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Evaluating Risk of Small Business Expansion into Latin America: A Study in Colombia, Chile, and Peru

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EVALUATING RISK OF SMALL BUSINESS EXPANSION INTO LATIN AMERICA: A STUDY IN
COLOMBIA, CHILE, AND PERU

By

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Submitted in Partial Fulfillment
of the Requirements for
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THESIS SUMMARY

Many multinational companies that expand their operations into Latin America do so with a 'Latin American strategy'. This follows the misconception that Latin American countries are so economically, politically, and culturally similar that one singular strategy will work in all countries. This thesis addresses the incorrect assumption that a Latin American strategy is effective and that Latin American countries are similar enough to be interchangeable in a business sense.

This report looks at three Latin American countries – Colombia, Chile, and Peru – that are similar in terms of trade activity and that have well-developed business environments, in order to evaluate the differences in economic policy, legal environment, and culture between the three countries. Data from the Business Monitor International database and indices is used to evaluate these countries, mainly their Country Risk Index and Operational Risk Index. The Operational Risk Index is further divided into the Trade & Investment Risk Index and Legal Risk Index. This report also utilizes Hofstede's Cultural Dimensions to evaluate the business culture in each country in terms of power distance and individualism v. collectivism. These factors are the rulers by which the risk environments of the Colombia, Chile, and Peru were evaluated.

Colombia scores the lowest in overall Country Risk, meaning that it has the most risky environment overall. Taking into account the cultural, economic, and legal landscapes for Colombia, legal risk is the most important consideration for companies that wish to successfully engage in the Colombian market. Corruption and the weakened rule of law make it difficult, if not impossible, for companies to enforce contracts or protect their property rights. Therefore, it is advised for companies to partner with Colombian businesses in order to form strong relationships and to benefit from their

knowledge of Colombian law. Colombia also does not protect intellectual property rights, and so would represent a risky environment for companies dependent on research and development, such as pharmaceuticals. However, Colombia's free trade agreements and elimination of tariffs on consumer and industrial goods encourages U.S. companies to export to Colombia, a strategy that avoids the operational risk of operating a business in Colombia.

Chile presents the least risky environment overall, outperforming Colombia and Peru in every category, and ranks second out of 42 Latin American and Caribbean countries in terms of trade and investment risk. Its market liberalization policies in the 70s and 80s created a free market and encouraged trade with many countries including the United States. The Chilean government strongly encourages FDI and currently has the third highest FDI stock in the region at \$215.5bn (BMI Research, *Chile Trade*). For firms looking to start a business in Latin America, Chile is the most receptive country for FDI. The strong legal system, protection of property rights, lack of corruption, and open economic policies make Chile a welcoming environment for foreign investment and exports of consumer and industrial goods.

The prevalence of corruption in Peru's legal system is a large concern for companies, especially small and medium sized enterprises, attempting to operate in Latin America. Contracts are rarely enforced and legal battles can be lengthy and expensive, for example, cases on intellectual property rights. Peru has been on the U.S. Trade Representative's Special 301 watch list for Intellectual Property Rights since 1992, posing a threat to companies in R&D intensive industries. Small firms may not have the resources to fight a legal battle over IPR, and without legal protection, these companies

lose their competitive advantage in the market. Besides the political and legal deterrents, Peru is also struggling with social unrest in more rural areas. Rural townspeople and indigenous peoples are protesting the operation of large multinational mining companies in the country. This kind of conflict can largely affect opportunities for incorporation in those areas and sectors. However, companies focused solely on trade with Peru instead of foreign direct investment, such as manufacturers of consumer goods or mining and construction equipment, have a positive outlook because they avoid many of the risks associated with incorporating and operating in Peru.

This report provides analysis of the business and risk environments of three Latin American countries and will benefit the South Carolina Small Business Development Center, an organization committed providing small and medium sized enterprises tools and assistance towards entrepreneurial growth and success. Part of their mission is to help small firms that are interested in expanding internationally. These firms will use this as a resource for preliminary analysis of the Colombian, Chilean, and Peruvian markets, as well as a basis for their product-specific market research to then successfully engage in these Latin American markets.

INTRODUCTION

From a shared past of colonization, struggle for independence, and the ongoing search for *identidad nacional*, Latin American countries have developed similarities that tie them together as a region. A shared language and history are examples of characteristics that, from an outside perspective, present Latin America as a more homogeneous region than other parts of the world. This misconception often leads businesses to develop a strategy for Latin America as a region, rather than for the individual countries that they wish to target. For many companies, this results in failed marketing and trade strategies that do not account for the cultural and societal differences between Latin American countries. Especially susceptible to this kind of misstep are smaller firms without the international experience or network to gain firsthand knowledge of how to conduct business in these countries.

The purpose of this report is to analyze three of the most promising Latin American countries for U.S. exporting and foreign direct investment – Colombia, Chile, and Peru – in terms of trade and investment risk, including economic openness and legal environment, and cultural environment to assess the risk landscape of these countries and to make a recommendation for small businesses entering the Latin American market. Trade and investment risk will be evaluated in part by data from the BMI Research Country Risk Index, an evaluation of 130 countries around the world that gauges the dangers of foreign investment in a country based on its economic, political, and business environments. The BMI Index is presented as a barometer of risk, measuring the vulnerability of the business environment in a country (BMI Research, *Country Risk Index*). It is comprised of four indices: a composite index (Country Risk Index), an economic index, a political index, and a business environment index (Operational Risk

Index). This report will focus on the data from the Country Risk Index and the Operational Risk Index, which contains the subcategory of Trade and Investment Risk. It will not include rankings from the political or economic indices for the following reasons. Operational Risk is the most relevant factor to consider when evaluating exporting to and investing in a country as it evaluates the business environment and stability. Country Risk Index, on the other hand, is a compilation of the scores in all categories to provide a general risk ranking, meaning it comprises the political and economic risk rankings. Therefore, it is unnecessary, considering the scope of this report, to separately analyze the political and economic categories within Country Risk. For all indices, countries are scored from 0-100 in each category with 100 representing the lowest possible risk state. The BMI Index states that the scores are comprised of 20 sub-index scores and 79 individual data sets and surveys, all of which factor into the final scores and rankings.

Trade statistics from the GlobalEdge database will also provide support for the analysis of these countries. The data gathered from the GlobalEdge database contains import and export statistics between the United States and Latin American countries to further analyze the United States' most active trading partners.

In addition to these resources, this report will use country data from The Hofstede Centre on Hofstede's six dimensions of culture to analyze the business culture in Colombia, Chile, and Peru. Professor Geert Hofstede is the founder of comparative intercultural research, and his theory of cultural dimensions has been widely studied by business academics and multinational corporations alike. His study evaluates how workplace values and behavior are influenced by culture, measured from 0-100 on the six dimensions of power distance, individualism, masculinity, uncertainty avoidance, long

term orientation, and indulgence (“Geert Hofstede”, 2016). This report will analyze the business cultures in Colombia, Chile, and Peru through the lens of power distance and individualism.

Power distance is the perceived level of authority between different levels in a hierarchical system. In the case of a business environment, this would be exemplified by the relationship between an employee and his immediate boss. In countries with a higher power distance, businesses are more likely to have a top down management structure with an authoritative relationship between a worker and his boss. In this type of environment, feedback given from a worker in a lower rung of the hierarchy would be considered out of place and, in some cases, offensive. In low power distance environments, businesses have flatter, horizontal management structures that promote collaboration and constructive feedback between group members. Managers expect their workers to be honest with them when providing opinions and welcome ideas from any level of the organization. Another difference in power distance is type of person who can become a senior member as promotion in a high power distance environment is very closely related to age. In a low power distance workplace, promotions are more merit-based and age has less effect on who will advance within the organization.

Individualism v. collectivism is a dimension that evaluates how members of a group or society view others in their society, otherwise referred to as the in-group. In an individualistic environment, scoring closer to 100, individuals feel the need to take care of themselves and acknowledge their own efforts for their successes and failures. In these types of societies, a graduate moving back in with his parents might be perceived as a failure to succeed through his own efforts. In individualistic work environments,

interpersonal competition is more visible as employees put more weight on their individual accomplishments. However, collectivist societies, those scoring on the low end of the scale, are focused more on the wellbeing of the in-group. Members prioritize supporting each other and take comfort in the security net offered by the group loyalty. In these types of societies, such as most Latin American countries, it is more common for extensive families to live under the same roof and for children to live with their parents until their late twenties. Collectivist work environments are generally more collaborative and there is a communal sense of ownership over projects, eliminating the occurrence of the free rider effect. Nepotism is not seen as corruption in these societies, but is viewed as taking care of the members of the in-group.

This report will compare these countries' scores on the power distance and individualism dimensions to the United States' scores in order to evaluate differences in values and behavior between the countries. By recognizing these differences, U.S. businesses expanding to Latin America can adjust their orientation to better work with local companies.

SCOPE

For the purposes of this analysis, Latin America is defined as the countries in the Americas where mainly Spanish and Portuguese are spoken. The region includes Mexico as well as the majority of countries in Central and South America, but excludes French Guyana, Guyana, and Suriname.

Mexico and Brazil were excluded when determining the countries of focus for this report because they represent outliers in many of the region's statistics – including GDP, exports, size, and population – so they could not realistically be compared with smaller

Latin American countries. Figure 1 below uses 2014 World Bank Data to show Latin American countries ranked in descending order by Nominal GDP.

