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## **Driving SACU-Mercosur: Trans-Atlantic Co-operation in the Automotive Industry**

Lyal White

Reports

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**Driving SACU–Mercosur:  
Trans-Atlantic Co-operation  
in the Automotive Industry**

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# Trans-Atlantic Co-operation in the Automotive Industry

Lyal White<sup>1</sup>

## Identifying Sectors that Can Drive the SACU–Mercosur Trade Agreement

The South African Customs Union (SACU) and the Common Market of the South (Mercosur) have entered negotiations toward a free trade agreement (FTA). This will be the first of its kind between the customs unions of regional groupings that represent developing markets.<sup>2</sup> Brazil and South Africa, the undisputed economic powers in their respective regions, have naturally assumed a leading role in the process. The political affinity between these two nations is evident both in the common positions they adopted in multilateral fora and in the personal relationships between their leaders, as shown by the presence of Thabo Mbeki at the inauguration of the Brazilian president, Luiz Inácio Lula da Silva, on 1 January 2003. A strong political bond which extended through their respective regions, has developed between the two countries.

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<sup>1</sup> LYAL WHITE is the Anglo-American Chairman's Fund Latin America Researcher at the South African Institute of International Affairs (SAIIA), based at the University of the Witwatersrand, Johannesburg. He has conducted extensive research on SACU–Mercosur relations. This report follows research conducted both in South Africa and Mercosur member countries between January and April 2003, sponsored by DaimlerChrysler.

<sup>2</sup> SACU is made up of South Africa, Botswana, Lesotho, Namibia and Swaziland, while Mercosur consists of Brazil, Argentina, Paraguay and Uruguay in South America.

The current FTA proposals between SACU and Mercosur are very much the result of a politically driven initiative. This is a derivative of the popular South-South proposal, which aims to link developing countries in Latin America, Africa and Asia so that together they can find ways to address the particular difficulties that globalisation presents to their emergent economies. However, while the strengthening of South-South relations is a noble cause, there is very little else driving the initiative apart from the political will and the relentless energy of a few individuals. Bilateral trade and investment between developing countries are minimal, and countries of the South are becoming increasingly dependent on the developed countries of the North. South-South relations seem to lack real economic and commercial incentives, the key ingredient required for a SACU-Mercosur agreement.

The process of negotiating the FTA was considerably hampered by the poor economic performance of both Brazil and Argentina in recent years, and the hesitant approach initially assumed by South Africa (a country which was inexperienced in international trade negotiations). This has changed as Brazil has gained greater economic stability and Argentina has begun to emerge from its dramatic economic and political crisis, while South Africa has acquired experience and confidence since discussions with Mercosur first started.

After a long process of visits between official government representatives and trade delegations and the resumption of negotiations, SACU<sup>3</sup> and Mercosur are finally preparing to conclude a trade agreement. Lists of products which might be included in the FTA are being exchanged, for scrutiny by both sides. SACU and Mercosur are also starting to identify whole sectors that should be

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<sup>3</sup> SACU has been incorporated into the negotiations with Mercosur only recently. The original framework agreement was signed between South Africa and Mercosur.

included. This is an extremely important phase: not only does it add economic substance to a process that has been criticised for its lack of pragmatism and commercial feasibility, but it will also serve as the first real test of the resilience of the relationship between the two regions — as economic partners in the developing world.

What has made negotiating this FTA difficult is that economically both regions are competitive, not complementary. Because SACU and Mercosur are direct rivals in international markets, economic incentives for embarking on an FTA have to be carved out between the two. Certain industries may be exposed if protective measures are reduced, making them vulnerable in their very own markets. This, however, is not the intention of the FTA. Rather, the purpose of the negotiations is to achieve broad economic benefits for all parties involved.

It is important to note that SACU and Mercosur are pursuing a sector-by-sector FTA, as opposed to creating a full-blown inter-regional free trade area. The negotiations that are currently taking place therefore lay the foundation for further negotiations. The present stage entails developing inter-industry links, with the intention of ultimately establishing a free trade area. For this reason, industries and sectors to be included in the initial agreement need to be selected carefully. Ideally, industries of importance in both the SACU and Mercosur economies should be considered, and areas of complementarity identified. This is where maximum returns could be achieved. However, because these industries make a substantial contribution to their own economies, the negotiating process is bound to encounter obstacles.

The automotive industry is one of these important industries. Its contribution to the manufacturing sectors of both the SACU and Mercosur economies is undisputed. The automotive industry is also highly diverse, and encompasses a number of related sectors. It contributes substantially to employment creation and overall GDP

growth. The automotive industries in both SACU and Mercosur (particularly South Africa and Brazil) are becoming increasingly integrated into the global economy. They are recognised internationally for their strong competitive position and high standards.

This report provides a brief analysis of the automotive industries of South Africa, Argentina and Brazil. It also investigates their strategies for continued sustainability in the global automotive market. The competitive environment associated with the auto industry means that careful analysis and planning are needed to achieve global integration and foreign market penetration. Bilateral or inter-regional agreements are consequently of great importance. This aspect is addressed in detail in the report.

<b>Timeline for the SACU–Mercosur FTA negotiations process</b>	
1996–97	The South African government shows substantial interest in Mercosur as a partner to boost South–South relations.
1998	President Nelson Mandela is invited to address the heads-of-state Mercosur summit in Ushuaia, Argentina.
December 2000	A 'Framework Agreement for the Creation of a Free Trade Area between South Africa and Mercosur' is signed in Brazil.
October 2001	FTA negotiations between South Africa and Mercosur are launched.
24–28 June 2002	A first combined trade delegation from Mercosur visits South Africa. Official delegates on both sides express commitment to the FTA process.
9–10 December 2002	The second round of trade negotiations takes place in Pretoria.
1 January 2003	President Mbeki attends the inauguration of Brazilian President.
February–March 2003	The two customs unions agree to hold technical meetings, which will be followed by an exchange of lists of products and industries involved that are to be included in the negotiations.
April 2003	The third round of negotiations due to take place is postponed.

The analysis that follows places the automotive industry in the context of the SACU–Mercosur FTA. It considers the domestic and international objectives of the automotive industry in Brazil, Argentina and South Africa and the concerns that affect relations between competing automotive industries. It also provides suggestions on how to integrate this important industry into the broader process of the FTA.

## **The South African Automotive Industry**

The South African automotive industry makes the single largest contribution to the manufacturing sector in South Africa. It currently accounts for about 29% of the country's manufacturing output, and contributes 5.7% to the country's GDP. The automotive industry has played an important role in the economic growth South Africa has experienced in recent years. The industry and its related sectors employed 261,200 people in 2001 and has been a pioneer in using incentive schemes to liberalise its operations.

Unlike other manufacturing industries in South Africa, which have reported relatively weak performance figures over the last 10 years, the automotive industry has experienced positive growth every year since 1993. This is largely attributable to the Motor Industry Development Programme (MIDP), which has not only opened new markets but has helped develop a far more efficient production process that is capable of competing in international markets. This policy, and the success of the automotive industry in general, has made it an example for other South African industries currently in the process of reorienting their activities to tap into global markets.

