sales.

All of the sectors surveyed by IBGE continued to register positive numbers in year-on-year comparisons. Output of capital goods fell 2.5 percent from August but rose 19.8 percent year-on-year and 25.7 percent for the year-to-date. Production of durable consumer goods expanded 18.3 percent year-on-year and 25 percent for the year, despite a 1.9 percent decline from August. Similarly, intermediate goods fell 0.2 percent compared with August but rose 6.4 percent year-on-year and 7.4 percent for the year through September.

Non-durable consumer goods, a sector heavily dependent on salary levels, registered a 1.5 percent expansion from August and was also up 4.9 percent year-on-year and 3.9 percent for the year.

Nationwide industrial sales, meanwhile, fell in September, declining 1.27 percent from August, according

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## Economy Growing (from page 15)

to the National Confederation of Industry (CNI).

Sales did, however, expand 15.6 percent versus September, 2003, and for the year through September were up 16.9 percent. CNI analysts called September's decline versus August a slowdown in the year's expansion rather than a reversal of this trend.

Other indicators in the CNI survey were largely positive. Industrial employment rose 6.0 percent year-on-year and through September was up 2.4 percent compared with the same period last year. Salaries improved 11.1 percent year-on-year and 8.5 percent for the year. Hours worked in production increased 7.3 percent year-on-year and 5.4 percent for the first nine months of the year.

Average capacity utilization in September was 83.5 percent, down from 83.8 percent in September but well above the 80.6 percent mark of September, 2003.

Nationwide auto production fell slightly in October, affected by the month's October 12 holiday in honor of Brazil's patron saint.

Total output of vehicles was 191,000 units, down 6 percent from September. Versus October of last year, however, production expanded 13.8 percent and for the year through October output totaled 1.8 million units, up 21 percent compared with the same period in 2003.

Domestic sales in October fell 0.58 percent to 136,900 units. Year-on-year, sales declined 2.8 percent.

"The domestic market is not growing as we expected but you can't say there has been a reversal of the trend," said Rogélio Golfarb, president of the auto manufacturers association Anfavea.

Exports climbed 9.9 percent in October from September to $796 million and were up 38.5 percent versus October of last year. For the year, exports now stand at $6.76 billion, an increase of 50.5 percent over the same period in 2003.

Despite rising interest rates, nationwide retail sales rose again in September. Sales have been climbing since December of last year and in September increased 8.87 percent compared with the same month in 2003. This was better than August's 6.95 percent year-on-year increase. For the year through September, sales were up 9.32 percent versus the same period last year and on an annualized basis expanded 6.72 percent.

September also showed a continued improvement in sales of items such as clothing and food which are dependent on income levels more than credit. This year's recovery has been led by credit sales as shown by higher growth rates for durable consumer goods and cars. In September, sales of durable goods rose 20.32 percent, still strong but down from 28.8 percent in August.

By contrast, clothing sales, which had fallen 1.1 percent in August, expanded 4.05 percent in September and food sales jumped from an increase of 3.84 percent in August to an expansion of 9.17 percent in September.

### Monetary Policy

Brazil's Central Bank in November raised the Selic (Brazil's overnight interest rate) by a half-point to 17.25 percent a year, the highest level since November of last year when the economy's base rate stood at 17.5 percent.

This was the third consecutive rate hike and the second half-point increase in a row. As in October, the Central Bank's monetary policy committee (COPOM) based its decision on inflation fears.

Although the financial market had predicted that COPOM would approve another half-point rate hike, the decision was immediately criticized by business and labor leaders. The São Paulo State Federation of Industries (Fiesp) said the increase of the Selic rate "maintains the country's base interest rate among the highest in the world. The only coherent alternative is to control government spending." Fiesp noted that, from January to September 2004, revenues increased 10.6 percent above inflation and spending grew 12.6 percent. It is necessary to have more fiscal controls and less increases in interest rates," the Federation said.

The National Confederation of Industry (CNI) warned that "the increase in sequence of interest rates could compromise this climate (of economic expansion) with a negative impact on future growth."

The pro-government CUT labor federation also attacked the rate hike, charging that the Central Bank is too conservative and "insensitive to the productive sectors of the economy, incapable of betting on different measures to control inflation."

Another quarter-point hike in the Selic rate is expected in December by the financial market which is projecting a year-end rate of 17.50 percent.

### Inflation

Brazil's Broad Consumer Price Index (IPCA) registered an October inflation rate of 0.44 percent, up from 0.33 percent in September. The result, however, was within the projections of the financial market.

Most of the increase from September resulted from October's 1.4 percent increase in the price of gasoline by state oil company Petrobrás. This added 0.15 percentage point to October's IPCA. The rising price of steel also affected October's result. Higher steel prices forced the auto industry to raise the prices of new cars by an average 1.29 percent.

Food prices, however, remained under control and declined 0.23 percent in October. For the year, the IPCA now stands at 5.95 percent and the annualized rate at 6.86 percent. The index is expected to end the year below the Central Bank's inflation target ceiling of 8 percent.

### Imports Surge as Economy Accelerates

October's record imports reduced the month's trade surplus to a six-month-low of $3 billion.

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## Economy Growing (from page 16)

Imports soared to $5.8 billion, the highest level ever and 33 percent more than in October, 2003, on a daily average. Exports, though, continued to keep pace, totaling $8.8 billion, up 34.4 percent year-on-year. This left the year's surplus at $28.1 billion compared with $20.3 billion for the same period last year. Exports for the year have increased 31.1 percent and imports are up 27.4 percent. The annualized surplus in October was $32.6 billion on exports of $91.8 billion and imports of $59.3 billion.

Although exports continued to run close to $9 billion in October, the month's result was heavily influenced by one item, $655 million for an offshore oil production platform. Exports in fact are in decline and are expected to continue to fall in November and December, a reflection of the end of the period of exports of agricultural commodities such as soybeans.

October's imports showed the growing importance of the expanding domestic economy. Imports of raw materials and intermediate goods soared 37 percent year-on-year as companies imported more inputs to raise production. Purchases of durable consumer goods rose 19.7 percent and capital goods increased 3.5 percent.

The rising price of petroleum caused a 44 percent jump in Brazil's oil import bill which went from $444 million in September to $640 million in October. For the year through October, imports of crude oil and derivatives totaled $5.53 billion, an increase of 73 percent versus the same period in 2003. ❑

### Funding for Technology

Brazil's Senate in November approved the government's "Innovation Law" which establishes conditions for increased cooperation between universities and business in scientific and technological research.

The goal is to help Brazilian companies improve their technology and become more competitive. The key element of the program is a promised package of fiscal incentives to stimulate investments in technological research. This, however, was not included in the approved bill. According to the legislation, the government will now have 120 days to send the tax package to Congress.

Among the measures contained in the innovation law are the following:

- the public sector at all levels may support partnerships between Brazilian firms, public entities and nonprofit organizations for the development of new technology;
- public sector entities may enter into technological research joint ventures with private sector companies as minority partners. The goal of these joint ventures must be to develop innovative products or procedures. The proceeds from any resulting intellectual property will be divided among the partners;
- public sector agencies may sign technology transfer agreements or licensing contracts for the use of any technology they may develop;
- investment funds may be created to provide capital for companies whose principal activity is technological innovation.

The bill has passed the lower house.

## Top Brazil Officials Laud 3Q GDP, Say Growth Sustainable

by Andrea Welsh

SAO PAULO (Dow Jones)—November 30 marked a proud moment for the top economic advisers of Brazil 's President Luiz Inacio Lula da Silva, thanks to the release of data showing the economy grew 6.1 percent in the third quarter and has been growing longer than originally thought.

Lula's top two economic officials, Central Bank President Henrique Meirelles and Finance Minister Antonio Palocci, both publicly lauded the third quarter data, which showcased a 20.1 percent surge in investment and marked Brazil's fourth straight quarter of year-on-year growth.

Meirelles told a congressional committee Brazil is entering of virtuous cycle of vigorous growth with controlled inflation, while Palocci called a press conference to reaffirm Brazil's commitment to orthodox monetary policies based on the twin pillars of inflation targeting and a floating currency.

"The growth we're seeing at this moment is more vigorous than originally shown," Palocci told a packed room of reporters in Brasilia. Then, casting his gaze toward the future, he said, "The level of investment is definitely consistent with an environment of sustainable growth."

### Economy Grew by 6.1 Percent

On the morning of November 30, the government's IBGE statistics institute said gross domestic product grew 6.1 percent on the year in the third quarter as rising domestic demand added to an export boom long underway. GDP grew 1 percent on a seasonally adjusted basis in the third quarter from the second, showing Brazil's economy continued to accelerate after languishing last year and getting a modest start in 2004.

The agency also revised prior GDP growth numbers to show that the economy expanded 0.5 percent last year in-

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# 3Q GDP (from page 17)

stead of shrinking 0.2 percent as originally reported. According to the revised numbers, GDP shrank slightly in the third quarter last year but then went on to grow 0.9 percent on the year in the fourth quarter, 4.0 percent in the first quarter of 2004 and 5.6 percent in the second quarter.

Together, the numbers showed that Brazil's economy slowed but didn't suffer a recession last year and started rising again in the fourth quarter, earlier than previously thought.

That's good news for Lula, Brazil's first Workers' Party president, who rode into office last year on a job-creation platform but then opted to pursue orthodox economic policies to battle a surge in inflation. Interest rates rose and the economy stalled, forcing unemployment higher as inflation ate away at real wages.

But that tough medicine appears to have paid off and put the economy on a more stable footing. The November 30 data pleased not only Brazil's top officials but also most economists. Many noted the data revisions could point to more sustainable growth for Brazil going forward.

### Composition of Growth

"The important thing was the composition of growth, which showed a lot of investment," said Deutsche Bank economist Jose Carlos de Faria, explaining that the investment should help Brazil increase productive capacity to sustain higher growth rates going forward.