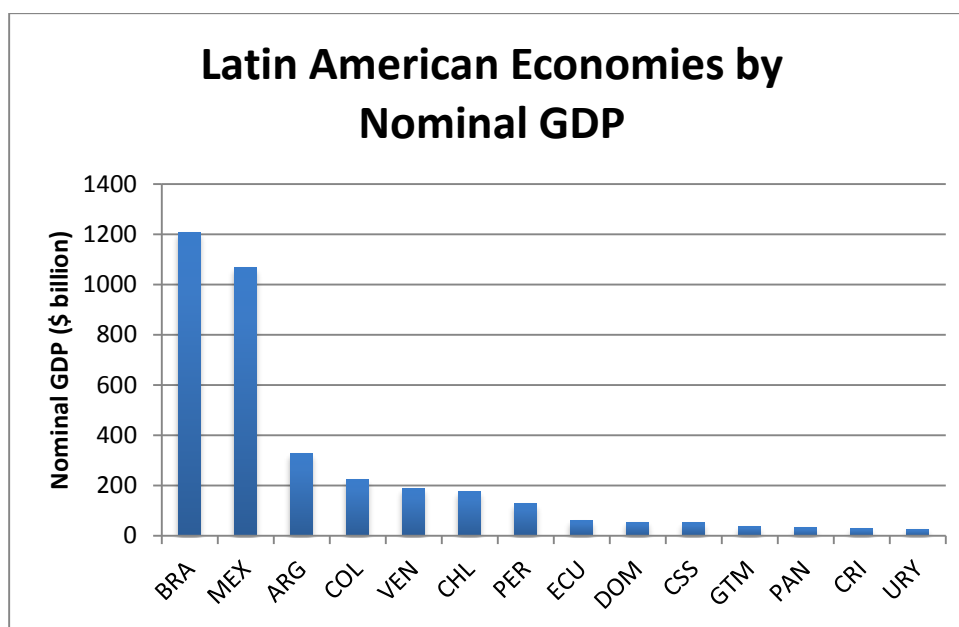


Figure 1: Latin American Countries ranked by Nominal GDP. 2014 World Bank Data

Mexico has the fifteenth largest economy in the world with a nominal GDP over twice as large as the next ranked Latin American country. Because of its membership of NAFTA since 1994 and geographic proximity to the United States, Mexico has already been established as the natural market for exporting by U.S. based companies. Therefore, Mexico has been excluded to instead provide insight on Latin American countries whose policies and operational risks small U.S. business may not be as familiar with.

Brazil has also been excluded from this report for various reasons, despite its status as a BRIC country and its trend of incredible economic and market growth. Firstly, as the seventh largest economy in the world, with a nominal GDP in 2015 of \$2.346 trillion (The World Bank), Brazil is also considered an outlier in Latin America in terms of economic activity. In order to analyze countries of similar economic size as determined by GDP, it was excluded from the data set in this report. Another factor that

disqualified Brazil from consideration in this report is the bureaucratic process and red tape that still permeates Brazilian business operations. In the World Bank's 2016 Doing Business Report which measures regulatory quality and efficiency of countries around the world, Brazil ranked 116th out of 189 total countries. The difficulty of conducting business in Brazil is a strong deterrent for small businesses without the capital and in-country resources to overcome those barriers. The final reason for its exclusion is the difference in official language between Brazil and the rest of Latin America.

The goal of this report is to dispel the misconception that all Spanish-speaking countries are culturally and economically similar. It will examine the current and projected business environments in Colombia, Chile, and Peru in order to provide a platform from which small businesses can begin their analysis of expansion into Latin America.

COLOMBIA

BACKGROUND

Colombia is a country of roughly 50 million people, located at the junction of Central and South America. It is the only South American country that can claim both an Atlantic and Pacific Coast, bordering Ecuador in the West, Venezuela in the East, and Peru and Brazil to the South. Colombia represents the fourth largest economy in Latin America after Brazil, Mexico, and Argentina with a reported GDP of \$223 billion in 2014 (The World Bank). Its economy is heavily dependent on petroleum and coffee exports, and has been negatively impacted by falling global commodity prices in the past few

years. Macroeconomic analysts worry that a sharper decline in oil prices in 2016 will significantly stunt Colombia's economic growth (BMI Research, *Colombia Country*).

In the BMI Country Risk Index, Colombia ranks 76th out of 130 countries ranked with a total score of 58.7 out of 100. This places Colombia 7th in Latin America, outperforming most of its immediate neighbors in terms of overall risk. The main reason for this above average ranking is its relative political stability in comparison with several other South American countries (BMI Research, *Colombia Country*). It maintains strong democratic institutions that ensure peaceful elections and the protection of civil rights ("The World Factbook: Colombia"). However, it also boasts some of the region's worst income inequality with one third of the population living below the poverty line according to the CIA World Factbook. In addition, Colombia is the largest source of refugees in Latin America and has one of the world's highest levels of forced disappearances ("The World Factbook: Colombia"). Illegal drug trade is also a large legal and social issue present in Colombia. However, due to its institutional stability and in spite of its social conflicts, Colombia has become a strong presence in regional trade and has also built a mutually beneficial trading relationship with the United States.

Colombia is ranked fifth in South America in terms of total imports (The World Bank). The World Bank reported that in 2014 Colombia's total imports of goods and services equaled \$75.199 billion (current US\$), growing from \$62.942 billion 3 years prior. The United States accounts for 28.51% of that value as their top trade partner in imports, with China ranked second accounting for 18.41% of total imports (UN Comtrade). In the years from 2007-2013, the U.S. has comprised over 20% of

Colombia's total imports on average, and Colombia has considered the U.S. a stable supply market for manufactured consumer goods (BMI Research, *Colombia Trade*).

OPERATIONAL RISK

The BMI Country Risk Index is comprised of five sub-indices: short- and long-term political risk, short- and long-term economic risk, and operational risk. This paper is focused on the analysis of Colombia, Chile, and Peru from the perspective of operational risk. The following sections will refer to Trade and Investment Risk, a component of operational risk. A country's scores in this and other categories are averaged to determine their overall Operational Risk score.

TRADE AND INVESTMENT RISK

Figure 2 below displays the BMI Trade and Investment Risk Index scores for Colombia, Chile, and Peru from the 2015 report data.

Index	Colombia		
	Score	Chile Score	Peru Score
Legal Risk	47.1	69.1	46.5
Beurocratic Environment	60.8	61.6	56.5
Legal Environment	33.5	76.6	36.5
Economic Openness	50.6	68.3	63.4
Trade Openness	37.2	56.4	45.8
Investment Openness	63.9	80.2	53.8
Government Intervention	63.0	65.4	49.8
Taxation	53.6	58.0	48.9
Financial Barriers	72.4	72.8	77.8
Overall BMI Trade and Investment Risk Index	53.6	67.6	53.2

Figure 2: BMI Trade and Investment Risk Index and Sub-Indices for Colombia, Chile, and Peru

Colombia ranks 16th out of 42 Latin American and Caribbean states in overall Trade and Investment Risk, but remains below only Chile in South America, representing

low risk in the region. Over the past few years, Colombia has reported increased foreign direct investment, FDI, demonstrating a positive perception of the investment risk environment. The increase is mainly due to recent economic reforms to draw in business and increase bureaucratic efficiency. This risk index can be further broken down into Legal Risk and Economic Openness scores. Figure 3 below compares the Legal Risk, Economic Openness, Government Intervention, and combined Trade and Investment Risk scores for Colombia, Chile, and Peru.

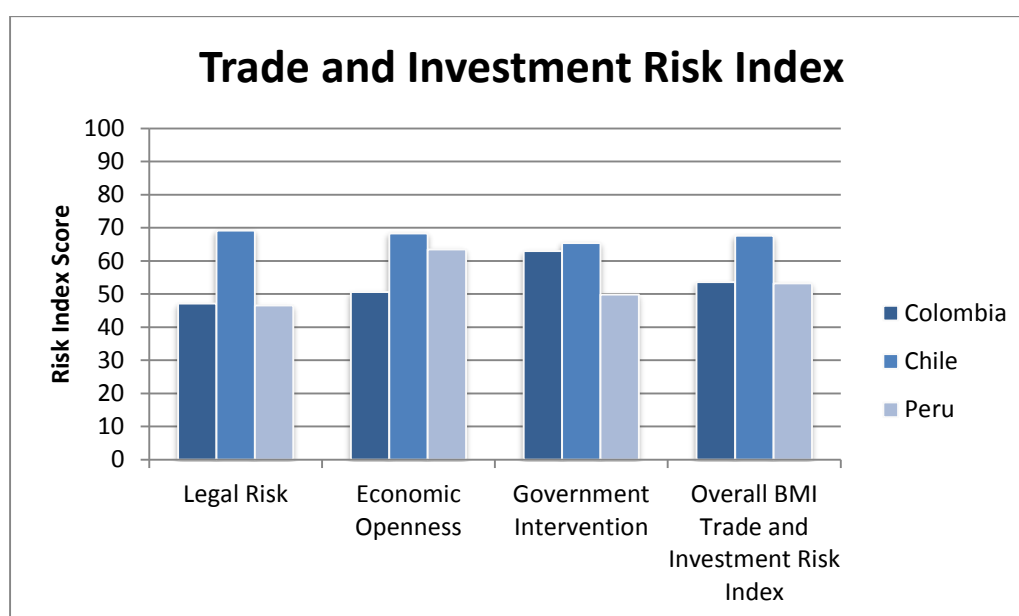


Figure 3: Comparison chart of Trade and Investment Risk Index scores for Chile, Colombia, and Peru.

LEGAL RISK

In terms of legal risk, Colombia ranks similarly to Peru and far below Chile at 53.6 out of 100. Colombia's weak legal system presents some risk to foreign investors. The domestic conflict between left-wing rebels and right-wing paramilitary groups throughout the 20th century weakened the rule of law in Colombia and promoted the perception of government corruption.

For decades, beginning in the 1960s, Colombia suffered through a violent conflict between left-wing rebels and right-wing paramilitary groups. The largest and oldest left-wing group in this conflict is known as FARC (the Revolutionary Armed Forces of Colombia). They are one of the world's richest guerrilla armies, founded in 1964 to overthrow the government and institute a Marxist regime ("Profiles: Colombia's Armed Groups"). During the 1990s, the right-wing paramilitary forces began an offensive against FARC and the group turned its attention to the illegal drug trade in Colombia as a way to raise money for their cause. Their increased involvement in the drug trade created violent tension in the area. Government intervention remained ineffective until 2006, when President Alvaro Uribe launched a strategic offensive against FARC with assistance from the U.S. military. In 2012, after six years of conflict with the Colombian government forces, FARC began peace talks focusing on six main points: land reform, political participation, disarmament of rebels, drug trafficking, victim's rights, and implementation of a peace deal ("Profiles: Colombia's Armed Groups").