Notwithstanding the South African automotive industry's success, this sector is highly sensitive to price and cost fluctuations, like other automotive industries around the world. This has become more



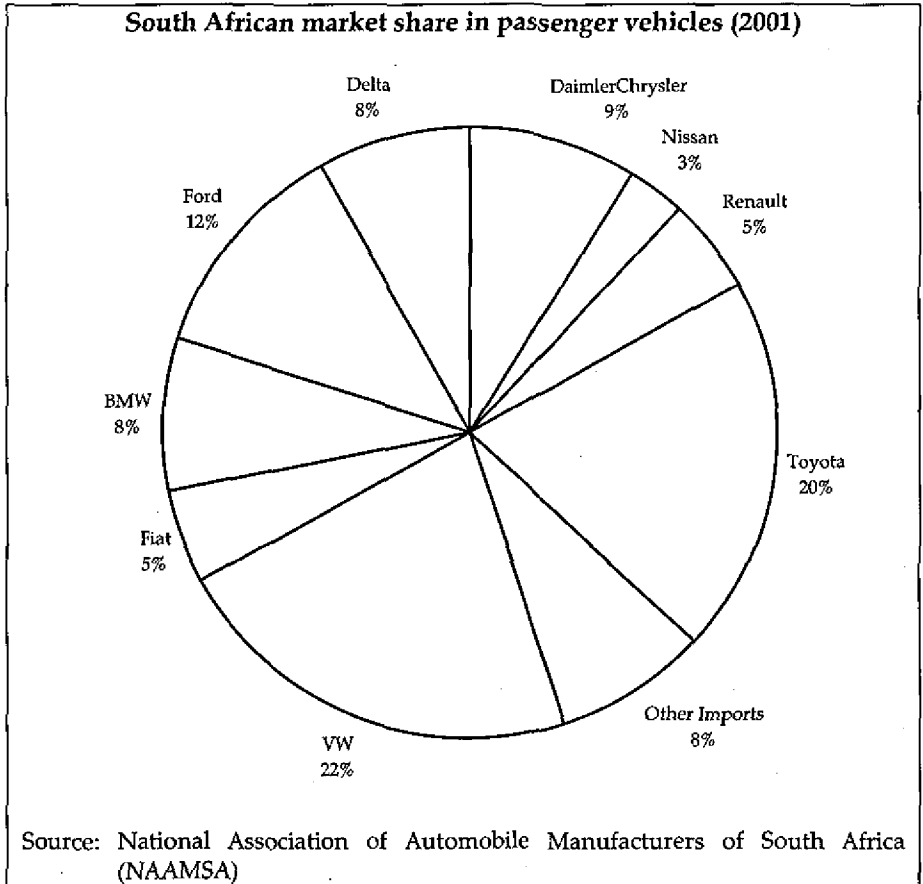
obvious in recent years as markets have liberalised, exposing the South African automotive industry to the realities of the fiercely contested international trading environment. Here, a variety of factors that influence competitive pricing come into play, including production levels and volume, total capacity and price-quality ratios — all of which bring into question the economies of scale. These factors are often related to basic macroeconomic instruments such as exchange and interest rates, standard tariffs and export incentives, all of which must be compatible with the rules and regulations of the international trading system.

Accordingly, the South African automotive industry has been forced to rationalise its operations — producing fewer models in larger volumes and at lower cost. Here again, the MIDP has played a central role in determining the strategic approach of the automotive industry. Further cautious planning and management will be required to ensure that the automotive industry maintains its progressive trend, as South Africa seeks additional bilateral trade agreements in pursuit of increased trade liberalisation. (This aspect will be discussed in greater detail in the section dealing directly with the MIDP.)

### **A brief overview of the South African automotive industry**

While the South African automotive industry is a significant force in the country's economy, its importance is comparatively small in global terms. South Africa is the 18<sup>th</sup> largest automotive producer in the world, contributing approximately 0.72% to world production. (Brazil, Mexico, South Korea and China are all ranked in the top 10 automobile-producing countries). The smaller size of South Africa's automotive industry does, however, offer a comparative advantage through its greater flexibility. This has been made possible by superior infrastructure development and well-established assembly and component sectors. These advantages, together with the fact

that South Africa has the largest automotive market in Africa, have lured all the world's major motor manufacturers to the country, confirming the country's importance in the global automotive industry.



Among the major Original Equipment Manufacturers (OEMs) represented in South Africa, the market share for passenger vehicles is dominated by the six largest producers — Toyota, Volkswagen, Ford, DaimlerChrysler, Delta and BMW, which together accounted

for 80% of the market share in 2001. Toyota and Volkswagen (including Audi models) hold the largest market share for passenger vehicles in the country, with the first place position alternating between them year after year. However, if light and medium commercial vehicles are included, Toyota is the largest seller in South Africa — a position it has held for 22 consecutive years.

<b>South African vehicle production and sales: 1996–2002 (thousands)</b>							
	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002*</b>
Sales of domestically produced vehicles	374.8	342.5	286.2	266.3	289.3	299.0	283.0
Exports	11.5	19.6	25.9	59.7	68.0	108.0	133.9
<b>Total domestic production</b>	<b>386.3</b>	<b>362.1</b>	<b>312.0</b>	<b>326.1</b>	<b>357.4</b>	<b>407.0</b>	<b>416.9</b>
Exports as proportion of domestic production	3.0%	5.4%	8.3%	18.3%	19.0%	27.0%	32.0%
Imports	46.3	56.7	65.4	59.4	66.7	85.1	n/a
<b>Total local market (including imports)</b>	<b>421.1</b>	<b>399.3</b>	<b>351.5</b>	<b>325.8</b>	<b>356.1</b>	<b>384.1</b>	<b>n/a</b>
Imports as proportion of local market	11.0%	14.2%	18.6%	18.2%	18.7%	22.1%	n/a
n/a:	Not available						
*	Projected figures						
Source:	Adapted from NAAMSA						

Rationalisation is a clear priority for South African OEMs. Their aim of achieving economies of scale by specialising in the production of high volumes of a small range of models seems to be a move in the right direction. The number of passenger and light commercial vehicle models manufactured in South Africa has declined from 42 at the commencement of the MIDP to 27 at present. This is likely to be

an ongoing trend, as South Africa integrates further into the global automotive industry.

The local automotive industry has performed extremely well over the last few years. While global production of cars declined by 3.5% in 2001, South Africa's automotive production increased by 13.9% to reach 407,036 vehicles. As a result domestic revenue from this sector (excluding export revenue) rose to R38.7 billion during 2001 compared with R32.6 billion in 2000. Estimated production for 2002 was in the region of 417,000 vehicles, approximately 2.5% higher than production in 2001.

As the MIDP has begun to take effect, the automotive industry and the associated sectors have experienced gradual and consistent growth in domestic sales as well as in imports and exports. The growth in international sales is particularly evident (see table above) and illustrates the way in which the OEMs have utilised the programme to rationalise their production and become more competitive.

Given the relatively small local market, the South African automotive industry will increasingly focus on foreign markets. Underdeveloped markets such as India or even China should be targeted, while developed markets that continue to experience high growth, such as the US and the EU, offer great potential for expansion.

## The Motor Industry Development Programme (MIDP)

*The official position of NAAMSA is to preserve the integrity of the MIDP, which is essentially a trade creation and reciprocity programme.*

Nico Vermeulen, Director of NAAMSA.<sup>4</sup>

The MIDP, introduced by the Department of Trade and Industry (DTI) on 1 September 1995, was broadly viewed as a solution to the challenges the automotive industry was bound to encounter through the inevitable process of integration into the global market. Previous strategies and policies that had helped establish a significant, self-sufficient — though completely internally focused — assembly and component sector, were replaced by the less protective MIDP.

South Africa's MIDP was modelled on the Australian motor industry's liberalisation programme, which was launched in 1984. The rationalisation process — which in many respects could be viewed as one of the initial phases of the MIDP, entailed the production of fewer models in higher volumes and at lower costs. This helped to convert the South African automotive industry into a more competitive player over a 12-year period ending in 2007. The results so far have been an increase in both imports and exports.

Key features of the MIDP included:<sup>5</sup>

- reduced tariffs on light vehicles and components, with these being phased down even faster than required by the World Trade Organisation (WTO);
- removal of the local content requirements;

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<sup>4</sup> This was the position expressed by both Nico Vermeulen, director of NAAMSA, and Clive Williams, director of NAACAM, during an interview in March 2003. They were responding to questions concerning an international trade strategy for the automotive industry.

<sup>5</sup> Black, A & Mitchell, S, 'Policy In South African Motor Industry: Goals, Incentives and Outcomes.' Presented at the TIPS Annual Forum 2002 held in Johannesburg.

- duty-free importation on components, making up 27% of the vehicle's value; and
- duty rebate credits on the export of vehicles and components, which could be used for duty-free imports of vehicles and components.

In December 2002, when the effectiveness of the MIDP was evaluated, it was broadly regarded as the manufacturing sector's answer to gradual global integration. It was also described as one of the best examples of public and private sector co-operation being practised in South Africa. Because of the MIDP's success, few questioned its extension from 2007 to 2012 by the DTI, although some minor adjustments were introduced. For example the rate of the phasing down of import duties between 2007–12 was slightly retarded.