Even economists who had been expecting slightly higher GDP growth in the third quarter said the actual data was better than originally hoped.

"There was a small deceleration on the margin for the quarter-on-quarter growth, but it's a pace of growth that's more sustainable for the economy," said WestLB economist Adauto Lima. "Growing 7 percent is lovely, but it's not sustainable."

Later November 30, WestLB raised its forecast for Brazil's 2004 growth to 5.3 percent from 4.6 percent. Markets currently expect the economy to grow about 4.7 percent this year, according to a broad Central Bank survey.

The November 30 data showed third quarter GDP growth lifting the pace of growth over the last 12 months to 4.2 percent. Over the first three quarters of this year, the average pace of year-on-year growth was 5.3 percent. At present, Brazil's economy is on track to expand faster in 2004 than any year since 1994, when GDP grew 5.85 percent.

### Export-Led Recovery Spreads to Local Economy

Both output and consumption improved in the third quarter as an increase in activity to boost exports finally triggered greater domestic demand. Industrial production soared 7.0 percent from the same quarter a year ago, while agricultural output rose 4.9 percent and services grew 4.7 percent.

On the demand side, household consumption jumped 5.7 percent on the year, the biggest year-on-year rise since the second quarter of 1997. As investment soared 20.1 percent on the year, government spending rose only 0.3 percent.

### Growth in Construction, Retail

Roberto Olinto, head of the IBGE's quarterly GDP division, said third quarter growth was driven in particular by a surge in construction activity, which rose 11.6 percent on the year.

Retail activity, meantime, jumped 10.4 percent from the same quarter a year ago thanks to rising employment and real wages, Olinto said. Brazil's jobless rate fell to 10.9 percent in September after peaking above 13 percent earlier this year, and the average real income earned by workers has also increased this year.

### Exports Up by 18 Percent

Brazil's trade sector continued to outperform thanks to continuing strong demand from overseas markets, which is what unleashed the current growth cycle in the first place. Exports jumped 18.2 percent on the year in the third quarter, keeping pace with the rate of expansion seen in recent quarters. Imports also accelerated, jumping 17.7 percent on the year thanks to the rise in domestic consumption.

***"Growing 7 percent is lovely, but it's not sustainable."***

Nevertheless, GDP numbers lag the real economy by several months, and the November 30 data failed to completely quell worries that a monetary tightening cycle now underway could slow economic activity next year.

"We can't forget that industry started to lose steam from September due to the central bank's monetary tightening, and durable goods started to feel the effect," said Julio Hegedus, an economist with Rio de Janeiro's Lopes Filho Consultancy.

Brazil's Central Bank started raising its base Selic interest rate in September to counter inflationary pressures stemming largely from soaring global prices for commodities such as oil and steel. Domestic gasoline and diesel prices rose mid-November for the third time this year.

But the surge in investment should help check domestic inflationary pressures by increasing Brazil's productive capacity.

According to a broad Central Bank survey published November 29, markets currently expect Brazil's base interest rate to jump another half a percentage point in December to end the year at an annual 17.75 percent, one of the highest rates in the world. Still, the same survey predicted Brazil's economy will grow 4.7 percent this year and 3.5 percent in 2005. ❑

# Chile: Looking Ahead

## *Economy is Booming, but Political Clouds on Horizon*

by Walter Molano

The Chilean economy is booming, thanks to a robust export sector and an improvement in consumer confidence. Copper prices traded above 1.43/lb. recently, adding to the optimism in the external and fiscal accounts. The surge in copper prices allowed for export earnings to spike 100 percent y/y in October. Not surprisingly, Chile's level of economic activity reached a seven-year high during the third quarter of 2004, with GDP expanding 6.8 percent y/y. Given the improvement in macroeconomic conditions, there is a good chance that the rating agencies will upgrade Chile's debt rating before the end of the year.

The economic conditions bolstered public support for President Lagos. The Chilean president started his term on a sour note. A series of emerging market crises and low copper prices debilitated the Chilean economy. Moreover, Lagos was a Socialist, and many members of the business community questioned whether Chile was ready to return to the Left.

President Lagos also suffered several political setbacks. His confrontational approach escalated small incidents into major crises. He failed to introduce many of the necessary reforms that Chile needed to move into a higher level of development. Chile desperately needs to implement labor, education and tax reforms. Lagos also wasted a lot of effort pursuing high profile (and costly) bilateral trade agreements, which produced minor economic benefits.

As a result, the quality of the current economic recovery has been poor. Unemployment has remained high despite a sharp increase in economic activity.

Nevertheless, Chileans relished the sight of a strong leader. Lagos was a confident voice, who represented Chile well in international circles. He was an able statesman who stood up against the U.S., defended the interests of regional leaders and played gracious host at global forums. Unfortunately, Lagos' term ends at the end of 2005, and he cannot be sequentially re-elected. Therefore, Chileans are focusing on his successor.

### Political Uncertainties

The political spectrum in Chile is comprised of two coalitions. The center-right consists of the UDI and RN. The Concertacion dominates the center-left. The main parties of the Concertacion are the Socialists and the Christian Democrats (DC). The latter was once the backbone of the Concertacion, but the Socialists gained ground during the late 1990s. Today, the Socialists are Chile's most dynamic party. In October, the Concertacion swept the municipal elections—with the Socialists and more radical elements of the Concertacion performing the best. The municipal elections set the tone for the next presidential elections, which are in December, 2005. Meanwhile the Left gained during the past three years, as the center right fell apart. The center right coalition was plagued by a series of scandals and vicious infighting. The center-right's perennial candidate, Joaquin Lavin, was initially expected to win the next presidential elections, but the problems within the coalition and Lagos' success diminished the likelihood of this scenario. Still, it is too early to write Lavin off.

Lagos' success reinvigorated the Concertacion, but the coalition is facing new problems. Lagos' strong personality eclipsed many of the political figures within the coalition and prevented a clear successor from emerging. Initially, most political analysts expected former President Frei to run again under Concertacion's flag. President Frei was also popular and he hails from the centrist Christian Democrat party. However, two new names recently came to the forefront—former Foreign Minister Soledad Alvear and former Defense Minister Michelle Bachelet. Both women are leading in the polls and both hail from the Left.

***President Lagos failed to introduce many of the necessary reforms that Chile needed to move into a higher level of development.***

Although Alvear and Bachelet have a strong following, many Chileans wonder whether the country is ready for a female president. Moreover, the Concertacion does not have a mechanism in place to select presidential candidates. There is no primary process. Unfortunately, the clock is running out. With 12 months remaining before the election, the candidates are becoming impatient. There are rumors that some of the candidates may run as independents. A splitting of the ticket could debilitate the Concertacion and improve the chances of the Right winning in 2005. Therefore, the political outlook for Chile is not clear.

Chile thrived under the strong hand of President Lagos, but the country may find itself adrift if it does not put more attention on defining the political slate for 2005. ❑

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# Safety Requirements for LNG Storage Terminals

by Benjamin Torres-Barron

In compliance with the Federal Law of Measurement Units and Norms, the Ministry of Energy published the Official Mexican Standard NOM-013-SECRE-2004 (NOM-013) entitled "Safety requirements for the design, construction, operation, and maintenance of terminals for liquid natural gas storage which include systems, equipment and facilities for the reception, transportation, vaporization and delivery of natural gas," in the Federal Official Gazette (DOF) on November 8, 2004.

NOM-013 replaces NOM-EM-001-SECRE-2002 entitled "Safety requirements for the design, construction, operation, and maintenance of terminals for liquid natural gas storage, which include systems, equipment and facilities for the reception, transportation, regasification and delivery of such fuel."

Likewise, NOM-013 has its origin in the Official Mexican Standard Project NOM-013-SECRE-2003 (Project) published in the DOF on September 19, 2003.

NOM-013 consists of four sections: the first section applies to LNG storage terminals with fixed facilities in firm ground. The second section applies to LNG storage terminals installed off-shore, from the LNG point of reception to the point of delivery of such natural gas on gaseous form to a transportation system through pipelines, and including systems for the reception, transportation, storage, and vaporization of LNG and delivery of natural gas. The third section of NOM-013 refers to the design of the underwater pipeline for the transportation of natural gas from the storage terminal out to sea to the littoral. Finally, the fourth section of NOM-013 deals with the Conformity Evaluation Procedure (PEC), which sets out the methodology to determine the licensee's level of compliance with NOM-013 in connection with the design, construction, operation and maintenance of the different kinds of terminals for liquefied natural gas storage, which include systems, equipment and facilities for the reception, transportation, vaporization and delivery of natural gas.

## Design, Construction

The design, construction, operation and maintenance of the LNG terminal must comply with the minimum requirements established in NOM-013, and must not prevent the use of other systems, equipment, methods or means for quality, resistance, effectiveness, structural integrity, durability and security purposes, which may be equivalent or superior to those set forth in such NOM-013.

For issues not specifically established by NOM-013, including recent systems and design equipment, terminals or facilities that are not in firm ground or, generally, technology innovations with insufficient operative experience at the international level, the licensee will be required to justify before the Energy Regulatory Commission (CRE) the technology to be used for such purposes. The licensee must also submit documentation and technical references evidencing those practices that have been internationally recognized.

In accordance with article 49 of the Federal Law of Measurement Units and Norms, the licensee may request the CRE's authorization to use or apply materials, equipment, procedures, test methods, mechanisms, alternative procedures or technologies, in which case, the licensee would have to submit scientific or objective evidence that may be required to prove that the proposed alternative satisfies the objectives of NOM-013.