Today, FARC is still on the U.S. and European terrorist organization lists, maintaining loose control of rural areas in the South and East of Colombia. However, peace talks are expected to conclude this year, marking a milestone in political stability and security in the region if they are successful. Ongoing negotiations have improved the security outlook for foreign investors, increasing confidence in Colombia as a trading partner and a potential target for FDI (BMI Research, *Colombia Country*). According to the BMI Country Risk Index SWOT Analysis, support from the IMF and major credit rating agencies has also boosted confidence in the stability of Colombia's economy, making it a more attractive market for investment. All three major ratings agencies have

upgraded Colombia's government debt to investment grade ("The World Factbook: Colombia"). Although peace talks are expected to conclude successfully, indicating increased faith in the government, Colombia still ranks 83rd in the world in the 2015 Corruption Perceptions Index ("Transparency International").

Lack of faith in the government and legal system makes firms hesitate when considering investing in Colombia. Another concern pertinent to the operation of business is the strength of companies' legal rights in Colombia. The current government does little to ensure contract enforceability or protect property rights, two aspects of the legal system most used by foreign businesses to mitigate risk. However, despite the pitfalls of Colombia's legal system, the lack of bureaucracy positively factors into Colombia's index score. The World Bank released a 2015 report of their Ease of Doing Business Index where Colombia ranked 54th in the world. The lack of red tape allows businesses to be formed quickly and efficiently, encouraging foreign investment in Colombia.

Considering all of these factors, however, Colombia underperforms regionally in the Legal Risk Category, ranked 24th out of 42 Latin American and Caribbean countries with a score of 47.1 out of 100.

ECONOMIC OPENNESS

Colombia ranks lowest of the three countries in terms of Economic Openness with a score of 50.6 out of 100. Colombia ranks 5th out of 42 Latin American and Caribbean countries behind Mexico, Brazil, Chile, and Argentina. Colombia boasts one of the largest total trade volumes in the region, its import/export total equaling \$319.7 billion in 2015 (BMI Research, *Colombia Trade*). Its extensive free trade agreements, few barriers

to trade, and competitive free trade zone arrangements make Colombia attractive for foreign investors. Colombia implemented a free trade agreement with the United States (its biggest import and export partner) in 2012, reducing tariffs for a variety of key products. At the time of implementation, 80% of U.S. consumer and industrial good exports to Colombia were tariff-free, and the rest will be phased out by 2022 ("U.S.-Colombia Trade Promotion Agreement"). According to the Colombian Embassy in Washington, D.C., between June 2012 and February 2013, U.S. exports to Colombia increased by 20%, demonstrating major increases in oil, aircraft and parts, and electric machinery ("US-Colombia Free Trade Agreement", 2013).

Colombia has also negotiated FTAs with Canada, El Salvador, Guatemala, Honduras, Mexico, and Chile, showing trade openness in South as well as North America. Free trade agreements with the Republic of Korea, Costa Rica, and Israel have been negotiated but have not yet been implemented. This range of free trade agreements demonstrates Colombia's desire to encourage regional and global trade and reduce the cost of importing products. It is regionally integrated as a member of the Pacific Alliance Trade Bloc (other members include Mexico, Chile, and Peru) and is a member of the World Trade Organization. Due to its broad range of free trade agreements and regional organizational memberships, Colombia has an average tariff rate of 2.0%, a rate below Chile, but above Peru's rate of 0.7% (BMI Research, *Colombia Trade*). Colombia is expected to continue its pursuit of FTAs in the future, further lowering its average tariff rate.

Currently, Colombia presents a trade deficit with imports outweighing exports at \$72.9 billion and \$66.9 billion, respectively, boding well for companies looking to export

to Colombia. However, the trade deficit is expected to increase with the reduction of oil exports due to the global drop in oil prices. This continued decrease in global oil prices, Colombia's key export, will slow economic growth, affecting consumer confidence and reducing demand for imported consumer products (BMI Research, *Colombia Trade*). Colombia's imports experienced stable growth in the years since the global financial crisis, however only saw growth of 0.8% in 2015 due to pressure on consumer spending (BMI Research, *Colombia Trade*). While low tariff rates and free trade agreements make a welcome trade environment, the fall of global oil prices could decrease Colombia's importing power in the long run.

CULTURE

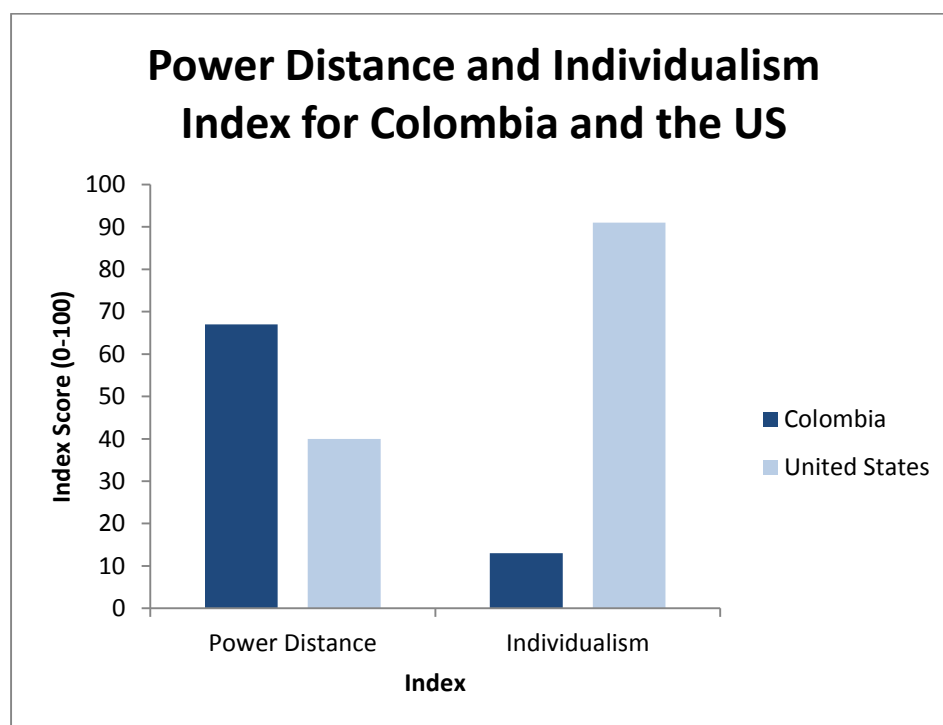


Figure 4: Power Distance Index and Individualism v Collectivism Index scores for Colombia and the United States.

On the Power Distance Index (PDI), Colombia scores high with 67 out of 100, meaning that inequality in Colombia is accepted as a part of life, and as such, in the

Colombian work environment, vertical management structures are much more common than horizontal structures. Because managers have a higher rank than the employees, the relationship is more authoritative. Employees are expected to respect the ideas of managers (usually their elders) and to withhold criticism or feedback. On the other hand, the United States scored below average with a score of 40 out of 100 on the Power Distance Index. The United States work environment is more moderate with a mix of these two attitudes, but there is a strong weight towards low power distance coming from the long-held American belief in equality. In this type of environment, horizontal management structures are preferred and managers welcome feedback from their employees.

On the scale of Individualism v. Collectivism, Colombia scores extremely low in the index at 13, meaning it is one of the most collectivist cultures in the world. In Latin America, it is only surpassed by Ecuador, Panama, and Guatemala (“Geert Hofstede”, 2016). In this type of society, nepotism is more common and family names carry more weight when conducting business and negotiating contracts because it identifies someone as part of the in-group. Paired with the high PDI score, a high collectivist score means that Colombians have strong group identities tied to socio-economic classes (“Geert Hofstede”, 2016). Conversely, the United States scored 91 out of 100 on the individualism v. collectivism scale, meaning that it is an extremely individualistic society. Workers are more geographically mobile, focusing on personal achievements and career over family and group connections. Americans are also generally more willing to judge business partners on their merit and individual accomplishments rather than by their association with a certain group.

When conducting business in Colombia, American businesses need to be aware of the difference in power distance between the two countries. For example, in a business meeting with Colombian executives, Americans must evaluate their status within the company and how their Colombian counterparts view them, whether as an equal or as an inferior. By reorienting their perspective to an environment with a higher power distance, businessmen can phrase their comments and feedback in a way that avoids misunderstandings or offense. Individualism v. collectivism also plays a large role in business interactions in Colombia as Colombians focus more on building relationships through their business visits than on completing specific tasks and negotiating (“Geert Hofstede”, 2016). For American businessmen, this can seem like an inefficient use of time, but for Colombians, establishing relationships is an important step in determining if business partners will become a member of their group.

CHILE

BACKGROUND

Chile is a country that covers most of the western coast of South America, with a population of 17 million, 5 million of which reside in the capital city of Santiago. It is the longest country measured north to south in the world covering 38° of latitude. Its strategic location provides access to shipping lanes between the Pacific and Atlantic Oceans, specifically the Strait of Magellan, the Beagle Channel, and the Drake Passage. The 6,435 km of coastline is host to over 30 sea ports and container terminals (“The World Factbook: Chile”). Chile’s economy is heavily dependent on copper exports, which account for over 40% of the country’s total exports (Jamasmie, 2012). It is by far the

world's largest copper producer and exporter with possession of 28% of the estimated global reserves according to the U.S. Geological Survey commodity report. Commodity exports, including copper, make up 75% of Chile's total exports, making the economy extremely reactive to global commodity prices.

Figure 5 below shows the top ranked Latin American countries by Country Risk Index.