According to the MIDP, the rate of import duties on Completely Built-Up (CBU) light motor vehicles and OEM components is set as follows:

	Rate of import duty on CBU light vehicle	Rate of import duty on OEM component
1 January 2000	47.0%	35.0%
1 January 2001	43.5%	32.5%
1 January 2002	40.0%	30.0%
1 January 2003	38.0%	29.0%
1 January 2004	36.0%	28.0%
1 January 2005	34.0%	27.0%
1 January 2006	32.0%	26.0%
1 January 2007	30.0%	25.0%
1 January 2012	25.0%	20.0%

Source: Trade Investment South Africa (TISA)

While many consider the MIDP a highly complicated programme, it is in essence a trade incentive scheme that encourages imports

through exports. This is applicable for all products, from small components to fully assembled vehicles. At the same time the entire industry is undergoing tariff and local content reductions in line with the specifications of the WTO.

Under the MIDP, for every rand exported, that exporter may import goods to the value of an equal amount duty-free. That is the exporter is credited with equivalent imports duty-free.<sup>6</sup>

Successful implementation of the MIDP, and the subsequent achievement of the objectives stipulated in the programme, have not only brought about a great deal of growth in production and trade, but have successfully:

- improved the international competitiveness of the South African automotive manufacturing and associated industries;
- made vehicles more affordable;
- encouraged growth in the vehicle market and in the component manufacturing industry, particularly in the field of exports;
- stabilised employment levels in the industry; and
- created a better balance between the industry's foreign exchange outlay and foreign exchange earnings.

## **The future of the South African automotive industry**

On average, the automotive industry was operating at between 65–70% capacity in 2001 with imports of approximately 130,00 vehicles. Vehicle exports from South Africa are expected to exceed 190,000 units by 2007. If the industry expects to achieve those levels of exports as well as higher domestic sales, its production capacity

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<sup>6</sup> For example, if you export products to the value of R100 million from South Africa, and you then import products with a 38% tariff rate (eg. passenger vehicles), you will be reimbursed to the value of the duties of the first R100 million (ie. R38 million).

needs to be increased. This would also enable the automotive sector to accommodate a sudden surge in demand for a specific product from the US or EU. Capacity can be improved through an increase in capital investment or the forming of alliances with manufacturers in other countries. From the point of view of the OEMs, an alliance with a partner in another country requires less capital investment and is therefore a more rational option. Partnerships would also enable multinational corporations (MNCs) to make use of all the resources they have in various countries around the world.

Certain MNCs have already taken advantage of the MIDP to rationalise their operations worldwide. South African manufacturers are producing specialised models which are exported to markets around the world. Through the MIDP's reciprocity programme, they are able to import alternative models duty-free.

Volkswagen has already reaped benefits from this initiative. Its exports of the Jetta 2 to China and the Golf 4 to Europe have made it the leading vehicle exporter from Africa in 1999 and 2000. Other companies such as Toyota, BMW and DaimlerChrysler have launched similar export programmes. Toyota South Africa has started exporting its locally built Corollas to Australia in return for the duty-free importation of the Australian-built Camry. BMW is rapidly expanding its 3-series exports to North America, taking full advantage of the African Growth and Opportunity Act (AGOA).<sup>7</sup> DaimlerChrysler is currently producing the popular Mercedes-Benz

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<sup>7</sup> AGOA is a non-reciprocal initiative of the US aimed at assisting the growth and development of sub-Saharan Africa by extending duty-free and quota-free access into the US market to certain products. The South African automotive industry is one of the industries included in this Act. Through the double benefit of the MIDP and duty-free access into the US, OEMs can benefit by manufacturing in South Africa and exporting to the US. Cars and other passenger vehicles, and a broad range of automotive products are included in this agreement. BMW has taken advantage of this opportunity.



C class in South Africa for export to Japan, Australia, UK, Mauritius, Thailand and Singapore, among others.

There is also an increase in the importation and exportation of auto components as a result of the MIDP. Trade in components might be more complicated than that in built-up vehicles, due to the diversified nature of the sector and the number and size of the companies operating in it.<sup>8</sup> Nevertheless, the automotive and auto components markets with which South Africa is currently trading should be analysed carefully, in order to formulate a more progressive trade strategy to enable the automotive industry and its related sectors to take the fullest advantage of complementarity and new market opportunities.

South Africa's primary trading partners in passenger cars are Germany, South Korea, France, the US, the UK, Japan and Australia. Components are traded with many of the same markets, while medium and heavy commercial vehicles are exported primarily to other African countries.

According to a comment made in an MIDP document released by Trade and Investment South Africa (TISA):

Vehicle manufacturers and their suppliers are increasingly having to work together to reduce the cost gap against world-class benchmarks in the short to medium term and, in the longer term, will have to collaborate closely to achieve sustained net cost reductions to enable the industry to become more competitive internationally, to expand the industry's export business and to provide more affordable products to the local market.

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<sup>8</sup> These complexities in the auto component sector hampered growth following the initial implementation of the MIDP. This, however, seems to be changing, with a 60% increase in auto component exports from 2000 to 2001. Catalytic converters and leather seat covers make up the largest part of the value of component exports from South Africa.

Thus, while it is clear that the South African automotive industry is extremely vulnerable to external competition, and industries in countries such as Brazil pose an obvious threat to those in South Africa, areas of complementarity may still exist. A relationship between the automotive industries of South Africa and Brazil (and other countries that make up Mercosur), and a common understanding between the OEMs on either side of the Atlantic, could offer a viable solution to the challenges the South African automotive industry is likely to face in the near future. However, this option can be explored only once a clear understanding of the Mercosur automotive industry is established.

## The Mercosur Automotive Industry

Mercosur is not only the world's fourth largest new vehicle market, but its regional automotive industry has been identified as having tremendous growth potential.<sup>9</sup> Its primary producing countries are Brazil and Argentina. Both have well-developed automotive industries that contribute substantially to the overall Mercosur automotive industry. However, Brazil is far more dominant in global terms. Argentina's recent economic woes crippled its automotive industry, and made any balanced analysis of that sector extremely difficult. The focus of this report will therefore fall on the Brazilian automotive industry, with some references to Argentina's.<sup>10</sup>

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<sup>9</sup> Mercosur produced over 2 million vehicles in 2001, most of which came from Brazil. Domestic sales exceeded 1.8 million units.

<sup>10</sup> Uruguay and Paraguay, the other two members of Mercosur, have certain tax and investment incentives worth exploring. Paraguay, in particular, has a *maquiladora* policy similar to that instituted in Mexico. This provides automotive and auto component manufacturers with a tax-free environment for their first five years of operation. The fact that products are manufactured in Paraguay also gives them duty-free access to other Mercosur markets such as Brazil and Argentina.

Within Mercosur, as in other regional integration schemes around the world, the automotive industry has always been a contentious issue. Vehicles and components were initially not included in the overarching Mercosur customs union agreement concluded in 1991, which came into effect in 1995. Free trade in vehicles and components was agreed only in terms of a phased-down process in which tariffs were reduced every year from 1994. The intention was to establish completely free trade in autos and related products by 2006.

The integration process was jeopardised in the late 1990s when Brazil was forced to float its currency, making production costs far lower and giving Brazilian producers a price advantage over Argentine producers, whose costs were still pegged to the US dollar. In an industry highly sensitive to input costs and competition, the shift in the Brazilian exchange rate policy delivered a serious blow to the Argentine automotive industry, and ultimately to the Mercosur automotive agreement.

Lower production costs in Brazil, coupled with the mass exodus of automotive and component manufacturers from Argentina, effectively ended the phase-down process instituted by Mercosur. Because of the importance of the automotive industry in both economies, this put additional pressure on the increasingly fragile Mercosur agreement.

Ironically, the crisis in Argentina during 2002 created a stronger Mercosur, because the country was forced to abandon the system of a currency pegged to the US dollar, and instead to adopt a monetary policy closer to Brazil. This in turn had positive repercussions on the Mercosur automotive industry. While 2002 was by no means a growth year, the long-term prospects for the Mercosur automotive industry are positive. With greater macroeconomic congruency, the automotive industries of Brazil and Argentina will be able to develop

a synergy that creates a more diversified automotive industry in Mercosur. This is a situation favoured by all member countries.