Those interested in participating in the development of LNG projects in Mexico should carefully review NOM-013. ❑

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Tax Perspective

# Improved Tax Regime for the Maquiladora Sector

by Jaime González-Béndiksen

The maquiladora export industry for decades has been a driving force of the Mexican economy, generating jobs and foreign currency, so needed by the country. This article summarizes the background of the maquiladora industry, primarily with respect to the applicable tax laws, the tax regime in China (Mexico's main competitor in attracting foreign in-bond operations), the evolution of Mexican tax law as it applies to the maquiladora regime (resulting from arduous work over the course of years), and concluding with the author's reflection on amendments Mexico should pass to face the challenge of being competitive with other countries in the taxation of in-bond operations.

## Background

When they first arose, maquiladora operations were established to alleviate the under-employment at Mexico's northern border. The first maquiladora-related decree was called the "Decree to Alleviate Under-employment in the Northern Border Zone of the Country." This decree, dating back to the 1960s, was a regulation of Article 321 of the Customs Law in effect at the time, setting the basis for the maquila programs we know today.

As the program was jobs-oriented, the tax authorities did not focus on the companies that entered them as revenue-generating sources.

The first signs of change were seen in the early 90s, when tax collections from salaries paid to nonresident individuals working at Mexican maquiladoras began to increase. The Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público*—SHCP) used to issue annual rulings to the National Council of the Maquiladora Export Industry (*Consejo Nacional de la Industria Maquiladora de Exportación*—CNIME), declaring that such wages were not subject to income tax. In a matter of years, the terms of the annual rulings changed to limit the exemption to only certain upper executives. Later, in the mid-1990s, the SHCP stopped issuing the rulings, and the tax for nonresident maquila employees began to be enforced exclusively under the provisions of the Income Tax Law and the U.S.-Mexico tax treaty. This means that salaries paid to such persons are presently taxable in Mexico, with certain exemptions.

Originally, the Mexican tax authorities were not concerned as to whether the foreign entities that contracted in-bond services with Mexican maquiladoras were subject to the asset tax on the machinery, equipment, tools and inventories they owned, provided under free bailment or consignment to their Mexican counterparts. In this regard, the SHCP used to publish general rules waiving the tax for the nonresident owners. Over the years, the asset tax exemption was increasingly limited, first to the percentage of maquiladora production allocated for export, i.e., if 20 percent of a maquiladora's production were sold in the domestic market, then the foreign enterprise that owned the assets located in Mexico would have to pay 20 percent of the normally applicable asset tax. In the second half of the 1990s, when the transfer pricing regime discussed below was first implemented, the asset tax exemption was further limited to maquiladoras that fulfilled the general rules provided by the SHCP to facilitate transfer pricing compliance.

***Over the years Mexican tax authorities have introduced changes to the maquiladora tax regime, to some extent mitigating the overall tax impact.***

Then, the new phenomenon of "permanent establishment" appeared. While the Income Tax Law had included a definition of permanent establishment for some time, the U.S.-Mexico tax treaty triggered a new interest. Apparently at the insistence of the United States, the treaty provides that a permanent establishment exists in Mexico when a U.S. resident has a dependent agent in Mexico that habitually processes merchandise owned by the nonresident, using assets provided thereby or by a related party. This is the description of a maquila opera-

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# Maquiladora Sector (from page 21)

tion; thus, the treaty is basically saying that nonresidents that carry on in-bond operations with Mexican maquiladoras have a permanent establishment in Mexico. The treaty entered into force in January, 1994. To avoid the detrimental effects to the maquiladora industry that the enforcement of this provision would cause, a transitional article was added to the 1997 tax reform, establishing that no permanent establishment would be deemed to exist, provided that the maquiladoras complied with their transfer pricing obligations. To facilitate transfer pricing compliance, the SHCP issued general rules that essentially gave maquiladoras the option to obtain an advance pricing agreement (APA) from the authority, or to generate a tax profit (income minus allowable deductions, before NOLs) of no less than 5 percent of costs and expenses. In 1999—a terrible year for maquiladoras—the annual tax reform provided, among other matters, that beginning in 2000 the transitional provision described above would be repealed. This meant that starting in 2000 maquiladora operations would create a permanent establishment for the foreign enterprises that used them.

***A modification to the VAT Law is needed to recognize maquiladoras' right to credit the VAT paid on some imports.***

The impact of the provision's repeal is obvious. Having a permanent establishment in Mexico was an unacceptable situation for foreign companies, not only because it implied paying tax in Mexico but because of the lack of definition, in Mexico and elsewhere, of the possible basis for taxing income of a permanent establishment, such as: Would permanent establishments be taxed on the arm's-length income that would be derived from providing technical assistance to a maquiladora? Or would they be taxed as if they were manufacturing goods in Mexico, on the profit generated from the sale of such products? Or otherwise?

To resolve this uncertainty, which could have dramatically undermined maquila operations in Mexico, it was necessary for the U.S. tax authorities to intervene. Competent authority discussions between the two countries led to a so-called mutual agreement in October, 1999, under the tax treaty, setting the requirements that a maquiladora must satisfy to avoid creating a permanent establishment. The mutual agreement was complemented with a supplemental agreement in August, 2000. Under these agreements, the SHCP and later the Tax Administration Service (*Servicio de Administración Tributaria*—SAT) would issue the rules to be met by maquiladoras to not create a permanent establishment by reason of their activities. The rules were not always a true reflection of the mutual agreement between the countries; they introduced alien elements and unilateral interpretations by Mexico that made compliance with the rules considerably complicated and burdensome. Furthermore, the rules were frequently modified.

### Taxes Affecting Maquila Activities

The principal taxes that affect the cost-sensitive activities of maquiladoras are:

- income tax, currently at 33 percent of taxable income
- asset tax, at 1.8 percent over asset value
- social security, ranging between 17 percent and 30 percent of payroll
- retirement savings system (SAR), at 2 percent of payroll
- housing fund (INFONAVIT), at 5 percent of payroll
- local payroll tax, at 2 percent of payroll
- real estate tax, 0.3 percent of assessed value
- value added tax (VAT), 10 percent to 15 percent (recoverable)
- real property transfer or acquisition tax, 2 percent

### Comparison with Chinese Tax Regime

A large amount of new in-bond investment is being diverted to other countries, especially China. Unfortunately, this is also happening with operations already set up in Mexico, that close down and look for other places to operate.

The following are applicable taxes in China, that are interesting to compare with Mexican figures:

- income tax: 30 percent
- local income tax: 3 percent
- dividends: 0 percent
- asset tax: 0 percent
- real estate tax: 1.2 percent on 70 percent of purchase price, or from 12 percent to 18 percent of rent
- payroll tax: 5 percent to 45 percent
- tax on services and sales of real estate and intangibles: 3 percent to 5 percent
- VAT: 17 percent (recoverable)
- tax incentives for enterprises with foreign investment: 100 percent income tax exemption for two years; 50 percent income tax exemption for three years
- additional tax incentives for promoted industries, exports and technological activities: 50 percent income tax exemption after first five years
- profit reinvestment: income tax refund of 40 percent to 100 percent
- regional incentives, varying by region

### Proposals to Increase Competitiveness

Despite the progress, there is still a long way to go. Given other countries' major competition to attract in-

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# Maquiladora Sector (from page 22)

bond operations, Mexico must close the gap, making the establishment and operation of Mexican maquiladoras more attractive, safe and simple. In this regard, the author offers the following suggestions he considers to be needed for immediate action:

- *Permanent establishment.* The current provisions for avoiding permanent establishment are unclear, as a literal interpretation would seem to indicate that they apply only to maquiladoras whose parents reside in countries having a tax treaty with Mexico. While a historical and equitable construction clearly shows that the provisions also apply to countries that have not entered into a tax agreement with Mexico, it would be desirable to draft the necessary amendments into law.
- *VAT credits.* VAT is a consumption tax that, in theory, should not affect the various stages of production because the producer may recover all VAT paid. Maquiladoras' daily activities, however, present problems for crediting the VAT paid. The law provides that only the VAT corresponding to deductible expenses may be credited. In maquila operations, the foreign company that owns the goods manufactured with temporarily-imported product often decides to sell the finished products in Mexican territory. In these cases, the Customs Law provides that the maquiladora (and only the maquiladora) must (not may) change the customs regime of the temporarily-imported goods to the definitive importation regime. In a literal reading of the VAT Law, when the regime is changed the VAT is incurred on the importation and should be paid by the importer, i.e., the party that changes the regime, necessarily the maquiladora. However, as noted, the VAT Law appears to state that the maquiladora cannot credit the VAT paid upon changing the customs regime, because it has not made any expenditure to acquire the products whose customs regime is changed (since they are sold by the nonresident owner to customers situated in Mexico). Thus, the requirement that the VAT paid must correspond to a deductible expense would seem not to be satisfied. This interpretation has no reasoning in logic, law or the nature of the VAT; if maquiladoras are taxpayers for VAT purposes because their operations are subject to that tax, and if the law imposes the obligation to change the regime and pay the VAT, it should recognize their right to credit it. Thus, a modification to the VAT Law is needed to recognize maquiladoras' right to credit the VAT paid on importation, under these conditions.
- *VAT on services provided to maquiladoras.* In addition to the submaquila operations described above, maquiladoras often contract for services, labor and otherwise with resident companies. Since the services are incorporated into export goods, by nature they should be entitled to the 0 percent rate applicable to all exports. There is at least one judicial precedent in this sense. However, the law should clearly specify this treatment.
- *Refunds.* Also with regard to the VAT, under the general system, manufacturers pay VAT to their suppliers and recover with VAT they charge to their customers. Maquiladoras, as exporters of services, shift the VAT to their customers at the 0 percent rate. In other words, they do not collect any amount of VAT from their customers, which they could use to recover the VAT paid to their suppliers. Thus, maquiladoras must request the refund of their favorable VAT balances. However, it is well known that

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### Changes Favoring Maquiladoras

Over the years Mexican tax authorities have introduced changes to the maquiladora tax regime, to some extent mitigating the overall tax impact. Some examples of these modifications include:

- annual SHCP rulings excluding nonresident workers' salaries from the income tax;
- general rules issued over the years (and still being issued), on the now-partial asset tax exemption for nonresident-owned assets;
- Mexican tax authorities' willingness to negotiate and sign the mutual agreement and its supplement, with U.S. tax authorities;
- 2002 tax reforms, as follows: codification of guidelines for maquiladoras to avoid creating a permanent establishment for their parent companies; codification (in transitional provisions) of other aspects of maquiladoras' transfer pricing compliance and elimination of the permanent establishment risk;
- tax reform for 2003, with the introduction of new criteria for maquiladoras to eliminate the parent companies' permanent establishment—namely, a transfer pricing study increased with a 1 percent return on the foreign-owned machinery and equipment;
- the following amendments to the Value Added Tax Law, introduced in 2003: recognition of the 0 percent rate for sales by nonresidents, constituting actual or virtual exports; recognition that all exports made by Mexican residents pursuant to the Customs Law are entitled to the 0 percent rate; recognition that submaquila activities also are entitled to the 0 percent rate applicable to maquiladoras;
- the income tax incentive under the presidential decree published October 30, 2003, of up to 3.5 percent of costs and expenses or 3.9 percent of assets value.