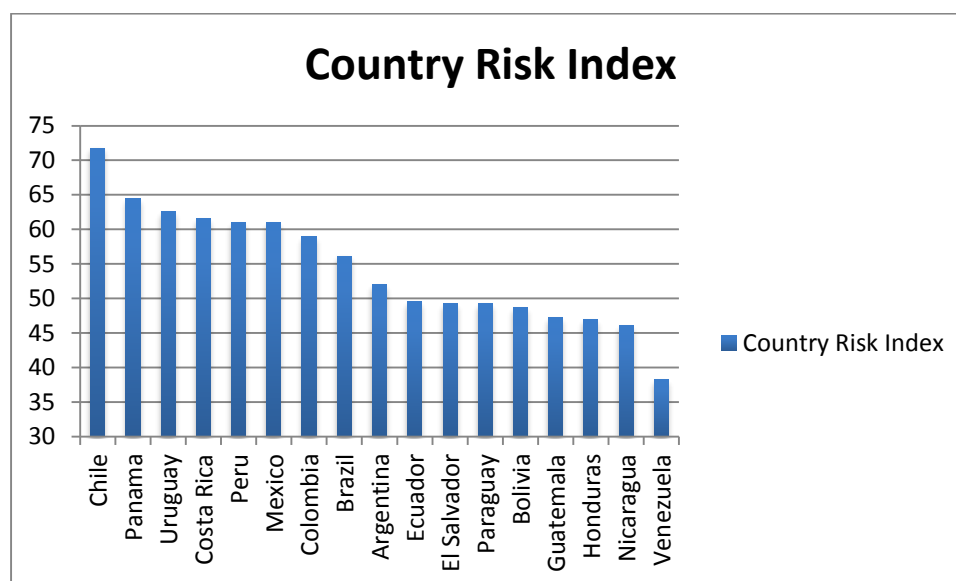


Figure 5: Comparison of Latin American countries by Overall Country Risk Index

In the BMI Country Risk Index, Chile ranks 1st out of 42 Latin American and Caribbean countries with a high score of 71.5 out of 100, and ranks 29th globally. For comparison, the Eurozone placed 33rd with a score of 69.8 and the United States placed 12th scoring 78.2. Chile far outperforms regionally with the next highest ranked Latin American country, Panama, ranking 46th globally. Chile stands out regionally for its promotion of foreign trade as one of the countries with the most bilateral free trade agreements in the world. Although the highly regulated trade environment and small market size are mild deterrents, in assessing risk, Chile is the standout in Latin America.

According to the World Bank's World Development Indicator Data, Chile had total imports in 2014 of \$82.631. China is their number one source of imports, making up 20.88% of their total imports, while the United States is a close second at 19.77% of total imports (UN Comtrade). The United States and Chile entered into a free trade agreement in 2004 that classified 80% of U.S. consumer and industrial goods exported to Chile as duty free. The remaining tariffs were phased out gradually until, as of January 2015, 100% of those products were duty free. In the 11 years since the FTA went into effect, U.S. exports to Chile have increased 513%, from only \$2.7 billion in 2003 to \$16.6 billion in 2014 ("The U.S.—Chile Free Trade Agreement (FTA)"). The success of the free trade agreement shows the incredible market potential that Chile demonstrates as a destination for U.S. exports, and the effectiveness of Chile's free trade policies. Chile also has a well-developed manufacturing environment and a strong agricultural sector, reducing demand for manufactured consumer products and food products. However, there is a large market for machinery, vehicle parts, and mechanical appliance imports to support the national mining industry.

TRADE AND INVESTMENT

Figure 2, referenced on page 13, shows the Trade and Investment Risk Index scores for Colombia, Chile, and Peru from the 2015 report data. Chile is tied with the U.S. Virgin Islands for second place out of 42 Latin American and Caribbean states, ranked behind only Puerto Rico. It is considered an extremely stable and safe country in terms of trade and investment. Chile scored 66.3 out of 100, outperforming the region average of 49.7 by more than 16 points. Chile's open market policies and the strength of its financial institutions are factors that contribute greatly to its high performance.

ECONOMIC OPENNESS

Chile's open market and push for free trade agreements can be traced back to its economic policies in the 1970s and 80s. From 1974-1984, the Pinochet government undertook a radical reform of the Chilean economy and its policies. When Pinochet came into power in 1973, Chile's annual inflation rate was 286 percent. In the coming months, that rate grew to 508 percent. Goods like milk and eggs became extremely scarce and prices for goods across the board soared as the average tariff for imports reached 105 percent and imports slowed (Büchi, 2006). With a growing deficit, hyperinflation, and growing import tariffs, Chile was in crisis.

Pinochet turned to the Chicago Boys, a group of economists who studied economy theory at the University of Chicago under the mentorship of Milton Friedman and Arnold Harberger. These economists became advisors for the Pinochet government and proposed many of the reforms that made Chile one of the most prosperous countries in South America today. These reforms were ahead of their time, especially in South America, and embraced the oncoming globalization of trade. They involved market liberalization, privatization of inefficient state companies, and tight fiscal and monetary policies (Büchi, 2006). The most important of these reforms was the decision to open trade to the rest of the world by lowering tariffs to record levels in order to encourage trade and pursuing as many bilateral free trade agreements as possible (Büchi, 2006). These policies opened the door to trade and economic growth the likes of which South America had not seen in decades, putting Chile years ahead of other countries in the region.

However, the worldwide economic crisis of 1982 threatened to destroy all progress made through the Chicago Boys' reforms. Chile was hit hard during the

recession, and in 1982 its GDP dropped 14.1 percent (Büchi, 2006). The combination of a quickly falling GDP and the overvaluation of their currency at the time made Chile more vulnerable to the economic crisis and stopped the flow of foreign investment into the country. Tariffs that had been lowered in 1979 soared to 35 percent during the crisis. Unemployment reached 20 percent with an additional 10 percent enrolled in government sponsored emergency employment programs (Büchi, 2006). The newly elected government employed a team of accomplished economic theorists to evaluate the economic crisis and implement reforms that would put Chile back on the path of growth and competitive trade. Hernán Büchi Buc was one of those economists, and he served as Chile's Minister of Finance from 1985 to 1989. In his article on the successful transformation of the Chilean economy at this time, he cites what he thinks were the most important reforms implemented. Trade openness, including the proposal of a flat tariff rate system, is the first, allowing Chile to compete in a global market despite their small population and geographic distance from hubs of global consumption (Büchi, 2006). These policies set Chile apart from other Latin American countries by promoting trade agreements and low import tariffs across the board and by opening the Chilean market up to foreign investment. The second most impactful reform was rebuilding a stronger private sector. One of the initiatives to that end was the restructuring of the banking sector through corporate, financial sector, and banking regulations. These regulations formed the foundation for the stable financial institutions celebrated in Chile today.

The restructuring of Chile's economy in the 1970s and the continuity of reform throughout the crisis of 1982 put Chile ahead of the pack in terms of international

competitiveness. The economic openness and positive foreign investment environment that Chile boasts today were made possible through these reforms forty years ago.

Today Chile is one of the countries with the largest number of bilateral free trade agreements in the world. It has 25 trade agreements with 64 markets which together represent 64.1% of the world population and 86.3% of worldwide GDP (“Relaciones Bilaterales”). It has trade agreements with major trading partners including the U.S., China, Canada, Japan, Malaysia, Australia, New Zealand, Singapore, and the European Union. For such a small country, Chile is well connected in global trade through these agreements and other organizations. Chile is also a member of the Pacific Alliance, along with Colombia and Peru, and signed the Trans-Pacific Partnership in February of this year, a controversial agreement that is currently in debate in the U.S. Congress (“The World Factbook: Chile”). Signing of the TPP by the U.S. would increase trade between the countries through elimination of taxes and barriers to trade, promote job creation, and raise standard of living in member countries.

LEGAL RISKS

In the Legal Risk Index, Chile strongly outperforms both Colombia and Peru with a score of 69.1 out of 100. One important factor in the legal risk index is the prevalence of corruption in each country. In the 2015 Corruption Perceptions Index compiled by Transparency International, Chile scores 70 out of 100 and ranks 23rd out of 168 countries for which data is available. Chile has a transparent legal system with very low levels of government corruption, especially for Latin America where the last decades of the 20th century were marred with dictatorships, coup d’états, and revolutions (“Transparency International”, 2015). A mere 1% of respondents to the World Economic

Forums Global Competitiveness Report noted corruption as a problematic factor when conducting business in Chile (BMI Research, *Chile Trade*). It is considered one of the least corrupt countries in Latin America.

The main legal risk associated with investing in Chile comes from the bureaucratic process of declaring bankruptcy and closing a business which may inhibit certain businesses from incorporating in Chile. However, Chile has the fastest times in the region for incorporating and opening a business at 5.5 days. This is far below the regional average of 39.5 days (BMI Research, *Chile Trade*). This efficiency counterbalances the inconvenience of resolving insolvency as well as new legislation introduced in November 2013 that significantly reduced the time required to complete bankruptcy proceedings (BMI Research, *Chile Trade*). This reform will simplify the bankruptcy process moving forward and address the minor concerns about the legal risks of Chile's business environment.

Chile is a popular target for FDI due to its adherence to international property rights law and its protection of property rights (BMI Research, *Chile Trade*). In the World Bank's 2015 Ease of Doing Business Report, Chile ranked 48th out of 189 countries ranked. Although there are small inconveniences with conducting business in Chile, the transparency of the legal system, strength of property rights, and speed of incorporation along with Chile's promotion of FDI make it a welcoming environment for foreign business. Overall, Chile is ranked 7th in Latin America in terms of Legal Risk.