## **Overview of the Brazilian automotive industry**

In 2001 Brazil had the tenth largest automotive industry in the world, producing approximately 1.8 million vehicles and contributing close to 3.2% of world production. While it does not come close to the production of world leaders such as the US and Japan, Brazil is undoubtedly one of the leading automotive manufacturers in the developing world, alongside Mexico and China. Apart from its sheer size, the Brazilian automotive industry carries significantly more weight than South Africa's, owing to its prominence in a region already regarded as important to the global automotive market.

Like South Africa's, the Brazilian automotive industry has been developed by large multinational companies from the US, Europe and Asia. The nature of the political and economic environment in Brazil, which offered a great deal of protection from external competition, facilitated the development of a self-sustained automotive industry, with a large and highly capable auto component sector to support it. The automotive industry in Brazil employs nearly 100,000 people (plus 170,000 employed in the auto component sector) and contributes over 10% to the industrial GDP. In other words, it performs a similar role to that of its counterpart in South Africa.

The composition of the Brazilian automotive industry is also very similar to that of South Africa. Once described as the 'offshore home for all major automotive manufacturers', Brazil has 27 automotive companies, with 53 industrial plants spread across the country. Most of these are concentrated around the industrial hub of São Paulo. Twenty-two of these plants were opened between 1996–2002,

indicating a high level of modernisation and quality standards that compare to the best in the world.

Many of the same automotive manufacturers that have invested in South Africa have also established themselves in Brazil. Volkswagen and General Motors are the largest producers in the country, each producing well over 500,000 vehicles per year (more than South Africa's entire automotive production). Other large manufacturers include DaimlerChrysler, Ford, Fiat and Renault, which, together with Volkswagen and General Motors, account for 90% of the local market share.<sup>11</sup>

The Brazilian automotive industry has undergone revolutionary change over the last 10 years. This involved in-depth consultation with all OEMs, prominent component manufacturers and government departments to enable it to transform itself from an inefficient relic of market protectionism to a globally competitive industry, capable of lifting and carrying a large and complicated developing economy.

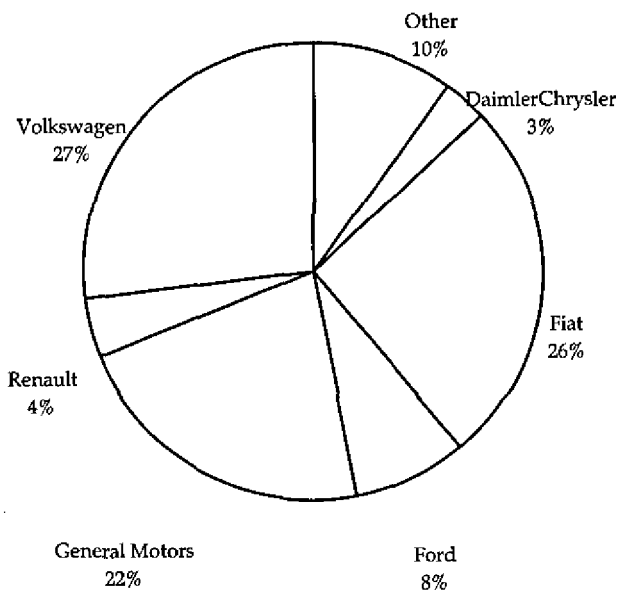
At the core of these changes was the central principle of rationalisation, which took place under both the Mercosur initiative and bilateral agreements with Mexico and Chile. These will be discussed later.

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<sup>11</sup> While General Motors produces more vehicles than Fiat (514,333 vehicles compared with Fiat's 436,607), Fiat has a larger local market share (as is evident from the chart below). This indicates that General Motors exports a higher percentage of its Brazilian production to external markets than does Fiat, and also that General Motors imports fewer vehicles than Fiat.

Another crucial factor was a large increase in investments. In the early to mid-1990s, investment in the automotive industry grew phenomenally, rising from \$938 million per year to about \$2.5 billion between 1991–98. This helped to raise production from around one million units per year in the early 1990s to the current figure of 1,812,119, generating a net revenue of more than \$20 billion per annum. Investments were also aimed at decentralising the automotive industry and encouraging a broader geographical distribution of large production plants so as to spread the benefits of Brazil's largest manufacturing industry to all parts of the country.

**Share of Brazilian local market sales  
(Passenger and commercial vehicles) (2001)**



Source: These figures were adapted from the *Statistical Year Book of the Brazilian Automotive Industry 2002*, released by The National Association of Automotive Manufacturers (ANFAVEA)

Brazilian vehicle production and sales* (million)							
	1995	1996	1997	1998	1999	2000	2001
Vehicle production	1.629	1.804	2.069	1.586	1.356	1.691	1.812
Domestic sales	1.359	1.506	1.640	1.187	1.078	1.315	1.422
Vehicle exports	0.263	0.296	0.416	0.400	0.274	0.371	0.388
Exports as % of domestic production	16.2%	16.4%	20.1%	25.2%	20.3%	22.0%	21.4%
Vehicle imports	0.321	0.200	0.273	0.318	0.161	0.146	0.158
Total sales (domestic sales + exports + imports)	1.943	2.003	2.330	1.906	1.514	1.832	1.969
* Vehicles refer to both commercial and passenger vehicles. Source: Adapted from the <i>Statistical Yearbook of the Brazilian Automotive Industry 2002</i> , released by ANFAVEA and <i>Brazilian Autoparts Industry Performance 2002</i> , Released by The National Syndicate Industrial Components for the Automotive Industry (SINDIPEÇAS)							

As is evident from the table above, the automotive industry suffered a severe drop in production and sales between 1998–99. Imports were particularly low from 1999 onwards. This was caused by the financial crisis that struck Brazil in 1998, and which led to a change in its exchange rate regime.

The vulnerability associated with local market fluctuations, and the steady increase in exports — predominantly to partner countries with whom Brazil has made bilateral agreements for automotive products — have both influenced the strategy adopted by the automotive industry to focus on external markets. The competitive position provided by the weaker currency has also helped promote exports.

Large inflows of investment have helped to prepare Brazil for a more export-orientated strategy, which will require greater efficiency and productivity in the industry. However, investment in capacity-building will yield benefits only in the long term, as they rely heavily on the acquisition of new and bigger markets. Few short or medium-term benefits have materialised yet. While new plants in alternative regions have provided some jobs, they have done little to stimulate greater economic activity. Some plants have even been forced to close due to lower demand and the higher costs associated with operating at a distance from São Paulo, the traditional automotive centre of Brazil.

Therefore, while Brazil is currently producing approximately 1.8 million vehicles per year, it actually has the capacity to produce 3.2 million: more than 40% of its capacity is unused. This is a serious concern in a country with minimal economic growth, where increasing social demands require more immediate economic results.

The Brazilian automotive industry is functioning relatively well, and is growing at 4–5% per annum. But this may not be enough. Many industry leaders have identified the need to increase both the local and the export markets to ensure the sustainability of the Brazilian automotive industry. The strategy assumed by all major manufacturers in the past has been an increase in market share. The large Brazilian population (170 million people) has managed to sustain the automotive industry for many years. But with slowing economic growth, lower per capita income, high interest rates and an increasingly saturated vehicle market, there is very little scope for increasing local vehicle sales. Producers are looking for alternatives. There is a growing insistence that capacity should be better utilised, so that the economic results can be fed back into the country to address the more immediate needs of the people. Hence there is a need to explore and penetrate foreign markets.