## Maquiladora Sector (from page 23)

although the law provides that VAT refunds should be paid in no more than 40 days, in reality refunds can take a year or two to be paid. This represents a high financial cost for maquiladoras, which are deprived of the ability to use their working capital. This is an additional operating cost that makes maquila activities less profitable in comparison with operations in other countries. Of course, the problem has been largely mitigated with the provisions that became effective on July 1, 2004, allowing for favorable balances of VAT to be offset against income and asset taxes, including in estimated payments. However, as the universal offset does not completely eliminate the problem of maquiladoras' favorable balances, the SAT must implement effective administrative processes to allow maquiladoras to recover their favorable VAT balances in no more than 10 days, as is the case for Altex-certified (high-export) maquiladoras.

- Another administrative problem that maquiladoras face and that affects competitiveness is the high cost of compliance. A key example of this is the fact that from 1995 to 2002, a large number of maquiladoras should have elected to request an APA to comply with their transfer pricing obligations, to eliminate the construction of a permanent establishment for the nonresident to whom they provide maquila services, and to avoid the asset tax payable by the nonresident. While many APAs have been resolved, a great number are still pending. The negotiation of an APA constitutes a considerably long, costly process. Note that the pending APAs were requested between 1995 and 2000. In many cases, the APAs are related to agreements already negotiated the profit margins with the SAT. Due to a change of officials in the APA area within the SAT, the incoming officials have sought to disallow the negotiations concluded between the maquiladoras and the outgoing officials, in their entirety. In addition to prolonging the process and increasing maquiladoras' costs, this sends the wrong signal to international investors. The perception is that the Mexican government cannot be held at its word and does not respect agreements reached with taxpayers. The SAT must instruct its officials that all pending APAs be released on the basis of agreements already reached by previous officials.

*The competitiveness of maquiladoras is also harmed by Mexico's high cost of compliance.*

- As the states and municipalities most directly benefit from the establishment and operation of maquiladoras, given the jobs and taxes they generate, exemptions from the real estate acquisition tax and payroll tax are proposed, to bring new or increased investments.
- Last, in general terms, it would be advisable to provide greater legal certainty to maquila operations with a proportional, fair tax regime that allowed at least medium-term tax planning, without the annual amendments that lead to uncertainty and frustrate any organized attempt at business planning. ❑

## Mexico's GDP Registers 4.4 percent Increase

by Ana Morales

The Ministry of Finance and Public Credit reported that Mexico's GDP registered a 4.4 percent year-on-year increase in real terms during the third quarter of 2004. However, Mexico's GDP only increased 0.64 percent with respect to the previous quarter in 2004, the lowest growth registered in the last four quarters.

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In the last year, Mexico has registered positive growth rates, mainly due to the sustained recovery of the U.S. economy. Most analysts believe that 2004 will be the best year for Mexico's growth performance. They predict a 4 percent annual GDP growth by the end of the 2004.

### Industrial Production Increases 5.2 percent

The Ministry of Finance and Public Credit reported that industrial production increased 5.2 percent in the period January-August, 2004. The Ministry said that three factors have contributed to this increase:

- an increasing growth trend in Mexico's manufacturing exports, which registered a 9 percent growth in September;
- a sustained recovery of Mexico's maquiladora industry in 2004; and
- a considerable increase in U.S. demand for Mexican manufactured goods. ❑

# The Mexico–Uruguay Free Trade Agreement

by Emilio Tuneu Mohr, Mariela Clérico Rhodes and Miguel A. Valdés

On July 15, the new Free Trade Agreement between Mexico and Uruguay entered into force, as the result of an intense process of negotiations boosted by the presidents of both nations with the aim to reinforce the 54 Complementary Economic Agreement signed by Mercosur and Mexico.

## A Significant Agreement

***Asymmetries***

The first feature that characterizes this agreement is the overwhelming contrast between Mexico (that boasts a $601 billion GDP in 2003 and a population of 105 million inhabitants) and Uruguay with scarce 3.3 million population and $11.2 billion GDP last year. In other words, an economy 50 times more powerful than the economy of the South American country. Yet, it is reasonable to wonder which expectations the Mexican government may have regarding this agreement, and the answer is that the dimension of a country has no influence in international economic relations, for this is the 42nd FTA that Mexico has signed in a program of fast expansion of its FTA network. The next one will be the Mexico–Japan Agreement. From the Mexican point of view, the interest in Uruguay arises, on the one hand, in its exports (such as woolen textiles, dairy, bicycles, motor components and beef), and, on the other hand, in considering Uruguay a hub in Mercosur, based on its advantageous geographical situation and financial market legislation. This is why some Mexican industries are studying strategic policies in areas such as vehicles, chemicals, electronics, computers and telecommunications.

For these purposes, Uruguay can offer concrete and competitive solutions, ranging from free zones offering logistic services, corporate laws that are the key tools to incorporate trading companies, or holding companies that benefit from very low taxation and tax-exempted regimes, to banking services that help foreign investors to work better in a globalized economy. Last but not least, Uruguay can also be regarded as a manufacturing platform for Mercosur, the same way Mexico has been a platform for NAFTA.

This is the first agreement signed with a Mercosur country. Another characteristic of this FTA is that, since Uruguay is a member country of the Common Southern Market, it operates as a gateway for Mexico to enter into the Mercosur. Indeed, as well as Chile, Bolivia and Peru, Mexico aims to participate in the bloc as an associated country in the free-trade area. Why should Mercosur be so interesting for Mexico? Because Mercosur could absorb some Mexican products (such as PC components, TV and audio equipment) that have lost competitiveness in the American market where the Chinese have gained ground. Additionally, Mercosur may still play a very important role as a food provider for China, which is already showing deficits in its agriculture.

***A "Last Generation" Agreement***

Finally, the content of the agreement has the characteristics of a modern, complete and "vanguard" text in accordance with the latest developments in international trade. Not only does this FTA tackle trade, but also services and intellectual property, including an updated and pragmatic controversy resolution scheme.

## Open-Door Policy to Services and Investments

This is a relevant agreement for Uruguay as regards to the services industry, which makes up almost 70 percent of its GDP. It is also important for Mexico, since it is currently the leading services exporter in Latin America. The access to the services market can be described as rather wide, even though some "sensitive" areas have been excluded in this instance, such as financial services, but the agreement commits itself to start its negotiations in the first two years after its entrance into force. Among the services included, consultancy and professional services are to be highlighted; for instance, these services could be sold by an Uruguayan firm without the burden to reside in Mexico. The agreement provides a temporary free entrance to business people visiting Mexico. Another chapter is reserved for academy recognition of university diplomas and other careers.

***The agreement will permit Uruguay to access NAFTA countries through Mexico, and Mexico to access Mercosur markets.***

As investments are concerned, the agreement establishes the rules of equity, non-discrimination, lawful measures and neutrality. The agreement is applied not only to future investments, but also to existing ones. Only the activities reserved to the states are excluded from this FTA. Included among the open access investment policies are a prohibition on imposing on an investor of a country a minimum participation in the enterprise of the other country, as well as the removal of requisites of

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## FTA (from page 25)

nationality for directors and incorporators of a company (save specific cases), or the prohibition to constrain an investor from selling or disposing of his investments on the grounds of his nationality. In addition to this, the agreement develops a series of guarantees to prevent a contracting party from expropriating investments made by investors of the other party. When inevitable, under restrictive circumstances, the expropriation must also comply with the guarantees provided therein. Among the possible investments, the agreement enumerates the participation in a company's share capital, the subscription of debentures or other titles of debt issued by a company, the contracting of a loan agreement, the investment in real estate, tangible or intangible goods, participation in gains, winding-ups, capital and other financial resources engaged in the development of economic activities.

While this FTA enables Uruguayan companies to have access to a 105 million people market, it can also trade in the NAFTA region through Mexico. Indeed, businessmen of both countries have already proved that this FTA really works, since figures show an increase of 133 percent of bilateral trade in the first months of the year, for an amount of $100,000,000. ❑

## 2005 Tax Reform (from page 4)

that the taxpayer exceeds the maximum ratio of 3-to-1 on January 1, 2005. The thin capitalization rules will not be applicable to financial institutions, or to certain taxpayers with related and/or unrelated party debt that obtain a ruling from the Mexican Tax Authorities which confirms that the terms of the loan are arm's length. A report issued by an authorized public accountant must be attached to the ruling request, and certain other formalities must be satisfied.