CULTURE

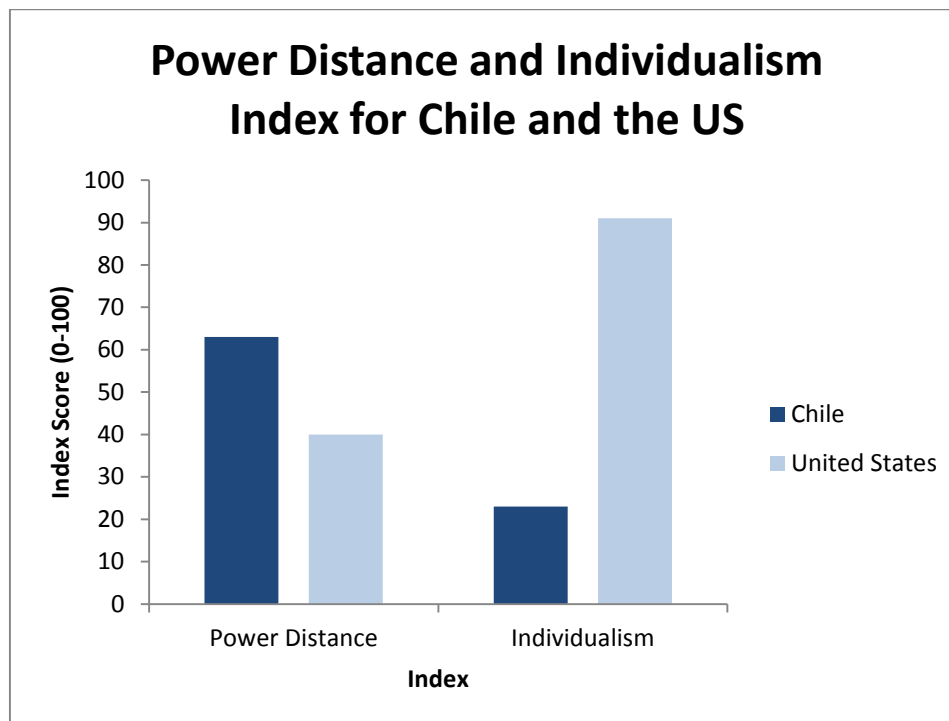


Figure 6: Power Distance Index and Individualism v Collectivism Index scores for Chile and the United States

On Hofstede's Power Distance Index (PDI), Chile scores slightly lower than Colombia with a score of 63 out of 100. This ranking aligns with many Latin American countries where inequality and vertical management structures are more common than horizontal, collaborative environments. As in Colombia, workplace relationships between managers and employees are more structured and criticism from subordinates is not common. The United States scored below average in this category with a score of 40 out of 100. As discussed in the comparison of Colombia and the United States, the work environment in the U.S. is based heavily on the idea of universal equality. Although the United States falls towards the center of the Power Distance Index, it leans towards low power distance.

On the scale of Individualism v. Collectivism, Chile scores higher than both Peru and Colombia with a score of 23 out of 100. While it is still very collectivist, it places a

more importance on individualism than the other two countries. A reason for this may be the rapid economic development of Chile in the past few decades which tends to favor individualism (“Geert Hofstede”, 2016). In the Chilean work environment, family names and associations are not as important as in Colombia, and employees are judged by their skills. However, outside of Santiago, in the northern and southern regions of the country, there is a stronger feeling of community due to the relative isolation of these cities. For example, it is imperative for companies interested in the Chilean mining sector, located primarily in the northern cities like Antofagasta, to recognize the importance of building relationships with Chilean business partners. Chileans in this region have a stronger sense of community ties, and so are wary of outsiders, especially in a business environment. Americans who are accustomed to a strongly individualistic society must make the effort to build strong relationships with Chilean counterparts before attempting to negotiate, or colleagues may view their negotiations as brow-beatings. Face to face meetings, especially for introductions, are essential to gain entry into the Chilean market ("Business Customs"). These meetings form the basis of any future relationship and may last through a business lunch or into the afternoon.

Rushing business meetings, jumping to negotiations, or behaving too informally can appear discourteous and may be detrimental to future business success. It is important for small business owners to remember that building relationships through personal interaction is the foundation for success in the Chilean business environment. These meetings both respect the elevated power distance in Chile and pave the way for successful acceptance as a business partner in a collectivist society.

PERU

BACKGROUND

Peru has a population of 30 million people, almost 30 percent of which live in the capital city of Lima. It is located on the western coast of South America, bordering Ecuador and Colombia in the north, Brazil and Bolivia to the east, and Chile to the south. Peru represents the 7th largest economy in Latin America, just below Chile, with a nominal GDP of \$128 billion in 2014 (The World Bank). With huge wealth in natural resources, its economy is heavily dependent on exports of metals and minerals, mainly silver and copper, which account for almost 60% of the country's total exports ("The World Factbook: Peru"). It is the second largest producer of silver and the third largest producer of copper in the world, making the economy fairly reactive to fluctuations in global commodity prices. From 2009-2013, the economy grew by an average of 5.6% partly due to the high prices for metals and minerals during those years ("The World Factbook: Peru").

In the BMI Country Risk Index, Peru ranks 68th out of 130 countries given a score of 60.8 out of 100. This score places Peru 6th in Latin America just above Colombia and below Mexico (BMI Research, *Country Risk Index*). The main strengths that help Peru's scores are its commitment to promoting free trade and current efforts to improve the bureaucratic process. However, an underdeveloped infrastructure, conflict between the government and indigenous populations, and a worsening corruption index negatively impact Peru's overall score (BMI Research, *Peru Country*). Peru also struggles with drug-related crime, specifically organized narcotics operations. Many of these operations have gained access to Peru through its shared border with Colombia. It is the 2nd largest

producer of the coca leaf (instrumental in the production of cocaine) and was the leading producer until 1996 (“The World Factbook: Peru”). A significant portion of the harvested coca leaves enter the drug market and are used to produce cocaine, making Peru the 2nd largest producer of cocaine in the world. This drug is shipped from Peru’s Pacific seaports to international markets, mainly the U.S., but the proliferation of narcotic drugs has unintentionally increased domestic narcotic consumption as well.

The World Bank reported that in 2014 Peru’s total imports of goods and services was \$48.464 billion (current US\$), growing only 11% since 2011 and decreasing by 2.8% from 2013-2014. Contracting import statistics indicate a lack of consumer buying power and will impact the country’s appeal for foreign investors. This largely affects the United States as American products constitute 20.86% of Peru’s total imports. China is barely ahead with 21.15% of total imports (UN Comtrade).

TRADE AND INVESTMENT

Referring back to Figure 2 on page 13, in terms of overall Trade and Investment Risk, Peru ranks similarly to Colombia with a score of 53.2 out of 100 and far below Chile’s score of 67.6 out of 100 (BMI Research, *Country Risk Index*). It ranks 22th out of 42 Latin American and Caribbean States, six places below Colombia, and in the bottom 50% of countries in the region, presenting more investment risk than either Colombia or Chile. Peru has an open policy towards FDI and has few restrictions on trade, both of which positively affect its score. However, corruption and a weak legal system jeopardize contract enforcement and adequate protection of property rights for foreign companies.

ECONOMIC OPENNESS

In the Economic Openness Index, Peru ranks 15th out of 42 Latin American and Caribbean States with a score of 49.8 out of 100 (BMI Research, *Country Risk Index*). Overall, Peru is an attractive market for foreign direct investment in South America. The Peruvian government encourages FDI in areas of special interest such as infrastructure, mining, and tourism (BMI Research, *Peru Trade*). However, recent years have seen slow growth in imports and exports due to low global commodity prices and low export demand, which in turn negatively affected foreign investment. Fortunately, Peru's history of free market reforms has resulted in strong trade connections and an environment that encourages foreign trade.

In the 1990s, after drafting a new constitution in 1993, Peru followed Chile's lead from the previous decade and established free market reforms to increase its competitiveness in international trade. Peru began pursuing free trade agreements with its neighbors and top trade partners and today holds agreements with China, the United States, the EU, the European Free Trade Area, Japan, South Korea, Singapore, Mercosur, Mexico, and Chile. Figure 7 below uses data from the World Bank Economic Indicators to show the significant increase in foreign trade (both in total imports and exports) that Peru experienced after the market reforms of the 1990s. The gray line marks the year 1993 when Peru implemented its new constitution.

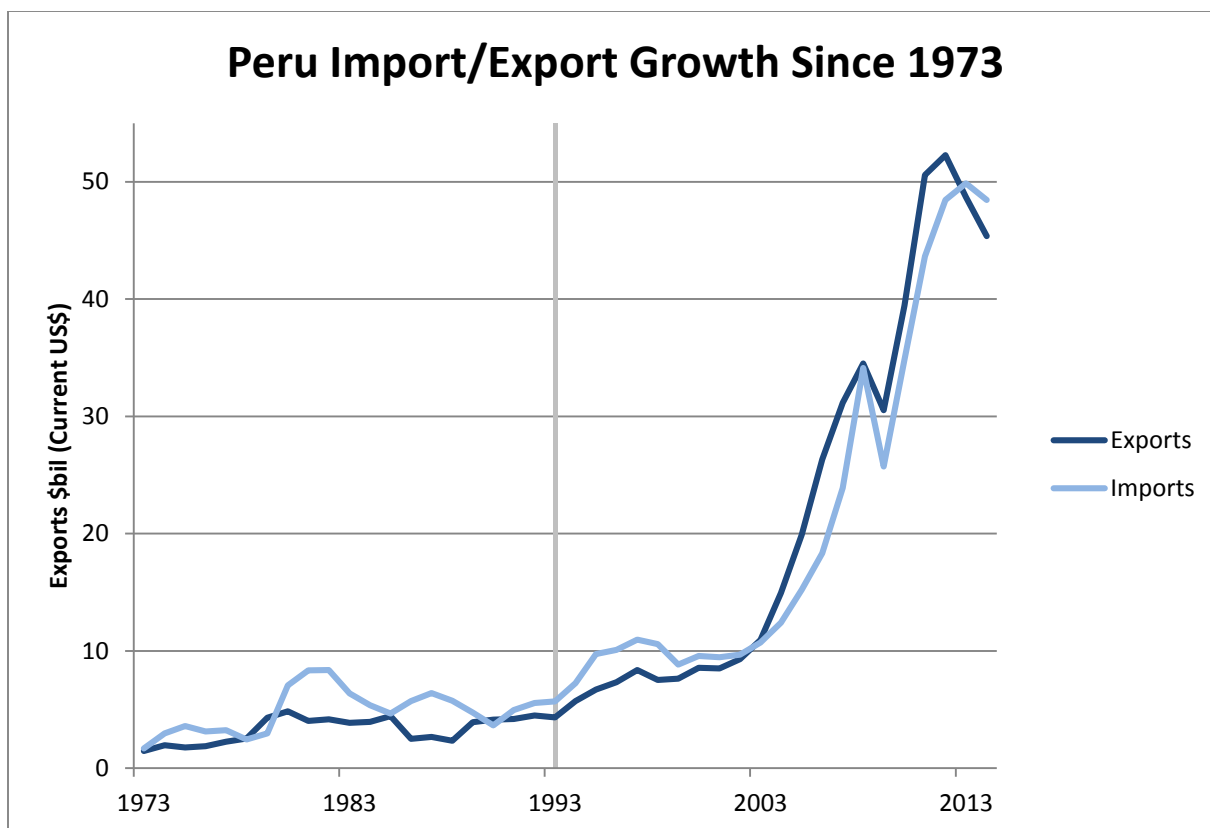


Figure 7: Peru's Total Import/Export of Goods and Services Growth from 1973-2014. World Bank Data for the years 1980-1989 is not available. Data for those years was interpolated from available World Bank Data.