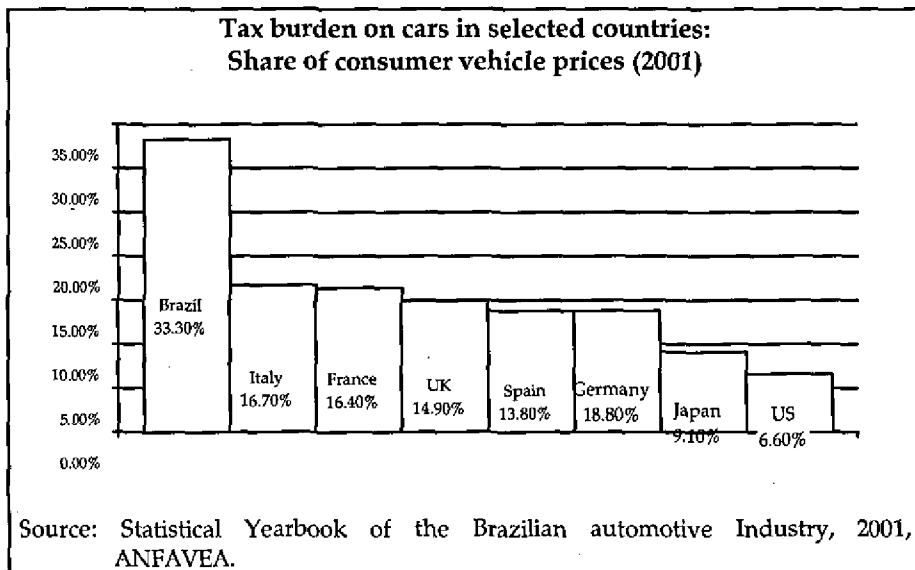
With its high volumes and lower production costs (compared to those of many other auto-producing countries), Brazil is in an ideal position to take advantage of the economies of scale required for international diversification. The country's automotive industry has used a number of bilateral agreements as stepping-stones to broader global integration. The conclusion of bilateral agreements with countries like Mexico have helped to boost the country's trade surplus in automotive products, which is currently in the region of \$2.4 billion, a large proportion of Brazil's \$13 billion total trade surplus. South Africa is clearly on the list of countries with which Brazil hopes to make agreements.

*The dynamics of the Brazilian automotive industry: Strengths and weaknesses associated with its future strategy*

The Brazilian automotive industry is not expecting any miracles to boost the industry in the next few years. However, the growth rate, which hovers around 4-5%, is expected to maintain its current level throughout 2003. Strategies are being implemented to help improve both local and export sales. Vehicle prices are therefore of great importance, especially those of the cheaper vehicles that are favoured by the majority in Brazil. During 2002, passenger vehicles over \$9,000 represented just 10% of sales: of the 1.4 million vehicles sold only 6,000 were luxury vehicles. Unfortunately, vehicles in the lower price range have limited margins for flexible pricing, and with the large number of accumulative taxes on Brazilian vehicles, it has been difficult to bring the prices of such vehicles down.

Each vehicle is subjected to a minimum of three different taxes, excluding import duty. These taxes differ from state to state, according to the fuel used and the size of the vehicle and engine. It is a highly complicated system that requires careful analysis and consideration by both the buyers and sellers of vehicles. While these taxes have dropped somewhat over the last 10 years, they are still

extremely high by international standards. The tax on vehicles in Brazil — at 33.3% — is more than double that of most European nations, which are notorious for such additional costs.



The levy system on vehicles bought in the domestic market can be broken down into four basic taxes:<sup>12</sup>

- ICMS — *Tax on services and circulation of goods or the value-added-tax.* This is a state tax on vehicles in each individual state. It therefore varies from state to state. It is currently 12% in São Paulo.
- IPI — *Industrial products tax.* This is a federal (therefore a national) tax. It varies according to the type of vehicle and engine size.
- PIS — *Government programme for social integration (social tax).*
- Cofins — *Contribution to social security financing.*

<sup>12</sup> These explanations are based on information provided in the *Statistical Year Book of the Brazilian Automotive Industry, 2002*, released by ANFAVEA. For a more detailed information consult their website: [www.anfavea.com.br](http://www.anfavea.com.br)

Taxes on vehicles with less powerful engines are significantly lower than on those that have larger engines. The IPI tax on a vehicle with a 1000cc engine is currently 9%. On 2500cc engines and light commercial vehicles running on diesel fuel this same tax can reach 25%. Lower tax rates are a clear incentive towards the purchase of smaller vehicles with less powerful engines, and would assist in the growth of the local market. Smaller vehicles have subsequently become a production trend in Brazil. They also represent an area of speciality for exports to external markets.

Other taxes such as the ICMS, PIS and Cofins remain the same between models produced within a particular state. However, the ICMS tax is different from state to state. For example, the ICMS tax in São Paulo could be higher than it is in Parana, making Parana a more attractive location for production. Local government uses this differentiation as an incentive for investment in particular states.

Brazilian taxes on vehicles (2000-01)							
Year	Taxes	Passenger vehicles			Light commercial vehicles	Trucks	Buses
		1000cc	Over 1000cc	Over 1000cc ethanol			
2000 and 2001	IPI	10.00	25.00	20.00	10.00	5.00	0.00
	ICMS	12.00	12.00	12.00	12.00	12.00	12.00
	PIS	0.65	0.65	0.65	0.650	0.65	0.65
	Cofins	3.00	3.00	3.00	3.00	3.00	3.00
	Total Share (tax burden)	25.30	33.30	30.80	25.00	21.30	17.70

Source: *Statistical Yearbook of the Brazilian Automotive Industry, 2002, ANFAVEA.*

The IPI tax, consistent throughout the various provinces in the federal republic and unrelated to social taxes, could be used to lower the final price of a vehicle sold in the Brazilian market. The ICMS tax contributes directly to individual state revenue and would therefore

not assist in an overall drop in vehicle prices nationwide. The PIS tax and Cofins contain social contributions, which could not easily be altered. Therefore a standardised federal tax is the best option if vehicle purchase prices are to be made cheaper.

In a variety of in-depth studies it was found that a 1% decrease in the price of passenger vehicles in Brazil would increase sales by 12%. A decrease in taxes would result in better sales and therefore higher tax revenue, to the benefit of all parties. Both the Brazilian government and ANFAVEA agree on this principle, and efforts to decrease vehicle taxes (particularly the IPI) have begun. However, taxes are still extremely high, and these should be reduced if Brazil is to promote its local market and earn the confidence of its bilateral partners.<sup>13</sup>

Another interesting area of the Brazilian automotive industry is the variation in fuel types used, and the vehicles produced for the different types of fuel — gasoline, ethanol and diesel. While engines for all three types of vehicle are produced in Brazil, passenger vehicles are not permitted to run on diesel fuel, which is used exclusively for commercial vehicles. Those passenger vehicles produced in Brazil that have diesel engines — and there are many — are all exported. This is an important point for countries trading with Brazil to consider. Ethanol,<sup>14</sup> a more progressive agent not yet used worldwide, could introduce another important factor in terms of international trade. Brazilian-produced ethanol engines could be produced for export to countries less advanced in this technology, or unable to produce them at a comparative cost. This would have to be in accordance with international environmental standards, but

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<sup>13</sup> The information relating to vehicle taxation was discussed in detail during an interview with Marcos Maduireira, the head of governmental affairs at DaimlerChrysler Brazil and a vice-president of ANFAVEA.

<sup>14</sup> Ethanol, an alcoholic fuel produced from sugar cane, is favoured according to international environmental standards over the use of petrol and diesel fuels.

obviously would also depend on the availability and cost of ethanol in other countries using this form of fuel.

Finally, the Brazilian automotive industry's foreign trade strategy is an area of particular interest. The industry has concluded agreements with Mexico, Chile and the other countries which make up Mercosur — Argentina, Paraguay and Uruguay.

The agreements reached with Chile and Mexico both concern quotas, but in other respects they differ substantially, due the vast difference between the Chilean and Mexican automotive industries. A quota agreement is essentially an equal exchange of a stipulated number of units, duty-free. This is obviously subject to the size of the industries and markets concerned, and can thus be altered according to transfer requirements and timeframes.

The Chilean market relies almost exclusively on imported vehicles, particularly from Brazil and a number of Asian countries. Mexico, on the other hand, has a large, well-developed industry of equal size to that of Brazil, but with a greater concentration on exports. Mexico currently exports approximately 70% of its production, while Brazil exports only 24%.

Both agreements provide Brazil with market access to the Chilean and Mexican markets. But, more importantly, they extend access to other, more lucrative, regions such as Asia and North America. In Mexico's case, areas of complementarity were established, providing OEMs with the opportunity of penetrating the lucrative US market. Naturally, there were problems associated with the rules of origin stipulations in the North American Free Trade Area (NAFTA), but these were ironed out. Brazil is now able to supply Mexican plants, which in turn export to the US market.