### CFC Rules

Mexican tax haven legislation was modified and is now referred to as a "Preferred Tax Regime" (PTR). The PTR includes any entity, regardless of its residence, that effectively pays tax of less than 75 percent of what would have been due under the Mexican tax rules. Gross revenues or profits (in certain cases) earned by taxpayers resident in these jurisdictions will be considered taxable by the Mexican shareholder as they are accrued regardless of whether dividends are actually paid. An exception exists for "active income" of a subsidiary in a jurisdiction that maintains a broad exchange of tax information agreement with Mexico. This rule will also be applicable to entities considered to be transparent in which the Mexican taxpayer is a direct or indirect shareholder.

Payments of certain types of "passive" income made by Mexican residents to PTRs are subject to a 40 percent withholding tax and are presumed to be nondeductible unless the taxpayer demonstrates that they are made at arm's length (i.e., a treatment similar to the current tax haven regime).

The term "business profits" is defined to exclude all payments that are subject to withholding tax under Mexican domestic tax law.

Income tax deferral rulings on the transfer of shares between foreign related parties will only be granted in connection with share-for-share exchanges.

Gain on the transfer of certain receivables by a non-Mexican resident to a Mexican resident will be considered to be interest subject to withholding tax. The tax reform law includes rules to determine which gains are included within the scope of these new rules.

The sale of the beneficial ownership of shares will be treated as a sale of the shares themselves.

The sale or exchange of the shares of a company (whether Mexican or non-Mexican), more than 50 percent of the accounting book value of which is indirectly attributable to Mexican real property, will be deemed to generate Mexican source income and, therefore, be subject to Mexican Tax.

The definition of Mexican source salaries will include amounts relating to the exercise by an employee of stock options granted by a Mexican employer or a related party.

Debts with banks and foreign parties will be deductible from the asset base for purposes of computing the Mexican Tax on Assets.

Many of these changes are significant and may merit the immediate attention of multinationals with subsidiaries in Mexico, particularly those with debt-financed operations, consolidated tax groups or which manage material inventory balances. ❑

### Automotive Exports and Production Continue Decreasing Trend

According to the Mexican Automotive Industry Association (AMIA), total production of automobiles in Mexico reached 1,289,485 units in the period January-October, 2004, a 2.5 percent fall from the same period last year.

From January to October, 2004, automotive exports reached 940,336 units, a 6 percent drop from the same period in 2003. — *Ana Morales, White & Case*

# Maquiladora Industry Registers 7.7 percent Production Growth

by Ana Morales

After a three-year slump, the maquiladora industry is showing positive signs of recovery. The steady rise of the U.S. economy, the return of foreign companies, and the implementation of Mexican government policies (i.e., modification to the tax and social security regime applicable to maquiladoras) have contributed to the industry's improved performance.

In the period January-August, 2004, 800 new maquiladora companies were established in Mexico, 30 percent more than the previous year during that same period. In August, the maquiladora industry employed 1,131,000 workers, 8 percent more than in August, 2003.

Maquiladora exports have also performed well throughout 2004. In the period January-August, 2004, maquiladora exports reached $56.7 billion. In August, maquiladora exports reached $8.2 billion, 30 percent more than in August, 2003. These figures represent the largest gains registered on a month-to-month basis since January, 2003, and surpassed by 15 percent the historic figures of August, 2001, when exports reached $7.1 billion. In addition, Foreign Direct Investment (FDI) in the industry has also been strong, reaching $4 billion in the period January-August, 2004.

According to the National Council for the Export Maquiladora Industry (CNIME), the sectors that benefited most from this recovery are: electronics, automotive, aerospace, and medical equipment. Other sectors, including textiles and apparel, have benefited less due to the lack of government policies to support these sectors and increased foreign competition.

The Council expects that the maquiladora industry will achieve a full recovery in 2005 and analysts estimate the following figures for the industry: *(i)* 10 percent production growth; *(ii)* 8 percent employment growth; and *(iii)* 5 to 8 percent FDI growth.

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## *Ministry of Economy Will Implement New Regulations for Maquiladoras*

The Ministry of Economy and the General Customs Administration (AGA) agreed to implement new regulations for the maquiladora industry, electronics and auto parts companies. The regulations intend to simplify foreign trade procedures and are the following:

- *Holding Maquiladora.*[1] One company can import all its supplies in the name of its subsidiaries. The subsidiaries usually perform one or several parts of the import processes for one product.
- *Certified Company.*[2] Certified companies will not be subject to new reviews by the Ministry of Economy once the Customs Administration has reviewed and approved them.
- *Foreign Trade Operations Improvement Measures.* The Ministry of Economy and the Customs Administration will consolidate their electronic databases to reduce the amount of filings and bureaucratic procedures.

The Ministry of Economy expects to publish the new regulations in the upcoming weeks.

[1]The "holding maquiladora" term was created within the amendments to the Maquiladora decree of May 12, 2003. The holding maquiladora is a scheme where companies are able to consolidate foreign trade operations of two or more subsidiaries in only one controlling company.

[2]Among other things, the Certified Company program offers multiple benefits in customs operations to importers and exporters that meet the Ministry's requirements. ❑

## Investor Perspective

# New Incentives for Hydroelectric Generation Plants

by Juan Francisco Pardini and Gilda Berman de Vilar

The Panama Legislative Assembly approved Law No. 45 of August 4, 2004, that establishes an incentive regime for the fostering of hydroelectric generation systems and set forth other provisions. This law is a result of the merger of three bills proposed in 2002, all of which provided tax incentives for the establishment of mini and small hydroelectric power plants in Panama.

This law also is a result of the recently published Resolution No. 04002 of February 19, 2004, whereby the Energy Policy Commission approves the guidelines of the Energy Policy for the promotion of sources of hydroelectric energy. As indicated to local media by Legislator Fred Torres, who proposed the law, "this is the first step taken by Panama to establish in the near future a policy for the energy development in the field of cleaner and more economic energy."

For the purpose of the application of the incentives provided by these new regulations, the following definitions are set forth in the same:

- *Mini-Hydro.* Central Systems of Mini-Hydros are defined as those plants or group of generation plants with an installed capacity of up to 10 MW as well as all the lines, substations and distribution and/or transmission systems necessary for the due connection to the distribution and/or transmission system.
- *Small Hydroelectric Central System.* Further to the previous definition, Small Hydroelectric Central Systems are defined as those plants or group of generation plants with an installed capacity of 10 MW up to 20 MW as well as all the lines, substations and distribution and/or transmission systems necessary for the due connection to the distribution and/or transmission system.
- *Central Hydroelectric Systems.* These systems are those with an installed capacity greater than 20 MW, as well as all the lines, substations and distribution and/or transmission systems necessary for the due connection to the distribution and/or transmission system.
- *Geo-Thermoelectric Central Systems.* Generation plants that use resources from geothermal sources, as well as all the lines, substations and distribution and/or transmission systems necessary for the due connection to the distribution and/or transmission system.

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### Benefits

Subject to a limitation of 20 MW installed capacity, the systems defined above will enjoy the following benefits:

- Article 55 of Law No. 6 of 1997 (Regulatory and Institution Framework for the Provision of the Public Service of Electricity) is amended whereby as of the sixth year of said law, the granting of concessions regarding hydroelectric and geothermal generation will not be subject to the requirement of concurrency;
- the right to enter into direct power purchase contracts with distributing companies, subject to restrictions imposed on distributing companies by law;
- these companies will not be subject to a charge for distribution nor to a toll for transmission, when they sell directly or sell in the occasional market;
- systems of an installed capacity of more than 10 MW and up to 20 MW will not be subject to a charge for distribution nor to a toll for transmission for the first 10 MW of installed capacity during the first 10 years of commercial operation.

***Companies that build energy production facilities can receive a tax credit for 25 percent of the investment.***

### Tax Incentives

Law No. 45 also provides the following tax incentives for the construction and exploitation of Mini-Hydroelectric Central Systems, Hydroelectric Centrals and Centrals of other Renewable Resources:

- Tax exemption is granted from all taxes and duties that may be caused due to the importation of equipment, machines, materials, spare parts and others necessary for the construction, operation and maintenance of Mini-Hydroelectric Central Systems, Hydroelectric Central Systems and other Renewable Sources. This incentive will be also applicable to those

*Continued on page 29*

## Hydroelectric Plants (from page 28)

Systems that are in construction at the moment of enactment of this law.

- Corporations that develop new projects or increase the capacity of production of energy with an installed capacity of 10 MW can choose to obtain from the state a tax incentive equal to up to 25 percent of the direct investment in the project, based on the reduction of tonnage of carbon dioxide emissions equivalent for a year calculated by the term of the concession or license. This credit can be used to pay income tax return for the activity in a determined fiscal period, during the first ten years as of the beginning of the commercial operation of the project, as long as there are no other incentives, exonerations, exemptions and tax credits established in other laws.
- Corporations that develop new projects or increase the capacity of production of energy with an installed capacity of more than 10 MW, that begin construction after the entering into effect of this law, can choose to obtain from the state a tax incentive equal to up to 25 percent of the direct investment in the project, based on the reduction of tonnage of carbon dioxide emissions equivalent for a year calculated by the term of the concession or license. This credit can be used to pay up to 50 percent income tax return for the activity in a determined fiscal period, during the first ten years as of the entering into effect of the commercial operation of the project, as long as there are no other incentives, exonerations, exemptions and tax credits established in other laws.
- A tax credit for a maximum of 5 percent of the total value of the direct investment in concept of works, that after the construction of the plants will be converted into infrastructure of public use, such as highways, streets, bridges, sewage, schools, health centers and others of a similar nature. This credit cannot be assigned, transferred or used as compensation.