By 2003, Peruvian exports had doubled from their 1993 numbers showing the start of a trend in increased trade through bilateral free trade agreements. From 2003 to the global economic crisis in 2008, both exports and imports grew by over 300%. Peru opened up dramatically as a market for international trade, and the combination of trade agreements and booming commodity prices in the 2000s led to spikes in total trade volume. The decrease in imports and exports since 2013 can be attributed to falling global commodity prices, Peru's most valuable export. Chile and Colombia reflect the same trends as they too are dependent on commodity exports.

In addition to bilateral trade agreements, Peru is also an active member of the Andean Community of Nations and the Pacific Alliance trade blocs, and a signing

member of the Trans-Pacific Partnership. Because of its commitment to free trade and market liberalization, Peru has the lowest average tariff rate in the region at 1.0%. Even its highest rate of import duties only reaches 11% and applies to just 10.5% of goods, representing low trade costs with its trade partners (BMI Research, *Peru Trade*)

Despite poor growth rates of imports and exports in recent years, Peru remains an attractive partner due to its liberal market policies and wealth of natural resources. Should commodity prices rise in the future, Peru will attract even more trade, resolving the current slow growth in exports.

LEGAL RISKS

In the Legal Risk Index, Peru ranks 25th out of 42 Latin American and Caribbean countries with a score of 46.5 out of 100 (BMI Research, *Country Risk Index*). Some concerns for foreign companies come from financial barriers to entry in the Peruvian market. Examples of this are high levels of income tax, especially in the mining sector, one of Peru's most important areas for investment. This deters some firms from investing in Peru, especially after subdued growth in imports and exports for the past few years. However, improvements in the bureaucracy of founding, operating, and dissolving a business present some positives in the administrative environment. Administrative processes have been reorganized and simplified due to an online filing system (BMI Research, *Peru Trade*). This system, known as e-governance, is expected to increase the efficiency and transparency of the administrative process. Companies can now create a business, apply for permits, and approve documents online, making it easier to interact with government agencies and reducing the costs of incorporating in Peru.

However, there are profound drawbacks to foreign investment in Peru due to its weak legal environment. Corruption is a ubiquitous influence on Peru's legal system. In the 2015 Corruption Perceptions Index, Peru ranked 88 out of 138 countries included in the index with a score of 36 out of 100 ("Transparency International"). Peru's highly corrupt law enforcement division, including both police and the judicial system, has weakened the rule of law and poses a severe risk for foreign companies attempting to resolve disputes through the Peruvian court system (BMI Research, *Peru Trade*).

Contracts and property rights are not regularly enforced, and should a company refuse to bribe officials, they may be put at a disadvantage in court proceedings. However, foreign-owned companies do have the option to have disputes resolved in international arbitration instead. Policies like this one come from the National Plan to Combat Corruption implemented in 2012. While this is a step in the right direction for the current government, lasting structural changes must be implemented before real reform of the legal system can be realized.

Another large deterrent for foreign firms is the absence of intellectual property rights protection. Peru has been on the U.S. Trade Representative's Special 301 watch list for Intellectual Property Rights since 1992. In a 2015 Report from the United States Trade Representative, the "Special 301 Report...is the result of an annual review of the state of intellectual property rights (IPR) protection and enforcement in U.S. trading partners around the world" (Froman, 2015). As a country on the Special 301 watch list, foreign companies are right to be concerned about the protection of their intellectual property and patents. In R&D intensive industries such as pharmaceuticals, Peru presents a risky environment for FDI.

These negative aspects of Peru's legal environment are serious concerns for companies interested in FDI in Peru. The lack of protection for IPP and the corruption evident through Peru's legal system are strong deterrents. However, for companies focused solely on exporting to Peru, some of these legal issues can be avoided.

CULTURE

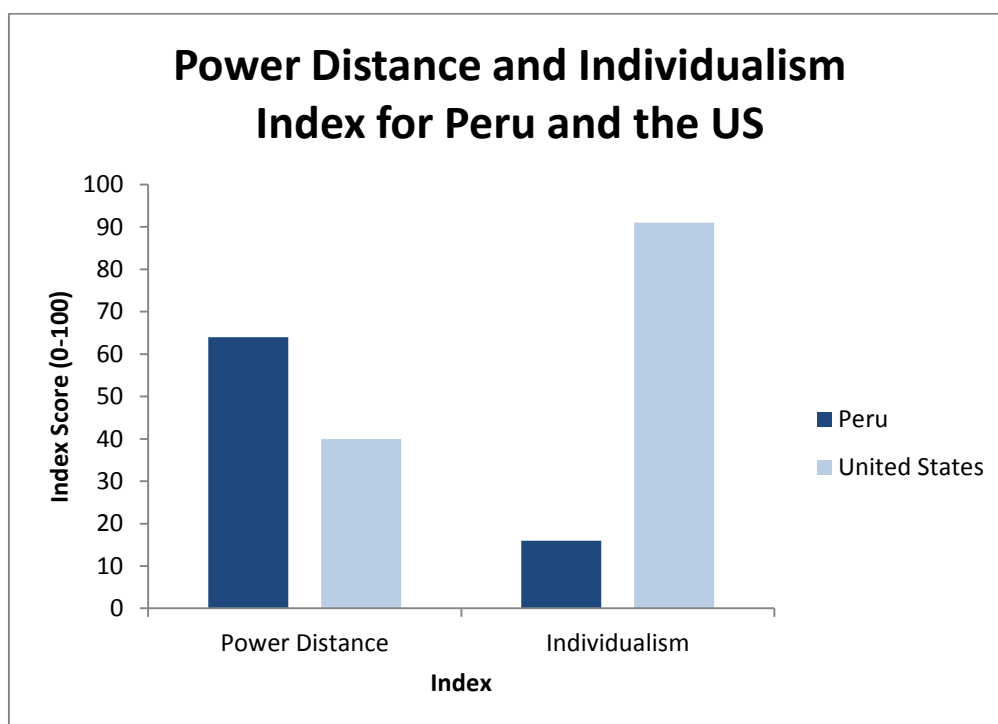


Figure 8: Power Distance Index and Individualism v Collectivism Index scores for Chile and the United States

On the Power Distance Index, Peru scores similarly to Colombia and Chile with a score of 64 out of 100. In Peru, vertical, centralized organizational structures are common reflecting the difference in perception of superiors and subordinates (“Geert Hofstede”, 2016). Business relationships are influenced by rank, and decisions are made by the upper levels of management and communicated downwards. Some believe that Peru's high power distance index can be related back to its history in the Inca Empire, a highly centralized society with high power distance. This trend was continued through

tightly structured colonial rule, authoritarian governments, and the Catholic Church (“Geert Hofstede”, 2016). The United States received a score of 40 out of 100. It represents a business environment with a lower power index where offices are more collaborative than in most Latin American countries. Input from subordinates is encouraged because ideas are judged on their own merit, regardless of who proposed the idea.

On the scale of Individualism v. Collectivism, Peru ranks similarly to Colombia with a score of 16 out of 100. It is a very collectivist society when in-groups provide security and protection in exchange for loyalty (“Geert Hofstede”, 2016). This can translate negatively into a business environment through nepotism and corruption. In a collectivist society, helping other members of an in-group through job opportunities, kickbacks, or business favors may be seen as acts of loyalty. This encourages corrupt practices, which in turn create a barrier for companies from more individualistic societies that are uncomfortable with such practices. In expanding practices to Peru, American companies will need to evaluate the business practices of potential partners to determine whether they violate the U.S. Foreign Corrupt Practices Act. If they decide to enter into a business relationship, they must make an effort to build that relationship to successfully join the in-group.

ANALYSIS

Considering the economic, legal, and cultural environment of Colombia, Chile, and Peru, this report provides small and medium-sized businesses a general risk landscape for each country. However, businesses must still perform market research specific to their product or service in order to determine the feasibility of expanding their

business to these countries. The problems facing small and medium-sized businesses are different from those facing large corporations; therefore analysis must be done keeping those barriers in mind.

According to the World Trade Organization, small and Medium-sized enterprises (SMEs) are defined as “companies with fewer than 250 employees” and which only conduct a small amount of business annually (determined separately by each country) (WTO). 40% of total economic activity in the U.S. is attributed to SMEs, and overall, SMEs contribute between 25% and 35% of global manufactured exports (“WTO and SMEs”). They represent a substantial portion of businesses, both in terms of sheer numbers and in economic impact, but also stand to experience the strongest barriers to internationalization for a variety of reasons: lack of capital, limited international experience, and low bargaining power. Some barriers that SMEs face include tariffs, lack of IPR protection, product standards, lack of support, and cultural and language differences (“WTO and SMEs”).

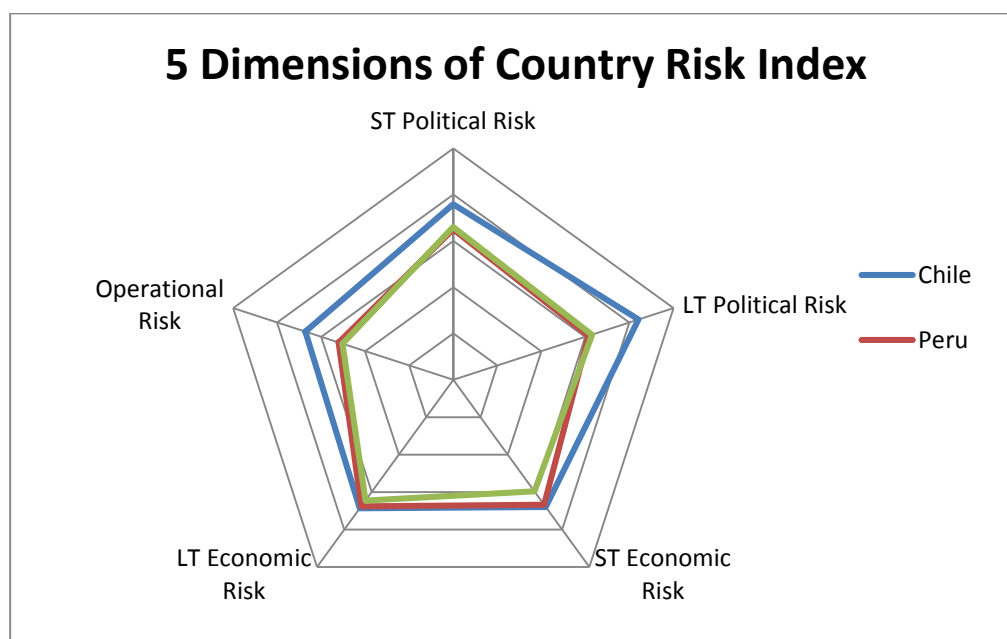


Figure 9: Radar chart showing the relationship between the 5 dimensions of the BMI Country Risk Index.