As previously mentioned, Brazil has a unique agreement with other Mercosur members. The trade-balancing programme between Brazil

and Argentina has made Argentina the largest export market for Brazilian manufactured vehicles, and the second largest market for Brazilian auto components. Other major trading partners for Brazil's automotive sector include Mexico, the US, Italy, Venezuela and Chile. Germany and Japan export high volumes of auto components to Brazil.

Argentina's economic crisis in 2002 also affected Brazil's exports. While Argentina was the largest importer of Brazilian vehicles in 2000, importing 28.4% of Brazil's total export items, the crisis in Argentina brought all imports to an abrupt halt. Commercial vehicles, previously exported in large quantities to Argentina from Brazil, went from approximately 7,000 units in 2000 to just 70 in 2002. Not one bus was exported from Brazil to Argentina during 2002. Instead, buses that had been imported during 2001 were sent back to the suppliers.

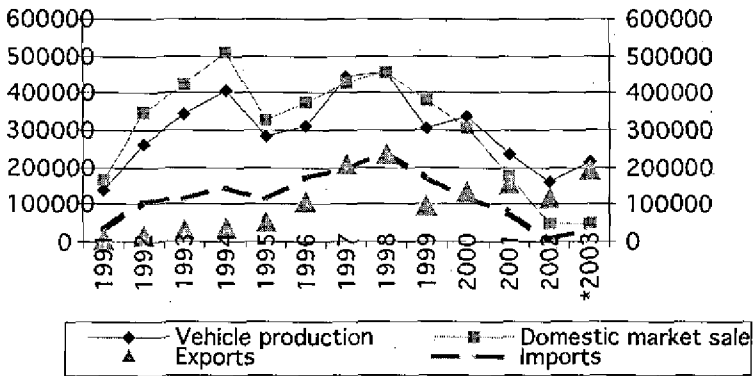
This incident provides a brief illustration of the current situation in Argentina. The Argentine automotive industry is important, and a critical contributor to the Mercosur automotive industry. Its future will affect Mercosur's ability to bring about the global integration and diversification of the auto manufacturing sectors in the grouping. A firm understanding of the dynamics that prevail at present is therefore required before any forecasts can be attempted.

### **The Argentine automotive industry**

In 2000 Argentina was the 21<sup>st</sup> largest vehicle manufacturer in the world, having produced approximately 340,000 units during that year. Its peak production levels were reached in 1998, when Argentina produced 458,000 vehicles — 100,000 more than South Africa in that year.

Current levels of production are difficult to measure in Argentina.<sup>15</sup> According to the Automotive Association of Argentina (ADEFA), production in 2002 was 159,401 vehicles, 33% less than the 235,577 manufactured in 2001. Domestic sales in 2002 failed to reach 50,000, in a market that had boasted sales of 508,152 vehicles in 1994. A total of 116,005 vehicles were exported in 2002, more than double the number sold on the domestic market. While export figures for 2002 were lower than those in 2001, exports of automotive products are likely to rise rapidly in the future, because its lower production costs vastly improve Argentina's competitive position in international markets.

Argentine vehicle production, domestic market sales, exports and imports (1991-2003)



\* Estimated figures  
 Source: Figures adapted from *Statistical Yearbook of the Brazilian Automotive Industry*; the ADEFA website at [www.adefa.com.ar](http://www.adefa.com.ar), and Barnes J, *Recent Performance Of and Challenges Confronting the Argentinean Automotive Industry*, 2001.

<sup>15</sup> While official figures are in the region of 160,000 vehicles, some analysts insist this amount may be inflated and that production levels are as low as 100,000 vehicles. This is, however, unlikely. Such low estimates are probably based on the drastic decline in domestic sales, which is not a reliable indication of production levels.

The chart above provides a clear outline of the events that have taken place in the Argentine automotive industry in recent years. Since 1991 the industry has achieved record highs and record lows. These fluctuations can be attributed to a number of significant events that have shaped the course of the Argentine automotive industry.

- Economic liberalisation and the establishing of a trade balancing programme with Brazil helped increase production levels during the mid-1990s. Reciprocal trade with Brazil led to unprecedented export growth, which reached a pinnacle in 1998. Imports also grew during this time.
- In 1998-99 Brazil suffered from a devastating financial crisis. This crippled the primary automotive market in Mercosur, on which both Argentina and Brazil relied. The Brazilian currency was devalued. Argentine exports, production levels and exports dropped dramatically.
- By 1999 it had become clear that Argentina had entered a recession. This was aggravated by the Brazilian crisis. The combination of Argentina's and Brazil's economic difficulties jeopardised the automotive agreement that bound the Mercosur member countries. Domestic sales plummeted and production levels dropped further as Argentina became increasingly exposed to the detrimental effect of its pegged exchange rate on its competitive position. OEMs and auto component manufacturers shifted their operations to cheaper locations in Brazil.
- By 2002 the automotive industry in Argentina had reached crisis point. Production levels were the lowest they had been since 1991, imports were non-existent and export sales, which were by no means impressive, exceeded domestic sales of vehicles.

The present situation in Argentina is not entirely doom and gloom. The devaluation of the Argentine peso has made Argentina one of the most competitive manufacturing countries in the world. The combination of the high standards that were established in the 1990s



and lower production costs has made Argentina an ideal automotive and auto component producer. Its automotive industry and related sectors are well established, and have the capacity to produce 700,000 units per annum. Production levels for 2003 are estimated to reach approximately 230,000 vehicles. Therefore, there is enormous scope for growth, but the stimulus is unlikely to come from the small, economically battered domestic market. Export promotion is critical for the survival and future progress of the Argentine automotive industry.

Like the South African automotive industry, Argentina's auto manufacturing sector boasts a large number of prominent players relative to its domestic market size. Ford, Renault and General Motors who are the largest OEMs in the country, are leading a rationalisation process intended to help Argentina to become an export leader in markets throughout the Americas and the EU. They have established strong relations with OEMs in Brazil and other countries in order to help their auto industries to diversify production and improve efficiency. General Motors and Ford are exporting 90% of their current production, which is a clear indication of their intentions.

With progressive leadership from some of the larger OEMs, and firm support from the highly effective auto component sector, Argentina could become a major player in the international automotive industry.

## **Trans-Atlantic Relations in the Automotive Industry**

The idea of developing a relationship of co-operation between the automotive industries of South Africa and Mercosur has been on the table ever since the SACU–Mercosur negotiations started to focus on a sector-by-sector approach for an FTA. Considering the enormous importance of the automotive industry to both regions, it is logical

that this should be the industry of choice for discussions on economic co-operation between SACU and Mercosur. The automotive industry would also draw a number of related sectors, and ultimately other prominent industries, into the process.

However, an agreement between the automotive industries of the regional groupings is not as simple or as complementary as was initially thought. Negotiators quickly realised that South Africa and Mercosur were similar in many respects, and that diminishing vehicle markets in both economies had heightened the competition between the two. The automotive industries of South Africa, Brazil and Argentina are rivals in international markets, which all parties have identified as essential to the growth of their respective industries. Mercosur, with greater capacity and superior economies of scale, has an advantage over South Africa. Therefore, many experts in South Africa insist that instead of liberalising trade in automotive products with countries such as Brazil, South Africa should be seeking greater protection.<sup>16</sup>

This may be the case in terms of bilateral trade. But when these relationships are analysed, it is always important to consider the global market and to recognise possible options for the future. These include new and growing markets, the individual capabilities of OEMs in certain countries and potential threats from alternative producers. From this point of view, collaboration between the automotive industries in South Africa and Mercosur might be beneficial to both groups. All options (including the advantages of co-operation) should be explored for the sake of the future progress of the automotive sectors in both South Africa and Mercosur.

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<sup>16</sup> This was the opinion expressed by Dr Justin Barnes during an interview in March 2003. Dr Barnes is a highly respected automotive expert and a managing member of *B & M Analysts*, which consults for a large number of auto component producers.

## **The globalisation of the automotive industries in South Africa and Mercosur**

Both South Africa and the Mercosur countries have embraced economic liberalisation, are actively involved in the global trading system, and pursue FTAs with partner countries and regions. This has direct implications for the automotive industry and for the possibility of trans-Atlantic trade relations between the different automotive industries.