Lastly, the new Law provides the obligation of the beneficiaries of this law to collaborate with the programs and official plans for improvement and conservation of the basin, including reforestation and the fight against erosion and others, with the purpose of conserving the natural resources of the country for future generations. ❏

## Interview (from page 3)

point this strengthening of the currency could affect competitiveness, but that hasn't happened yet. Exports are actually continuing to grow, so the Central Bank has been intervening in the market in order to try to contain the appreciation. From January to August the Central Bank bought $1.4 billion on the spot market. But this accumulation of reserves has not been enough to contain the appreciation and in September the Central Bank announced that it would intervene with another $1 billion in the last four months of the year. What we have heard is that only a small portion of this has been executed, perhaps less than $200 million, so the Bank still has some ammunition left to try to contain the appreciation. The problem with such aggressive intervention is that the Central Bank is putting pesos into the economy that need to be sterilized, and that is why the Central Bank is not being more aggressive intervening in the foreign exchange market.

***If global growth slows, Peru's economy will suffer.***

***LALBR: Many times central banks intervene discretely. By making this announcement, did the Colombian Central Bank hope to influence the exchange rate without selling so many dollars?***

**Oganes:** Yes. When it announced intervention, the peso corrected and weakened but when the market realized that the Central Bank was not being as aggressive as it had announced it would be, then the peso started to appreciate again. Moreover, the U.S. dollar has accelerated its depreciation versus the euro, and this is also helping to prop up the Colombian peso versus the dollar.

### Inflation under Control

***LALBR: If the Central Bank is not fully sterilizing the intervention, by selling government bonds, for example, is this because the bank is not worried about inflation?***

**Oganes:** The intervention without sterilization could be potentially inflationary; the Bank is pumping pesos into the economy and it is not fully pulling all of the pesos out by selling treasury paper. The stock of local treasury paper is limited, so basically the Central Bank cannot fully sterilize every time that it intervenes and this is the problem. Nonetheless, inflation seems to be under control and it looks like it is going to remain within the 5 to 6 percent target range.

***LALBR: How much of the capital flowing into Colombia is foreign direct investment?***

**Oganes:** We are expecting foreign direct investment for the year to total $2.2 billion, up from $1.7 billion last year. Next year we forecast FDI at around $2.5 billion. Another important source of capital inflow is coming from remittances from Colombians living abroad. This year the level of remittances to Colombia will be $4.5 billion, up by some 50 percent from last year's $3 billion.

*Continued on page 30*

# Interview (from page 29)

## Growth Spreads to Most Sectors

***LALBR: Which sectors of the Colombian economy are showing the greatest growth?***

**Oganes:** Basically every single sector is growing on a year-to-date basis, although as mentioned before, both mining and agriculture declined in the third quarter. Construction has grown significantly and is playing an important role in the recovery. Remember that during the economic slump of 1998-1999, the real estate market remained quite depressed. The negative wealth effect of the crisis was felt for a few years and finally we are starting to see real estate prices climbing and investment in real estate recovering, and this has been an important component of growth. But if you look across the board, every single sector is growing. I think the growth is quite diversified at this point.

***LALBR: Do you perceive a new sense of prosperity and confidence on the streets of Bogotá?***

**Oganes:** Absolutely. When I talk with Colombians now I am amazed at the change in optimism. This is one reason why Mr. Uribe's popularity is so high.

***LALBR: Mr. Uribe's approval rating at 70 percent is very high by Latin American standards. The congress has just approved a constitutional amendment that will let him serve a second four-year term. Is this good for Colombia?***

**Oganes:** I think it is. Many Colombians have a conflict with the idea of changing the rules of the game to favor an incumbent government, but reality is that Uribe's leadership has proven successful so far in turning around the economy, security and business sentiment, so the market welcomes the possibility of having his administration potentially extended for one more term.

## Foreign Investments Concentrated in Oil and Mining

***LALBR: Foreign investors in the past have concentrated their investments in Colombia's natural resources. Are foreign investors starting to move into other sectors?***

**Oganes:** Foreign investments have focused on the primary sectors, namely oil and coal. There are opportunities in the manufacturing side that might yet attract the attention of foreign investors.

***LALBR: Colombia is an important supplier of oil to the U.S., and there have been concerns that its oil industry is not as efficient as it should be. Have any serious proposals been made to privatize the government-owned oil company, Ecopetrol?***

**Oganes:** There has been no discussion of selling Ecopetrol, but there are joint ventures with private companies in some oil projects. Ecopetrol is not a monopoly, so private investment in the oil sector in Colombia is allowed.

***LALBR: Ore is one of Peru's leading exports, and the mining industry is closely linked to the economy. Can Peru diversify its economy from relying on mining?***

**Oganes:** There has been some progress in the diversification of exports. Under the ATPDEA [Andean Trade Promotion and Drug Eradication Act] [see box], many Peruvian exports (along with exports from Colombia and Ecuador) enter the U.S under preferential terms. This has encouraged diversification efforts. Non-traditional exports are gaining increased importance.

## Problems for Peru's Economy if Global Growth Slows

***LALBR: What would happen to Peru's export sector if commodity prices declined?***

**Oganes:** In Peru, both price and quantities have increased significantly on the mining side. Prices are higher but increased demand

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### Ecuador: macroeconomic indicators

| | Average 1997-01 | 2002 | 2003E | 2004F | 2005F |
|---|---|---|---|---|---|
| Real GDP, % change | 1.5 | 3.4 | 2.7 | 6.0 | 3.0 |
| Consumption[1] | 1.4 | 3.4 | 1.9 | 2.1 | 1.4 |
| Investment[1] | 0.7 | 5.7 | 0.0 | -0.1 | 1.0 |
| Net trade[1] | (0.6) | (5.7) | 0.8 | 4.0 | 0.6 |
| Consumer prices, %oya | 48.9 | 12.5 | 7.9 | 2.3 | 2.3 |
| % Dec/Dec | 47.8 | 9.4 | 6.1 | 2.0 | 2.5 |
| Producer prices, %oya | 57.0 | 5.1 | 6.6 | 2.5 | 2.0 |
| Government balance, % of GDP | (3.0) | 1.0 | 1.5 | 1.6 | 1.5 |
| Exchange rate, units/$, eop | 16,360 | 25,000 | 25,000 | 25,000 | 25,000 |
| Merchandise trade balance ($ bil.) | 0.4 | (1.0) | (0.1) | 0.8 | 0.4 |
| Exports | 4.8 | 5.2 | 6.2 | 7.3 | 7.4 |
| Imports | 4.4 | 6.2 | 6.3 | 6.5 | 6.9 |
| Current account balance | (0.2) | (1.3) | (0.4) | 0.4 | 0.0 |
| % of GDP | (1.2) | (5.4) | (1.6) | 1.3 | 0.0 |
| International reserves, ($ bil.) | 1.4 | 0.7 | 0.8 | 1.1 | 1.2 |
| Total external debt, ($ bil.) | 15.2 | 16.2 | 16.8 | 16.4 | 16.1 |
| Short term[2] | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 |
| Total external debt, % of GDP | 75.0 | 63.0 | 61.0 | 56.0 | 52.0 |
| Total external debt, % of exports[3] | 225.0 | 196.0 | 185.0 | 165.0 | 160.0 |
| Interest payments, % of exports[3] | 16.0 | 13.0 | 12.0 | 10.0 | 10.0 |
| Nominal GDP (US$ billion) | | 24.3 | 26.8 | 29.6 | 31.4 |

1 Contribution to growth of GDP.
2 Debt with original maturity of less than one year.
3 Exports of goods, services, and net transfers.

*Source: JP Morgan*

# Interview (from page 30)

has allowed many mines to expand production significantly. So volumes are also up. If global growth slows, particularly China, which has been a big source of demand for copper and other mining products, growth will suffer. As we have seen in the past, like in 2000 when there was even a recession in the U.S., some of these mines literally shut down while others operated well below capacity in order to prevent an over-supply in the market. Mines in general are very sensitive to what happens with global supply-demand conditions.

### Developing Tourism Sector

***LALBR: Peru has many possible tourist destinations. Why hasn't it invested more to develop tourism?***

**Oganes:** The government is stepping up its efforts to promote and market travel to Peru. Given the wealth of tourism sites, including archaeological sites, the history and architecture, it is true that Peru still lags behind other countries. The government has set a goal of three million tourists by 2006, which is the level of arrivals that Chile already receives now. What is lacking is sufficient tourism infrastructure. Airports, roads, and hotels in tourist destinations must be improved. Lima airport is being expanded, but the same thing needs to take place in the provinces.

***LALBR: Aside from the mining industry, what are the sectors with the greatest potential for foreign investors?***

**Oganes:** Certainly tourism, both because there is so much to be done and because of the opportunities, unexploited resources and capacity. Some foreign companies have already invested in agribusiness, but there is still much more that can be done, particularly with a free trade agreement with the U.S. coming by 2006, and also due to the benefits that exports have enjoyed from ATPDEA. The ATPDEA is expected to be made permanent, and this will spur investment and expansion of capacity. Once the FTA is signed I think we will see much private investment in export sectors.

***LALBR: Has the increased economic growth in Peru helped to reduce poverty?***

**Oganes:** Peruvians feel that the country is growing but that the economic growth is not trickling down. Unemployment has shrunk a bit but there is still much to be done in poverty reduction.

***LALBR: How much of Peru's economy is attributed to the informal sector?***

**Oganes:** Estimates vary, but the most common figure is around 40 percent of GDP.

### Government Needs to Rein in Spending

***LALBR: Is the high level of government debt putting Ecuador's economy at risk?***

**Oganes:** In terms of just the debt, the trend is actually positive. The government has not had access to the capital markets since it defaulted in 1999, so it has been forced to pay down its debt. It is not the debt, but rather fiscal management that raises serious questions. Oil prices are high, yet a country that exports much oil is running a deficit at the central government level. Basically the government is spending too much, particularly in public sector wages and subsidies to utility prices and pensions.