Two main factors that small companies need to consider when evaluating possibilities for international expansion, in addition to specialized market research, are the ease of doing business in a country and risk mitigation. The openness of the business environment is an important consideration because most small companies do not have the resources that multinational corporations have at their disposal. They do not have access to the capital or expertise required to push their way into a market where business regulation is complex, costly, and time consuming. Risk mitigation is the second largest factor because the international strategy for small growing companies focuses on one country or market at a time with high pressure for return on investment. For example, companies need to avoid politically high risk environments where they may have to pull out operations, or worse, be forced out in times of political unrest. Larger companies have the resources to absorb a loss or fight back legally in the case of such an event. However, smaller firms lack the power to accommodate either of those strategies effectively. The following section will detail how small and medium-size enterprises can enter into foreign markets and which types of companies have the highest chance of successfully engaging in these markets while avoiding political, legal, and economic risk.

COLOMBIA

As shown in Figure 9, Colombia's scores are the closest to the center of the radar graph, meaning that it has the most risky environment overall with operational risk as the variable that stands out. Taking into account the operational landscape for Colombia, legal risk is the most important consideration for companies that wish to successfully engage in the Colombian market. Corruption and the weakened rule of law make it difficult, if not impossible, for companies to enforce contracts or protect their property

rights. Therefore, it is advised for companies to partner with Colombian businesses in order to form strong relationships and to benefit from their knowledge of Colombian law. Relationships are the basis for business agreements in Colombia, where contracts are seen as guidelines or sometimes ignored, and it is more likely for companies to comply with their promises out of loyalty than through contract enforcement by the legal system.

Businesses focused on FDI and building operations in Colombia, such as manufacturers, will face increased risks. Any potential manufacturing operations in rural areas of Colombia are risky due to the present conflict and FARC's influence in the region. The threat of attack or conflict near manufacturing operations may be too great to justify investment in those regions. Should peace talks resolve successfully, the threat from these extreme groups will likely disappear and FDI will be a more viable option for companies manufacturing consumer goods, equipment, and other products in rural areas.

However, the U.S. represents almost 30% of Colombia's imports and is already a stable supplier of manufactured consumer goods. To avoid the increased risk of incorporating and operating within the country, and to accommodate the lack of capital of SMEs, exporting to Colombia is a steady and safer entry into the market. Colombia's free trade agreement with the United States eliminated tariffs for 80% of consumer and industrial good imports, and tariffs on the last 20% will be phased out by 2022 ("U.S.-Colombia Trade Promotion Agreement"). This provides a welcome environment for small firms looking to export goods to Colombia by breaking down a significant barrier to trade. However, as oil prices in Colombia fall, so may Colombia's importing power. Therefore, companies exporting goods with stable demand, such as manufacturing and

construction equipment and parts, will fare better than those exporting consumer products with more reactive demand.

Whether a firm is attempting to penetrate the market through exports or FDI, the firm will have to adapt to Colombia's business culture. Forming and nurturing personal business relationships is critical to business success in Colombia. Businesses should prepare for long meetings with Colombian colleagues, especially initially, and should avoid rushing negotiations and price discussions. When negotiating contracts, U.S. businesses should also hire a lawyer with experience in Colombian contract law as problems in the legal system can result in international trade issues. These actions may seem small but can set a company up for success from the initial meeting. For information on expanding business services internationally, including both FDI and exporting, companies should visit ProColombia.com. Also available as a resource is the U.S Commercial Service in Colombia which provides resources for small enterprises to successfully evaluate and enter the Colombian market as well as identify potential business partners already established in the market. The resources provided by the U.S. Commercial service are invaluable for small firms that lack resources and international connections.

CHILE

As shown in Figure 9, Chile presents the least risky environment overall, outperforming Colombia and Peru in every category. In evaluating the viability of small business operations in Chile, economic openness is the most significant variable and what sets Chile apart from other Latin American countries. Chile is tied for 2nd out of 42 Latin American and Caribbean countries in terms of safety of trade and investment. Chile's

economy is welcoming to both FDI and trade, especially with the United States, their second biggest trading partner behind China.

For companies contemplating exporting to Chile, the free trade agreement with the U.S., enacted in 2004, made 100% of consumer and industrial goods exported to Chile duty free by January 2015. Since 2004, U.S. exports to Chile have increased over 500%, showing the incredible market potential that Chile represents. SMEs that manufacture consumer and industrial goods are encouraged to take advantage of duty free exporting as it removes a significant barrier to entry for small firms. There is a large market for machinery and vehicle parts to support the national mining industry. However, Chile has a well-developed manufacturing environment, reducing the demand for consumer products, so firms must perform a thorough market analysis based on their particular products to determine the feasibility of entering the Chilean market.

The Chilean government strongly encourages FDI and currently has the third highest FDI stock in the region at \$215.5bn (BMI Research, *Chile Trade*). For firms looking to incorporate and build operations in Latin America, Chile is the most receptive country for FDI and offers many incentives. One of the many incentives run by the government is StartUp Chile. This program started in 2011 and offers grants to entrepreneurs, both native and foreign, trying to start a business in Chile which reduces the cost burden on small startup companies.

The important factors that enable businesses to invest heavily in Chile are that intellectual property right law is strictly enforced, property rights are protected, and corruption is rare, making running a business in Chile less risky than in other countries. However, there are few select industries that are not viable for FDI. For example, the

government does restrict FDI in the sectors of national security, defense, and maritime transportation for national security reasons (BMI Research, *Chile Trade*). Other sectors where FDI is restricted include hydrocarbon exploration, uranium mining, and telecommunications. In these specific sectors, market entry is difficult for large firms and almost impossible for SMEs. Therefore Chile is not recommended as an FDI target for companies in these sectors. Because mining is one of the largest and most important industries in Chile, projects in that industry must be authorized by the Chilean Copper Commission and must pass rigorous environmental standards. These requirements can delay projects and deter small enterprises from vying for these project bids against larger corporations. Companies in mining and construction eager to enter the Chilean market are encouraged to partner with a Chilean company in order to obtain authorization to work in the industry. Although all companies are treated equally under Chilean law, these partnerships will provide experience and competitive advantages over other foreign companies. To find and select these partners, SMEs should reach out to the U.S. Commercial Service in Chile, a unit within the Department of Commerce that performs market research, organizes meetings with potential Chilean partner companies, and host trade shows for various industries throughout the country. This department is an invaluable resource for SMEs that want to expand into the Chilean market.

PERU

In the past few year Peru has experienced mild trade contraction and slowed economic growth, but shows strong growth in the long run. With few restrictions on trade and positive policies towards FDI, Peru is a desirable target for investment economically. It has the lowest average tariff rates in the region at 1.0%, and the highest tariff reaches

only 11%, very low barriers that make SMEs competitive alongside large corporations (BMI Research, *Peru Trade*). The main risks in operating in Peru are due to the weak legal system and the social environment.

Peru's commonplace corruption affects the effectiveness of the entire legal system and presents risk for foreign enterprises attempting to resolve disputes through the court system. Contracts are not frequently enforced through the Peruvian courts. The general sentiment is that if a business has to go to court to enforce a contract, it is already too late. Companies with many projects or with plans to contract out help – in other words companies that will rely heavily on contract enforcement – should not view Peru as their best option. If drawing up contracts is necessary, it is advised that companies hire legal counsel familiar with Peruvian law. Companies should specify exact terms of payment and performance, monitoring details of the contract closely. In Peru, contracts are viewed more as guidelines of the relationship, so specificity in drawing up contracts is necessary for small firms when discussing deliverables. Companies that are looking solely to export to Peru can bypass many of these legal issues, thereby mitigating their legal risk.

Another risk to foreign direct investment in Peru is the absence of intellectual property rights protection. Peru has been on the U.S. Trade Representative's Special 301 watch list for Intellectual Property Rights since 1992, posing a threat to companies in R&D intensive industries. SMEs in industries like pharmaceuticals and others that rely heavily on research and development are encouraged not to invest in Peru. Small firms may not have the resources to fight a legal battle over IPR, and without legal protection, these companies lose their competitive advantage in the market. Companies that attempt to invest in Peru must register any patents and trademarks with the INDECOPI (National

Agency for the Competition and Intellectual Property Protection) to receive legal acknowledgement and protection.

Related to the legal process is the social environment in Peru and how it affects the operation of businesses within the country. There has been conflict between the public and the government over the operation of foreign businesses in rural areas of Peru, especially within the mining industry. For example, in 2011 a Canadian company was in the process of scouting a silver mine in Puno, but after violent protests from the public, the government withdrew the company's mining rights, forcing them out of the area. Again in 2015, an Argentinian company, Pluspetrol, was forced to terminate exploration of gas deposits due to public conflict (BMI Research, Peru Trade). Very recently, in May of 2015, troops were sent to restore order in Arequipa when protests against a new copper mine turned violent. These examples show that mining, construction, or extraction companies should not invest in Peru in the current situation. The tension surrounding these types of projects puts the enterprise at risk, and could result in violence against the company.

Companies focused solely on trade with Peru instead of foreign direct investment, such as manufacturers of consumer goods or mining and construction equipment, have a positive outlook because they avoid many of the risks associated with incorporating and operating in Peru. For these companies, the U.S. Commercial Service in Peru is an essential resource. Like other Commercial Service offices, the Commercial Service in Peru can meet personally with companies to evaluate market strategy, provide advanced market research, and inform companies of preferential trade practices, giving small firms the backing and encouragement of the U.S. government.

