

2001



Foreign investment

IN LATIN AMERICA
AND THE CARIBBEAN



UNITED NATIONS

ECLAC



ABSTRACT



Foreign direct investment (FDI) flows to Latin America and the Caribbean dwindled for the second year in a row in 2001, and preliminary data for 2002 show no signs of a recovery. This trend was observed in both greenfield investment and mergers, acquisitions and privatizations. The investments announced by transnational corporations (TNCs) for the coming years remain concentrated in the service and infrastructure sectors. This indicates that the region has continued to strengthen its links with the incipient networks being established in service provision at the global level. This development contrasts with the Latin American economies' gradual disengagement from international production systems led by TNCs in the manufacturing sector. This combination of trends has been most evident in the South American countries.

In addition to providing an overview of current FDI trends in Latin America and the Caribbean, this publication presents in-depth analyses of investment flows to Argentina both before and after the introduction of economic reforms, as a sample analysis of a recipient

country; of the European Union as an international investor region; and of the hydrocarbons sector as a branch of activity that clearly illustrates the role of sectoral reform in attracting FDI.



SUMMARY AND CONCLUSIONS



Foreign investment in Latin America and the Caribbean, 2001 Report comprises four chapters. The first presents a region-wide analysis of recent trends in FDI flows, comparing them to FDI flows in the global economy, and looks at the investment strategies and approaches being used by the primary transnational corporations with interests in the region. The second chapter focuses on foreign investment in Argentina, which is now in the throes of a major economic and political crisis that has affected all economic agents in the country, including TNCs. This crisis has forced the latter to reorient their strategy after a decade in which Argentina was one of the chief recipients of FDI. The third chapter analyses FDI from the European Union, whose members, as part of their integration strategy, chose Latin America as the developing region of greatest significance for the expansion of their transnationals' activities, and accordingly have supplied a substantial inflow of investment. The fourth and final chapter contains an analysis of FDI in the hydrocarbons sector, in which the reforms of the 1990s have attracted new participants and encouraged investment flows to the region.

The regional outlook

FDI flows to Latin America and the Caribbean reflect the global forces that shape the world environment, and are further conditioned by processes within the region. As a result, after their unprecedented growth in the 1990s, FDI flows thus far in the current decade have registered a drop from US\$ 105 billion in 1999 to US\$ 80 billion in 2001, although net inflows of this type of investment are still higher than their average level over the past five years.

While the statistics on FDI in Latin America and the Caribbean are not unfavourable in comparison to those on global FDI trends, since the former fell by 10% and the latter, by 50%, they reflect some factors that could adversely affect the region in the medium term. Some of these factors are related to current international conditions, while others are of a more structural nature.

Uncertainty about the recovery of the United States economy in the first quarter of 2002¹ and expectations of slow growth in Europe and Japan imply that the chances of a recovery in global FDI flows are slim. A low global growth rate results in lower levels of investment overall, a decline in corporate profits and a slide in their stock prices, all of which affect FDI.

The structural factors include the fact that the countries have completed the implementation of economic reforms, which attracted much of the wave of FDI in the 1990s, especially through the privatization of large State enterprises in the energy and basic services sectors. By way of example, between January and April 2002 only two transactions were conducted, both in

relation to electric power plants, for a total of US\$ 36 million. While FDI flows tend to vary widely from one period to another, if this rate of investment continues for the rest of the year, the final figure will reach only US\$ 432 million, which compares unfavourably to the US\$ 1.35 billion invested in 2001 and, particularly, to the US\$ 18 billion invested in 2000.²

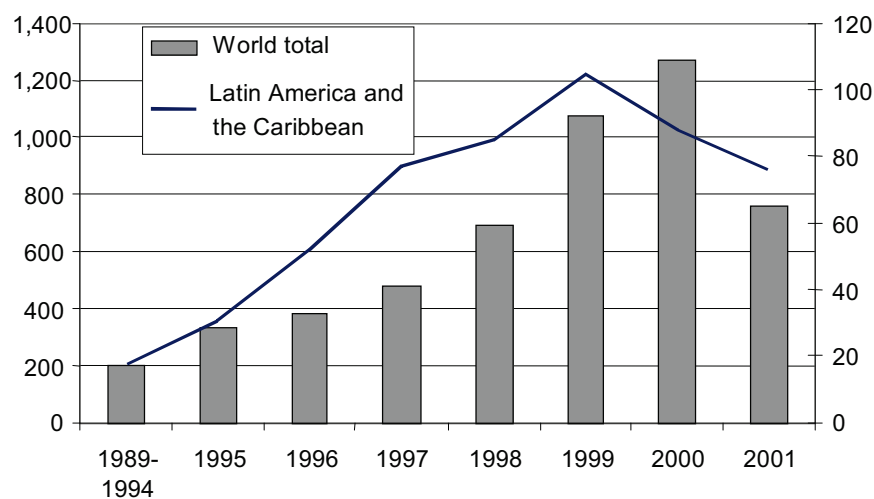
Secondly, the takeover of large domestic firms by TNCs, which generated a large proportion of investment flows in the late 1990s, has been succeeded by a period of consolidation of the resulting industrial organization. Transactions of this type in the first quarter of 2002 amounted to US\$ 4 billion. The annualized figure is lower than the one for 2001 (US\$ 25 billion) and much lower than the annual average for the biennium 1999-2000 (US\$ 43 billion).