***LALBR: Some of Ecuador's neighbors have reduced their spending by reforming their social security systems. Is Ecuador taking action to privatize its pension fund system?***

*Continued on page 32*

**Peru: macroeconomic indicators**

| | Average 1997—01 | 2002 | 2003E | 2004F | 2005F |
|---|---|---|---|---|---|
| Real GDP, % change | 2.0 | 4.8 | 3.8 | 4.5 | 4.7 |
| Consumption? | 1.4 | 3.3 | 2.5 | 2.7 | 2.9 |
| Investment? | (0.6) | 0.6 | 0.8 | 0.9 | 1.2 |
| Net trade? | 1.1 | 0.9 | 0.5 | 0.8 | 0.6 |
| Consumer prices, %oya | 5.0 | 0.2 | 2.3 | 3.7 | 3.1 |
| % Dec/Dec | 3.9 | 1.5 | 2.5 | 4.0 | 2.5 |
| Producer prices, %oya | 5.0 | (1.0) | 1.7 | 5.6 | 4.6 |
| Government balance, % of GDP | (1.7) | (2.3) | (1.7) | (1.4) | (1.2) |
| Exchange rate, units/$, eop | 3.27 | 3.50 | 3.46 | 3.35 | 3.40 |
| Merchandise trade balance ($bn) | (1.1) | 0.3 | 0.7 | 2.2 | 2.1 |
| Exports | 6.5 | 7.7 | 9.0 | 11.4 | 12.2 |
| Imports | 7.6 | 7.4 | 8.3 | 9.2 | 10.0 |
| Current account balance | (2.2) | (1.1) | (1.1) | 0.3 | 0.3 |
| % of GDP | (4.0) | (2.0) | (1.8) | 0.4 | 0.4 |
| International reserves, ($bn) | 9.3 | 9.3 | 9.8 | 11.1 | 11.1 |
| Total external debt, ($bn) | 29.0 | 28.7 | 30.2 | 30.5 | 30.9 |
| Short term? | 3.7 | 2.9 | 2.7 | 2.3 | 2.0 |
| Total external debt, % of GDP | 54 | 50 | 49 | 46 | 43 |
| Total external debt, % of exports? | 301 | 264 | 242 | 202 | 192 |
| Interest payments, % of exports? | 17 | 13 | 11 | 13 | 11 |
| Nominal GDP (US$ billion) | | 57 | 61 | 65 | 71 |

_ Contribution to growth of GDP
_ Debt with original maturity of less than one year
_ Exports of goods, services, and net transfers

*Source: JP Morgan*

## Interview (from page 31)

**Oganes:** Ecuador, like Venezuela, has not begun to privatize its social security system, and in this sense the country would have benefited if it had followed the lead of Colombia and Peru. These two countries created private pension funds in the early 1990s, and these funds have become the most important source of private domestic savings. Social security still remains under state control with big actuarial deficits that are not properly estimated. No one knows exactly how much the government owes in present value for pensions. Currently, these problems are manageable because oil prices are high, but when oil prices decline, then it will expose this vulnerability on the fiscal side including the burden of pensions. We don't expect to see a significant drop in oil prices next year, so there will not be an incentive to reform the public pension system.

***LALBR: Ecuador's president, Lucio Gutierrez, seemed likely to be impeached but several congressmen changed their votes at the last minute in the impeachment vote in October. Has the political uncertainty surrounding this unpopular president contributed to Ecuador's poor fiscal management?***

**Oganes:** Gutierrez has survived the impeachment attempts by establishing alliances with enough parties in congress so that they were able to block the impeachment. Given this fragility, the government is under permanent political pressure to increase expenditures. Although so far Gutierrez has managed to contain this pressure in most cases, the risks of fiscal mismanagement is high.

> ***Exports are actually continuing to grow, so the Colombian Central Bank has been intervening in the market in order to try to contain the appreciation of the peso.***

### Andean Trade Promotion Program

***LALBR: The United States government launched the ATPDEA program to reduce drug production and permit more Andean imports into the U.S. Have the Andean countries benefited?***

**Oganes:** The program has been successful, for some countries more than others. Certainly Colombia has seen the benefits. Peru has benefited but less so than Colombia. Ecuador has seen the least benefits. The program has helped to boost employment in the region through the development of export-oriented industries. The by-product of more companies manufacturing export goods is more employment. This increased employment has come in the formal sector, so the level of under-employment or of informal employment has also been reduced.

***LALBR: The Andean countries are meeting with the U.S. government in Arizona this week to continue discussions of the U.S.-Andean Free Trade Agreement. Free trade agreements, like the proposed Free Trade of the Americas Agreement, have been receiving greater scrutiny in recent years. Do you expect the Andean FTA to become a reality?***

**Oganes:** I think the agreement will be approved, but possibly not within the original timeline that was proposed. The original idea was to have the agreement negotiated by the countries by January, 2005, so that the congresses of the two countries could approve the agreements. However, there are many outstanding issues that still have to be negotiated. The hard deadline for the FTA to be signed is the expiration of the ATPDEA, which is 2006, so the parties have some extra time to continue to negotiate if necessary.

***LALBR: Have Colombia, Ecuador and Peru started to reduce their costs of doing business at least from the foreign investor perspective? That is, have they reduced the levels of red tape and discretion of clerical bureaucrats?***

**Oganes:** They have a ways to go. If one looks at the strength of institutions in the Andean region, and if you look at any kind of competitiveness ranking, the region does not fare well. The Free Trade Agreement will help here, because it will require the parties to adopt uniform standards in many areas, and will reduce some red tape. The business environment for foreign investors should be improved, dramatically, I think, by the agreement. ❑

### Andean Trade Promotion and Drug Eradication Act

In 2002, the United States signed the Andean Trade Promotion and Drug Eradication Act (ATPDEA) into law. The ATPDEA expanded and renewed the Andean Trade Preference Act (ATPA) that expired in 2001. The aim of ATPDEA is to promote economic development and provide economic alternatives to drug crop production.

The ATPDEA provides duty-free and reduced duty access to the U.S. market for certain goods produced in Bolivia, Colombia, Ecuador, and Peru. Apparel assembled with U.S. fabric, leather products, petroleum and petroleum products are among the products included in the expanded ATPDEA.

*Source: U.S. Dept. of Commerce*

# Judgment from Supreme Tribunal of Justice; Rule on International Investments, Technology Transfer and Technical Assistance

by Luis Ernesto Andueza and Rubén Eduardo Luján

### New Rules for Payments of Royalties, Technical Assistance

On August 23, 2004, Rule No. 056 of Foreign Exchange Administration Commission (CADIVI), which establishes the regime for the administration of foreign currency corresponding to international investments, to payments of royalties, use and exploitation of patents, trademarks, licenses and franchises, and to payments resulting from agreements for the import of technology and technical assistance agreements, was published in the Official Gazette. This rule abrogates Rule No. 029. Rule No. 056 applies to payments resulting from technical assistance agreements where one of the parties is a company that receives international investments and is not regulated by any other rule of CADIVI.

Interested parties must register with the Registry of Users of the Foreign Exchange Administration System (RUSAD), as set out in Rule No. 010 and complying with the identification, corporate, property, financial, tax and labor requirements indicated in Rule No. 056. Likewise, interested parties must request authorization to acquire foreign currency from CADIVI. This rule adds several new requirements for authorization. For instance, in order to request the acquisition of foreign currency specifically for international investments (it was previously required for all cases under Rule No. 029), it is necessary to submit the certificate of characterization of company and the registration of direct foreign investment with any amendments thereto, both issued by the national competent agency (Office of the Superintendent of Foreign Investments, Ministry of Energy and Mines, Office of the Superintendent of Banks and Other Financial Institutions, or the office of the Superintendent of Insurance, as the case may be).

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This rule requires the interested party to prove to the satisfaction of CADIVI the use of the foreign currency previously authorized under such rule as a prerequisite for CADIVI to grant new authorizations to acquire foreign currency, and to keep the documentation supporting the delivery of the foreign currency (which must conform to the concepts and amounts indicated in the relevant authorization to acquire foreign currency). In addition, this rule empowers CADIVI to grant authorizations to acquire foreign currency for a lesser amount to the one requested if CADIVI, based on the documentation submitted to it, determines that there are differences between the request and the results of its verification.

### Judgment from Supreme Tribunal of Justice Confirms the Legality of Exchange Control Regime

On August 17, 2004, the Constitutional Chamber of the Supreme Tribunal of Justice (TSJ) dismissed the action which contested as unconstitutional certain provisions of the Law on the Central Bank of Venezuela, the exchange agreement, the presidential decrees and the rules from the CADIVI, all of which constituted the statutory basis of the current exchange control regime.

In its judgment, the TSJ concluded that such provisions did not violate the following principle and constitutional rights which were allegedly affected: (a) the so-called "principle of legal reservation" (under which certain matters, based on a direct order of the Constitution, can only be regulated by law, whether it is a law passed by the National Assembly or a decree-law issued by the president of the Republic based on a previously enacted enabling law); and (b) the constitutional rights to own property, to freely move goods outside of the country, to perform the economic activity of choice and to participate in public affairs.

Consequently, the TSJ confirmed the legality of the provisions on which the enactment of the current exchange control regime was based.

The TSJ declined to consider in its judgment the potential conflict between the exchange control regime and the bilateral treaties for the promotion and protection of investments signed by Venezuela and other countries or the Agreement of Marrakech (related to the World Trade Organization), and did not refer to another judgment previously issued by the same Constitutional Chamber of the TSJ on November 21, 2001 (which was used as legal basis to request the annulment of the exchange control regime). Nevertheless, unless new unconstitutionality actions are successfully filed, which are based on arguments different from the ones already alleged, the position of the TSJ confirming the legality of the current exchange control regime is final and binding. ❑

# Venezuelan Legal and Business Developments

by Vera De Brito de Gyarfas

### Energy

The special royalty rate of 1 percent granted to Strategic Associations that upgrade extra heavy crude from the Orinoco Belt for a maximum period of nine years was unilaterally eliminated by the Venezuelan government and raised to 16-2/3 percent. The government claimed that the reasons for the initial royalty reduction (low oil prices, uncertainty as to the technology used for upgrading the extra-heavy crude and marketing of syncrude) were no longer present; therefore, there was no justification to maintain the 1 percent royalty rate despite the contractual agreement which regulated the termination of such benefit at the earlier of *(i)* the end of the nine-year period or *(ii)* when the ratio of investment-to-income reached a pre-determined number.