HYPOTHETICAL CASE STUDY

In order to more clearly demonstrate strategies for SMEs in these focal markets, consider the case of the fictional company, Smith and Oliver (S&O) Manufacturing. S&O Manufacturing is a South Carolina manufacturer with 200 employees located in Greenwood, SC. Their main products are industrial machinery (HS Code: 84) which includes machinery and plant equipment for large-scale manufacturing plants. Examples of these are power plants or plants that produce construction and mining equipment. S&O Manufacturing's expansion goals are to enter the Latin American market by forming a subsidiary to either manufacture goods in the target country or to distribute goods manufactured in the United States and exported to Latin America.

In terms of exporting, the executives at S&O Manufacturing realized that industrial machinery products represent the largest import product group for Peru and Colombia and the second largest for Chile. That product group makes up 12.1% of Chilean imports, 15% of Peruvian exports, and 12.8% of Colombian imports (UN Comtrade). All three of these countries represent a demand market for these goods. One concern for exporting to these countries are falling global commodity prices as these countries are all highly dependent on commodity exports. If global prices continue to fall over the next few years, the purchasing power of these countries will decline. Therefore, companies attempting to export luxury or non-essential consumer goods would see a decline in sales abroad. However, firms exporting industrial machinery to support the manufacturing sectors in these countries will experience much more stable demand, so S&O Manufacturing will be able to continue exporting to Colombia, Chile, and Peru once they begin. They would also benefit from economies of scale from increased

production and greater production efficiency in their Greenwood, SC plant (Madura, 420).

S&O Manufacturing's motives for FDI can be split into revenue related motives and cost related motives (Madura, 417-420). The revenue related motives include attracting new sources of demand through new markets and entering a profitable market where there is potential for high earnings. As for cost related motives, FDI would allow them to take advantage of foreign factors of production through low costs of labor and/or land.

The next sections will detail proposed plans for S&O Manufacturing for Colombia, Chile, and Peru and conclude with a recommendation for the country that provides the most opportunity for success.

S&O MANUFACTURING – COLOMBIA

Although there has been increased FDI in Colombia in recent years due to economic reforms and increase bureaucratic efficiency, Colombia is ranked 83rd worldwide in terms of corruption and suffers from a weak legal system that does little to enforce contracts or protect property rights. These factors combined together present significant risk to SMEs planning to build operations in Colombia. Another risk factor present with FDI is the conflict between the Colombian government and FARC. Manufacturing is normally established in rural areas to reduce land and operational costs, however, in Colombia, FARC still maintains some control in those regions, especially in the South and the East. As the feasibility of FDI is dependent on the outcome of political conflicts, it is not recommended that S&O Manufacturing build manufacturing plants or invest in Colombia until peace talks with FARC are resolved.

Therefore, exporting to Colombia would be the favorable, and less risky, strategy. S&O Manufacturing should manufacture their products in their Greenwood, SC plant and take advantage of reduced tariffs on 80-100% of industrial goods through the U.S.-Colombian FTA to export those goods to Colombia. This strategy avoids operational risk in-country while still reducing costs, representing a safer entry into the market. Also, Greenwood is located just over three hours from the port of Charleston, a major international port that services Colombia. This shipping route is the most convenient, and therefore cheapest, of all the prospective countries. Another benefit is that Colombia is currently running a trade deficit with imports outweighing exports which bodes well for U.S. companies looking to export to Colombia. All of these factors support the business plan of exporting manufactured goods to Colombia as opposed to investing in subsidiaries in-country. As soon as peace talks are settled between the Colombian government and FARC, the threat will most likely disappear and FDI will become a more feasible option. However, exporting is the best option for S&O Manufacturing in the current political and business environment.

S&O MANUFACTURING – CHILE

Chile represents the least risky environment of all three countries. It is the most receptive to FDI and companies, especially SMEs, can take advantage of the government incentives offered to foreign companies. Enforced intellectual property rights, protected property rights, and absence of corruption mitigate many of the risks associated with operating in Latin American countries, making it easier to conduct business there, especially for small firms with limited resources. The time to incorporate a business in Chile is 5.5 days, making it easy to enter the Chilean market quickly and start operations.

As a manufacturer of industrial equipment, S&O Manufacturing's should market its products to companies in Chile's mining and construction sectors. In Chile, mining projects may be hard to come by as they must be approved by the Chilean Copper Commission. However, S&O Manufacturing simply produces the machinery to then be used by mining companies, meaning they would be indirectly involved in the mining sector and would need no such approval. As the mining industry is so important to Chile's economic performance, there will always a need for industrial grade equipment to support that sector, providing steady, long-term demand for S&O products.

However, exporting to Chile is also an option for S&O Manufacturing. As of January 2015, 100% of U.S. consumer and industrial goods are duty free, allowing easy market entrance for small U.S. exporters like S&O Manufacturing. Chile's well-developed manufacturing environment reduces the demand for manufactured consumer products, but presents a large market for imported machinery and mechanical appliances to support the manufacturing and mining industries. By choosing to export to Chile, S&O Manufacturing avoids the upfront capital costs of incorporating and building operations in Chile while still obtaining access to the Chilean market. However, if S&O Manufacturing decides to focus on exportation, their potential clients would grow to include manufacturing plants in Chile as well as mining and construction companies, creating a larger consumer base.

To be successful in the Chilean market, S&O Manufacturing is recommended to either invest in building operations in Chile or to export as both represent low-risk, cost effective strategies. The decision depends on the company's long-term goals for involvement in Latin America. A potential plan might be to export products to Chile as a

way to test the market reaction and reevaluate FDI once the company has established a steady consumer base in country.

S&O MANUFACTURING – PERU

Peru is not currently the most attractive destination for U.S. FDI, not for any economic reasons, but due to concerns over legal risk. Corruption is prevalent in Peru, permeating the legal system and presenting risk for foreign companies operating in Peru. Its weak legal system and lack of contract enforceability create legal and operational risk for foreign firms attempting to resolve disputes through the legal system. If S&O Manufacturing were to build subsidiaries in Peru and suffer through these drawn out processes, it would significantly affect cash flows from the subsidiary to the parent company in South Carolina. The feasibility of a project is primarily measured through net present value and focuses on cash flow to the parent company. Any environment that can delay or halt those payments takes away from the feasibility of a business plan. Therefore, it is recommended that S&O Manufacturing mitigate legal risk by manufacturing in the United States and exporting to Peru.

Peru, much like Colombia, is suffering from contracted buying power due to falling global commodity prices upon which their economies are dependent. However, as with Colombia, luxury and non-essential consumer goods are the products that suffer from the decline in imports. Industrial goods that support the manufacturing, construction, and mining sectors will maintain more stable demand and pull through the commodity pricing slump. 80% of these industrial and consumer goods are no longer subject to tariffs due to the U.S.–Peru free trade agreement, and the last 20% will be phased out by 2019. Although not all goods are phased out yet, it is important to

remember that Peru has the lowest average tariff rate in the region, making exporting an attractive strategy for U.S. firms. If S&O Manufacturing were to pursue exporting to Peru, they should take advantage of the lowered tariffs and market to mining companies and manufacturing plants in Peru. However, shipping to Peru would be more expensive than to Colombia due to its location on the Pacific Coast of South America. S&O would have to ship from Charleston, through the Panama Canal, to Peru, or ship cross-country by truck to California and then by boat to Peru. This would result in increased costs to deliver the goods to the target market.

To be successful in the Peruvian market, S&O Manufacturing is not recommended to engage in FDI due to the prevalence of corruption and the absence of contract enforceability. The best strategy in terms of cost and risk mitigation is to manufacture their products in-house and export them to Peru. However, S&O Manufacturing should work with the U.S. Commercial service in Peru to create partnerships with Peruvian firms. These companies may take on some of the cost of shipment and therefore make this strategy more cost-effective for S&O Manufacturing.

RECOMMENDATIONS

Overall, considering operational and legal risk, cost, ease of doing business, and long-term sustainability, Chile would provide the most welcoming environment and opportunity for success for S&O Manufacturing. The country offers a business environment conducive to both exports and FDI along with a strong and transparent legal system to resolve any possible disputes. S&O Manufacturing would benefit from lack of tariffs and stable manufacturing and mining industries which provide demand for their products.

In order to form a detailed market entry strategy, S&O Manufacturing would have to analyze their products in order to narrow down their offerings and focus their marketing to a specific type of customer-mining companies, manufacturing plants, construction firms. They should then meet with both the South Carolina Small Business Development Center and the U.S. Export Assistance Center in South Carolina to take advantage of market analysis resources and specialized expertise in exporting to Chile.

CONCLUSION

There is a common misconception that because many Latin American countries share a common language, that they are similar economically and culturally. Many large corporations, when entering the Latin American market, create a Latin American strategy, assuming that it will be applicable and effective in every country. This is a gross misstep. A marketing strategy that performs well in Brazil will not always produce results in Chile. A market entry plan built for Colombia will most certainly fail in Venezuela. Each country has its own economic, political, and cultural environment, requiring analysis of the legal system, administrative bureaucracy, trade policies, political stability, business culture, and much more in order to design a successful business plan.

The purpose of this report is to use Colombia, Chile, and Peru as examples of similarly sized Latin American countries, with similar economic and trade impact, that have vastly different business environments. Their unique histories and economic policies have created unique competitive industries within each country that makes them attractive. The cultural differences between countries also have a significant impact on conducting business successfully in each country. This report has outlined many of the risk environments, competitive sectors, and cultural norms in each country in order to

provide a basic understanding of the business environments for small and medium-sized enterprises. Small firms will use this as a resource for preliminary analysis of the Colombian, Chilean, and Peruvian markets, as well as a basis for their product-specific market research to then successfully engage in these Latin American markets.

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Glossary

EU – European Union

FTA – Free Trade Agreement

Identidad nacional – a feeling of belonging to a commonly shared cultural, social, and historical identity, usually accompanied with national pride.

IPP – Intellectual property rights

PDI – Power Distance Index

SME – Small and medium-size enterprise

Trade deficit – the amount by which the cost of a country's imports exceeds the value of its exports.

TPP – Trans-Pacific Partnership

WTO – World Trade Organization