As mentioned in earlier sections of this report, South Africa has implemented the very successful MIDP, which has assisted the integration of the automotive industry into the global market. The MIDP is the centre of the South African automotive industry's trade strategy. It exists completely independently of other, broader trade agreements (for example those with the EU, US and SADC), as it will do if an agreement is signed with Mercosur. Altering the MIDP to accommodate Mercosur would undoubtedly jeopardise the agreements South Africa has with the EU and the US (through AGOA and a soon-to-be negotiated SACU-US FTA), which are of far greater importance to South Africa than Mercosur. Accommodation of the objections of certain parties to the MIDP is therefore not an option at this stage.

Apart from the MIDP being a non-discriminating programme that provides credit rebates and thus trade promotion for the automotive industry, it also stipulates a gradual reduction in tariff protection that is well within the timeframe required by the WTO. Rates of import duty on CBU light motor vehicles and OEM components in South Africa currently stand at 38% and 29% respectively.

In Mercosur these tariff structures are slightly more complicated. Through the trade-balancing agreement, Mercosur eliminated internal tariffs on a number of automotive products, following predetermined procedures. However, Brazil and Argentina have

different external tariffs for both vehicles and components. While Brazil exacts a 35% duty on all vehicles, Argentina's duties vary according to the size of the vehicle, and are generally lower than those in Brazil.<sup>17</sup> Commercial vehicles below five tonnes have a duty of 25% while those above five tonnes pay a levy of 18% in Argentina. Duties on components are even more diverse. Each country has at least three tariff categories, and these are further complicated by an additional common external Mercosur tariff of 2%.<sup>18</sup> According to most recent reports, Argentina's tariffs will converge with Brazil's by 2006, so that a common external tariff for Mercosur can be established.

In terms of FTAs with other countries, Brazil has indicated that all FTAs it has initiated so far will be negotiated and concluded with Mercosur and not exclusively with Brazil. Therefore, quota agreements Brazil has concluded with Mexico and Chile are essentially applicable to all members of the Mercosur group. To overcome differences in economies of scale and the problems associated with weaker economic performances among members, agreements with partner countries take the form of an 'umbrella agreement'. This means that while a broad agreement has been signed between Mercosur and Mexico, differentiated and preferential treatment is awarded to certain members of Mercosur. Brazil, which has a very similar automotive industry to Mexico's in terms of both size and performance, has an agreement with Mexico

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<sup>17</sup> The accumulation of local taxes and reference pricing in Brazil adds substantially to the final price of the automotive product in that country.

<sup>18</sup> Tariffs on components differentiate between those imported for vehicle production and those imported for the aftermarket. Argentina levies tariffs of 7.5%, 8.5% and 9.5% on components imported for vehicle production, whilst Brazil's tariffs are 9.1%, 10.4% and 11.7% on OEM components. These should converge in all Mercosur members to 14%, 16% and 18% by 2006. Tariffs on components imported for the aftermarket for both Argentina and Brazil are 17%, 19% and 21%. By 2006 these should have been reduced to 14%, 16% and 18% respectively — in parity with the components imported for vehicle assembly.

very different to that which Mexico has with other members of Mercosur.

<b>Overview of the automotive industries of South Africa, Brazil and Argentina in a global context (2001)</b>			
	<i>South Africa</i>	<i>Brazil</i>	<i>Argentina</i>
Total production	407,036	1,812,119	235,577
% of world production	0.72%	3.2%	n/a
Production capacity (2003)	600,000	3,200,000	700,000
Vehicle fleet/vehicles in use (1999)	5,865,000	18,685,000	6,607,000
Persons per vehicle (1999)	6.9	8.8	5.5
Total local market sales	384,099	1,601,312	176,702
Import duty on vehicles (2003)	38%	35%	18-25%
Exports	108,001	388,394	155,123
Imports	85,064	178,318	82,903
Primary trading partners	Germany Japan US	Mexico Argentina Italy	Brazil US EU
n/a: not available			

Reaching agreement between Brazil and Mexico was a complicated process (as is anticipated in the FTA being negotiated between SACU and Mercosur) The similarities between the automotive industries of Brazil and Mexico added a competitive element much like that between South Africa and Brazil. Through a great deal of flexibility, not to mention committed negotiation, consensus between Mercosur and Mexico was reached in 2001. The quota system agreed is a phasing-in process that will occur over a five-year period. By 2006, Mexico is expected to have duty-free access to Mercosur's automotive market. The quota agreed upon between Mexico and Brazil covers 700,000 units over a three-year period. If the

automotive industry in South Africa were to pursue agreement with Mercosur's, it would in all likelihood resemble that between Mercosur and Mexico, but obviously on a much smaller scale.

### **South Africa–Mercosur: Current relations in the automotive sector**

While a number of the same large automotive manufacturers have a presence in South Africa and Mercosur countries (in particular Brazil), a minimal amount of trade has taken place between Southern Africa and the South American motor industries. These manufacturers have instead (for obvious reasons) used OEMs located in South Africa and Brazil to access the previously lucrative domestic markets in those countries and other related markets. Trade in automotive products between South Africa and Brazil has been hampered by protectionist policies that have restricted trade flows between low-cost producers, and promoted trade with the home countries of the MNCs. Therefore, while little direct bilateral trade in vehicles and components exists between South Africa and Mercosur, many products travel via Europe to gain preferential access to markets on the other side of the Atlantic.

In 2001, South African automotive exports to Mercosur, which were almost entirely destined for Brazil, were worth a total of approximately \$8.4 million. These comprised mainly engine parts, auto tooling and exhausts. Imports from Mercosur (Brazil) to South Africa amounted to about \$69 million, and consisted primarily of commercial vehicles and original equipment. These figures represent 0.5% and 1.7% of South Africa's and Brazil's automotive exports respectively. This is a small amount compared to South Africa's trade in automotive products with the EU, which represented around 71% of total auto exports in 2001; or compared to Brazil's exports to Argentina, which comprised 30% of the total. It is also important to note that while trade between South Africa and Brazil is small, the

surplus is clearly in Brazil's favour. This is an area on which Brazilian automotive and auto component manufacturers might want to capitalise, using the MIDP or preferential market access provided through an FTA.

Despite the low levels of trade between South Africa and Mercosur, a number of initiatives linking the automotive industries in the two regions are already being implemented. Completely knocked down (CKD) versions of the Volkswagen Polo and Golf 4 are currently being imported from Brazil for assembly in South Africa. This will increase Volkswagen South Africa's exports by 20,000 vehicles in 2003.

In the past, DaimlerChrysler Brazil exported truck and bus chassis to South Africa. DaimlerChrysler has now increased the export of the Sprinter (a light commercial vehicle) to South Africa from Argentina. The Sprinter would be an ideal replacement for the taxi mini-vans in the South African market, offering a bigger and safer vehicle than those currently on offer.

Other large OEMs such as General Motors/Delta are in constant contact across the Atlantic. They are developing common inter-regional strategies that involve, among other things, the exchange of CKD vehicles. Ford, another manufacturer with large interests in both South Africa and Mercosur, is taking full advantage of the credit rebate system offered by the MIDP, and is exporting catalytic converters in exchange for other components. These are a few of the many possibilities for trans-Atlantic collaboration in the automotive industry.

## **Would an agreement between the two automotive industries be viable?**

The immediate reaction of both NAAMSA and the National Association of Automotive Components and Allied Manufacturers (NAACAM), the representative associations for automotive and auto component producers in South Africa, is that the automotive industry and related sectors should be excluded from any agreement between SACU and Mercosur. This is in contrast to the opinion shared by ANFAVEA and Sindipeças in Brazil that the automotive industry should lead the SACU–Mercosur FTA process.

The concerns of NAAMSA, NAACAM and a number of automotive experts in South Africa are justified. Mercosur has a large and very aggressive automotive sector. Its production volumes and pricing would outstrip those of its competitors in South Africa. This is particularly evident in the auto components sector. Brazil and Argentine products could flood the South African automotive market, while access to the lucrative Brazilian market for South African exports could be hindered by the complicated tax system, reference pricing and other non-tariff barriers.