The Ministry of Energy and Mines announced that it will begin to take the steps necessary to have the Orinoco Belt certified as crude reserves (232 billion barrels). In the past, the Orinoco Belt had been qualified as bitumen, but the Ministry indicated that it wishes it to be qualified as extra heavy crude with less than 10° API.

The Vice-minister of Hydrocarbons announced a new tender offer of approximately 20 marginal oil fields with a base production of 2000 bpd. These fields will be offered to Venezuelan companies to form consortia with international companies, which will in turn incorporate mixed companies where CVP will hold more than 50 percent of their corporate capital as required under the Organic Hydrocarbons Law.

The Ministry of Finance announced the 2005 draft budget which includes an average of 3.6 million of bpd of crude, an increase of 200,000 bpd from the 2004 budget.

Grant Geophysical Inc. announced that it has executed an agreement with PDVSA (Venezuela's state oil company) for a 3D seismic study in the States of Guárico and Anzoátegui.

The Minister of Energy and Mines announced that the Gulf of Venezuela and Northeastern Falcón tender offer of seven offshore blocks for free gas licenses has been delayed until the beginning of 2005 due to redelineation of the blocks. He also indicated that the seven blocks had been divided into 34 fields to comply with the maximum 1000 km2 permitted by the Gas Law. The blocks will each cover 500 km2.

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The Memorandum of Understanding executed between Venezuela and Colombia in regard to the interconnection of gas systems between the two countries was published in the Official Gazette of October 4, 2004. The purpose of the MOU is to design the agreements to structure the gas interconnection project for purposes of the commercialization of gas through bi-national associations (preferably) or through mixed or private companies. A negotiation committee is established and a deadline for a joint decision on the development of the project is set for November 30, 2004.

Venezuela hosted the XXXV Energy Ministers' Meeting of the Latin American Energy Organization (OLADE) in Margarita on October 27-29, 2004.

ChevronTexaco announced an important gas discovery in its Loran 2X exploration well in Block 2 of Plataforma Deltana.

Citgo Petroleum Corporation commenced and achieved a cash tender offer for any and all of its outstanding $550,000,000 11-3/8 percent senior notes due in 2011 and a solicitation of consents to eliminate certain restrictive covenants from the indenture governing the 11-3/8 percent notes.

***The government raised the special royalty on crude oil from the Orinoco region to 16-2/3 percent.***

PDVSA opened an office in Buenos Aires, Argentina, to commence sale of fuel oil to Argentina and advise that country with respect to the incorporation of ENARSA, an Argentinean state-owned oil company.

PowerSeraya, a Singapur electricity company, has completed the conversion of three plants to be fueled by Orimulsion. Now that the Venezuelan government has decided to stop producing Orimulsion, it is not clear how the plants will be fueled.

PDVSA's CVP executed a Cooperation and Reimbursement Agreement with the Municipality of Iribarren for the construction of the first phase of the subway system in Barquisimeto and another one for the financing of the Los Teques subway system.

The Vice-minister of Energy announced that it would be convenient to modify the Law of the Electricity Sector in order to eliminate the wholesale market and the requirement of juridical separation (accounting separation would be maintained) of the activities of generation, transmission and distribution of electricity, because such a system would make sense in a competitive electricity market but not in Venezuela, where 86 percent of the electricity infrastructure is state owned.

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# Legal Developments (from page 34)

### Mining

ICSID (International Center for Settlement of Investment Disputes) has admitted the arbitration procedure filed by Vanessa Ventures against Venezuela with respect to Vanessa's investment in Las Cristinas gold mines.

### Exchange Control

CADIVI (Committee for the Administration of Foreign Currency) has informed us that one of the requirements for the granting of the Authorizations to Acquire Foreign Currency (AAD) for the payment of royalties derived from contracts for the importation of technology or technical assistance contracts, etc., is the copy of the notification of the annual payments that the recipients of such technology or technical assistance must make to SIEX (Foreign Investment Office) or the Ministry of Energy and Mines (in the case of oil and gas companies) under Presidential Decree 2,095 which contains the Regulations of the Common System for Treatment of Foreign Capital, Trademarks, Patents, Licenses and Royalties approved by Decisions Nos. 291 and 292 of the Commission of the Cartagena Agreement.

SIEX and the Technology Division of the Ministry of Energy and Mines have informed us that the payments made in previous years may be notified via a brief for each year and for future payment a biannual brief, as applicable. In order to accelerate the issue of the Official Letter, SIEX suggests that the notification be made with a chart indicating the amount of the gross sales, net sales, percentage, amount of payment (in foreign currency with the conversion to Bolivars) and the amount of the withholdings made. Copies of the transfers made and the withholding forms must be attached to the briefs. In the case of the Technology Division of the Ministry of Energy and Mines, it issues special forms for purposes of notification of these payments.

### Labor

The oil industry collective bargaining agreement is under negotiation. The representatives of the unions that support the workers were questioned by PDVSA, and the Ministry of Labor indicated that the unions that are authorized to represent the oil workers are Fedepetrol, Fetrahidrocarburos and Sinutrapetrol.

### Taxation

Administrative Ruling No. SNAT/2004/0743, published in the Official Gazette of October 1, 2004, established the requirements to be complied with by the taxpayers, manufacturers of furniture and household appliances, that request the exoneration from Value Added Tax to operations related with the "Family Basket" Program.

Special invoicing procedures for companies that act as intermediaries of telephony services were established by the SENIAT (Venezuelan Tax Administration), via Administrative Ruling No. 0474, published in the Official Gazette of October 1, 2004.

Presidential Decree No. 3027 which grants an exoneration from Income Tax and Value Added Tax for specific operations of taxpayers located in the Municipalities of Bolívar, Hevia and Pedro María Ureña in the State of Táchira was reprinted in the Official Gazette of October 11, 2004. This benefit will have a duration of five years as from its publication in the Official Gazette.

The "2004 Family Vehicle Program" was established via Presidential Decree No. 3,172, published in the Official Gazette of October 15, 2004, as a renewal of the previous Family Vehicle Program. This program comprises the internal sales operations and imports of the components required for the manufacture of certain passenger vehicles defined by the Ministry of Production and Commerce via Resolution No. 505 published in the Official Gazette of December 14, 1999, and will be in force for a period of three years as from October 19, 2004. Additionally, the duration of the "2000 Family Vehicle Program" was extended until December 15, 2004 as per Presidential Decree No. 3,173 also published in the Official Gazette of October 15, 2004.

### Telecommunications

CANTV announced that it is in the process of acquiring Digitel, the third cellular telephony services provider in Venezuela. This transaction will require the approval of Procompetencia and CONATEL (National Telecommunications Commission), given that CANTV holds the second cellular telephony services provider, Movilnet.

### Competition

Procompetencia approved the commercial alliance between Empresas Polar and the El Tolón Shopping Center, on the grounds that the contracts of collaboration, advertising promotion and sales in terms of exclusivity bring about economic efficiencies to consumers and lessees of the shopping center. The investigation opened *ex-officio* by the agency evidenced that the objective of said contracts is to increase the traffic of consumers, thus allowing the establishments of the mall to compete with others located outside, and in the nearby area.

Due to the fire of October 17, 2004, which affected floors 34 to 56 of the Parque Central East Tower, the Pro-Competition Superintendency (with offices on the 19th floor thereof) announced on its web page the temporary suspension of its administrative activities, until further notice. This suspension has been confirmed by means of Decree No. 3184 dated October 19, 2004, which declared the existence of a state of national emergency in various ministries and entities, including Procompetencia. The

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## Legal Developments (from page 35)

decree was published in Official Gazette No. 38,053 of October 28, 2004.

### Antidumping

On August 30, 2004, the Antidumping Commission (CASS) opened an investigation in order to determine whether the expiration of the final duties established by means of Decision No. 015/99 dated August 12, 1999, would again lead to a damage or threat of damage to the domestic production of flat cold rolled laminated iron or stainless steel products with no alloy, 600 mm wide or wider, originating and coming from Russia, Ukraine and Kazajstan. The decision was published in Official Gazette No. 5,730 Extraordinary of September 23, 2004.

### Miscellaneous

The Ministries of Production and Commerce and Agriculture and Lands fixed the minimum referential price of sorghum at Bs. 420 per Kg; corn at Bs. 514 per Kg; and paddy rice "A" at Bs. 491 per Kg for the 2004 winter.

The Ministry of Infrastructure, through the National Institute of Civil Aviation, issued several Administrative Rulings to regulate *(i)* RAV 107—Security of civil aviation in airports (Seguridad de aviación civil en aeropurtos); *(ii)* RAV 108—Security of Airplane Exploiters (Seguridad de Explotadores de Aeronaves); *(iii)* RAV 109—Accredited Agents and Security Connected Operations in civil aviation; and (Agentes acreditados y Operaciones Conexas de Seguridad en la aviación civil); *(iv)* RAV 112—Security Service Companies of Civil Aviation (Compañías de Servicio de Seguridad en la Aviación Civil) (Official Gazette of October 22, 2004).

The Ministry of Production and Commerce modified and approved certain COVENIN norms related to security, health and protection, glass containers and cement, as per Resolution No. 353 of the National Autonomous Service of Normalization, Quality, Metering and Technical Regulations, published in the Official Gazette of October 28, 2004.

The Ministry for Financing of Development (Ministerio de Estado para el Financiamiento del Desarrollo) is now called the Ministry for Financing of Endogenous Development (Ministerio de Estado para el Financiamiento del Desarrollo Endógeno). ❏