Sindipeças insists it is unlikely that such problems in the component sector will hamper an agreement, because there are clear differences in the components used for vehicle assembly in OEM plants on either side of the Atlantic. This may, however, not be entirely correct. Differences in components can easily be overcome, and manufacturers in Brazil could quickly develop the technology required to produce rival products for the South African assembly market. However, even if this is not the intention of the Mercosur component sector, the real cause for concern lies in the aftermarket. This is an area in which South African component manufacturers will feel most threatened by the flood of cheaper Brazilian products.



Clearly, from the South African perspective, the only possible area in which trade co-operation is possible lies in automotive assembly. This could involve an exchange of CKD or built-up vehicles. Obviously this would help capacity building, and also open access to new and emerging markets. In the case of South Africa, these new markets would include African countries such as Nigeria. One or two SADC members countries have shown considerable interest in commercial vehicle imports. Other possible markets include India, Australia and a selected few from the Asia-Pacific region. Greater productive capacity is also needed if exports to the EU and US markets are to grow.

In the case of Mercosur, diversification of production would be the primary motive to establish relations with the South African automotive industry. This would enable the regional grouping to build capacity beyond that provided by the existing arrangements between Brazil, Argentina and Mexico. This in turn would enable Mercosur to incorporate and service markets further afield.

These points of justification raise three questions. Firstly, South Africa already has the MIDP, which essentially facilitates the type of interaction described above. Is an FTA with Mercosur's automotive industry necessary?

The second question relates to capacity. Both Brazil and Argentina are currently operating with huge capacity surpluses. Brazil is using only 57% of its total capacity and Argentina used less than 20% of its capacity during 2002. Trade co-operation agreements are usually pursued by countries operating at 90% capacity, which are genuinely seeking to build further capacity by collaborating with other countries in a similar position. This simply does not appear to be the case with Mercosur and South Africa. Would it not be more logical to first boost local production capacity, or at least achieve 60% levels, before exploring areas of co-operation with other over-capacitated countries?

Finally, this report has emphasised that the automotive industries in both South Africa and Mercosur are dominated by a handful of MNCs based in the US, Europe and Japan. These companies have absolute control over their operations in various regions around the world. They have the ability to invest or disinvest in a country, and to support or withdraw support from certain initiatives. Their endorsement is crucial to any trans-Atlantic agreement between automotive sectors. Would it not therefore be correct to presume that any arrangement between the Southern African and Mercosur automotive industries will not be decided by the governments involved, but rather by head offices in Germany?

These issues need to be clarified prior to any further FTA negotiations, to establish what options are available for co-operation between the automotive sectors in SACU and Mercosur.

### **Concluding Remarks: The Way Forward For Co-operation in the Automotive Industry**

Representatives of the automotive industry in South Africa have expressed serious reservations about an FTA with Mercosur in the automotive and related sectors. They have consistently maintained their commitment to using the MIDP as the central pivot of the South African automotive industry's international trade strategy. They have also stipulated that it should not be adjusted to accommodate wide-ranging FTAs with the likes of Mercosur. FTAs with the EU and US are regarded as having higher priority, and these will set the precedents for any preferential trade agreements involving the South African automotive industry.

The Mercosur automotive industry has also declared its interest in entering the EU and US markets. This is most likely to be achieved through the conclusion of an FTA between Mercosur and the EU

and by Mercosur's inclusion in the Free Trade Area of the Americas (FTAA). Mercosur's current priorities are, however, focused on its relationship with Mexico and on the consolidation of local resources to improve the Mercosur automotive industry. This sector is also courting other auto industries in countries identified by Mercosur governments as potential FTA partners. South Africa is at the top of this list. Members of the automotive and auto component associations in Brazil (ANFAVEA and Sindipeças) and Argentina (ADEFA and AFAC) are looking for opportunities for mutual commercial benefit and areas of co-operation for the automotive sectors in other countries. This could add economic viability to the SACU-Mercosur FTA.

It is clear that the markets in both Southern Africa and Mercosur are not growing at a rapid pace. While there are some incentives for market access and bilateral trade, such as DaimlerChrysler's Sprinter for the taxi mini-van market and in specialised auto components such as catalytic converters, scope for bilateral trade between Southern Africa and Mercosur is limited at present. The real benefits lie in other, more lucrative or emerging, markets, which can be entered if together they rake up a more competitive position. This can be achieved through increased volumes and lower prices. Co-operation between the auto industries in SACU and Mercosur will assist them to gain access to more lucrative markets: this should be the main focus of any agreement between the two.

To move forward on co-operation between the Southern African and Mercosur automotive industries, greater clarity on three issues is needed: The first answers the question, 'Why pursue an FTA if an MIDP already exists?' Quite simply, an FTA provides greater support for broader, more global initiatives. It will also carry market access benefits for South African producers. Mercosur could reciprocate the advantages offered by the MIDP by granting fixed quotas exclusively to South African producers. This would closely resemble the current arrangement South Africa has with the US in terms of AGOA.

'Why pursue an FTA for capacity building reasons when domestic capacity is still heavily in surplus?' This second issue has been a warning light for South Africa, because it suggests that producers in Brazil are looking for easy markets in which to dump their auto products. In such terms, South Africa would supply a quick-fix solution to the excess capacity problem Brazil and Argentina suffer from. However, as the Brazilians would argue, the South African auto industry would be part of a broader global strategy, which is to improve networking capacities in an effort to build a more efficient production process. Collaboration will also help the industry to manage the ebbs and flows associated with international demands. This in turn would mean that productive OEMs in both regions would be put to better use year-round. Any dumping of Brazilian products on the South African market would be a short-sighted move, because it would defeat any long-term objective.

'Would MNCs with fixed interests in South Africa and Mercosur favour an FTA between their automotive industries?' Many experts forget that decisions regarding automotive operations in South Africa or Mercosur are not made by the OEMs in those countries, but rather by their head offices in the US, Europe or Japan. Those who are aware of the dynamics of this relationship suggest that freer trade between South Africa and Mercosur may not be thought beneficial to the operating plants in Europe. Therefore, any such initiative will not be supported by the primary roleplayers. This is, however, not entirely true. The real benefactors of an FTA between auto-producing countries in South America and South Africa will be the prominent manufacturers, who will gain access to cheaper products, thus lowering production costs worldwide and increasing the rate of production for those MNCs involved. In effect, MNCs are likely to favour an FTA because it will improve production efficiency and individual capacity building far more cheaply and effectively than direct investments can. Cost-effective operations are after all a priority for companies participating in the highly competitive global automotive industry.

Another factor to bear in mind is that an FTA between South Africa and Mercosur has a strong political component to it. Some agreement between the automotive industries will probably emerge. To be effective it should ensure that the more vulnerable South African industry and related sectors are not unduly exposed. It should also prepare the automotive industries of both Mercosur and South Africa to enter the global market. This will require a great deal of trust, flexibility, transparency and dedication to a committed negotiation process. The end result should be an agreement to act reciprocally, in a manner that benefits all parties equally.

Obviously, previously signed agreements will serve as a benchmark for such a process. The quota agreement between Mercosur and Mexico would provide an ideal framework for South Africa and Mercosur to follow. However, Brazil and Mexico are in many respects equal partners. This is not the case with regard to South Africa. (An umbrella agreement, similar to that between Mercosur and Mexico, would be viable if far fewer products were included at first.) Emphasis needs to be placed on building relationships through confidence-building between the automotive and component producers. The FTA should therefore include a smaller number of products and be seen as a starting point, leading to deeper integration at a later stage.

The auto components sector adds complications to any agreement. Even a strictly managed quota system may prove too difficult to manage. For this reason, the initial agreement should involve only the automotive industry; it should exclude the related sectors, which could be incorporated at a later stage. The agreement would thus cover built-up and CKD vehicles in relatively low quotas. Rules of origin and other requirements would also have to be considered and addressed carefully. The agreement would be reciprocal, allowing for an exchange of various specialty models produced in either South Africa or Mercosur.

Such a toned-down version of the agreement will help to address the concerns that have hampered progress toward co-operation between Mercosur's and South Africa's auto industries to date. Although its scope would be far narrower than originally planned, the FTA would nevertheless serve as a clear starting point for further agreements in the automotive sector. Hopefully it will also contribute to a successful global campaign for the automotive industries in South Africa and Mercosur. Finally, and most importantly, the establishment of a trans-Atlantic agreement between auto manufacturers should have a positive influence on the SACU-Mercosur FTA process.



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