Future investment is expected to comprise a larger proportion of greenfield investment, which is harder to obtain and depends on the projections of TNCs in Latin America and the Caribbean within their overall strategy. These projections hinge not only on the countries' political, economic and social stability, but also on the region's dynamic potential for economic and technological growth and development. The future investment plans which TNCs announced to the press between January 2001 and April 2002 focus mainly on infrastructure sectors, while investment in manufacturing, which accounted for 24% of the total in the 1990s, represents only 4% of the total projects announced.

¹ It should be borne in mind that the United States economy's annualized growth rate of 5.8% primarily reflects a slowdown in firms' inventory build-up and high government expenditure, especially on defence. Household consumption grew by 3.5%, but fixed investment declined; this will be extremely counterproductive for sustained economic growth. (More information on this subject can be found in "A hard act to follow", published in *The Economist*, 2 May 2002.)

² See table I.10 of this publication, table I.13 of the 2000 edition and the *Economic Survey of Latin America and the Caribbean, 2000-2001*.

NET FDI INFLOWS IN LATIN AMERICA AND THE CARIBBEAN AND IN THE WORLD
(Billions of dollars)



Source: ECLAC, Information Centre of the Unit on Investment and Corporate Strategies, Division of Production, Productivity and Management, on the basis of chapter I, table I.1, of this publication.

**LATIN AMERICA AND THE CARIBBEAN: AMOUNTS OF FUTURE PROJECTS
ANNOUNCED BY TRANSNATIONAL CORPORATIONS BETWEEN
JANUARY 2001 AND APRIL 2002 ^a**

Sector	Amount (Millions of dollars)	Percentage
Primary	5,008	15.7
Petroleum and natural gas	5,008	15.7
Manufacturing	1,360	4.3
Services	25,528	80.0
Financial	129	0.4
Electricity	14,030	44.0
Telecommunications	5,480	17.2
Commerce	726	2.3
Infrastructure and transport	4,331	13.6
Sanitation	832	2.6
Total	31,896	100.0

Source: Chapter I, annex table A.I.1.

^a Announced projects scheduled to be carried out in the next five years.

Lastly, a phenomenon that is particularly influential in Asia and the Pacific, but nonetheless affects Latin America and the Caribbean as well, is China's strong attraction of global FDI (see the first section of chapter I). FDI flows to China approached US\$ 40 billion in the past five years and continued to increase in 2001. Factors such as the country's entry into WTO and its relatively low wages, announced improvements in infrastructure and enormous domestic market, which is expected to register a strong increase in purchasing power, are likely to divert FDI flows targeting developing countries towards China.

The key problem, then, is to identify which of the factors that have emerged since the implementation of economic reforms can encourage capital inflows and, at the same time, strengthen regional development. The authorities of several countries have considered this question³ and have concluded that, in an environment of keen competition for dwindling FDI flows, countries must have more policy options regarding this type of investment. In comparison to what has happened in Asia, the Latin American countries have tended to limit themselves in the area of productive development policies. This is evident both in the negotiation of bilateral or multilateral investment agreements and in the investment clauses of free trade agreements, which merely provide guarantees and protection to investors without defining their relationship to the national development strategy. The countries of the region have also been somewhat reluctant to use all the instruments at their disposal. For example, they use targeting⁴ much less often than countries in Asia or Europe, where this strategy is commonly employed.

To compete more successfully for FDI, to make better use of the relevant resources and to ensure consistency between the objectives of corporate strategies and national policy goals, the countries must activate and

clarify all aspects of their FDI policy. Accordingly, the "development dimension" must be spelled out in future multilateral negotiations on FDI. In other parts of the world, policies to establish and strengthen links between transnational and local firms are becoming increasingly widespread. Some important features of successful programmes are strong political commitment, consistency between ends and means, definition of responsibilities and effective cooperation between the public and private sectors.

At the microeconomic level, TNCs are playing an increasingly important role in the regional economy. There are many indicators of this trend, but the ones discussed in this publication are the shares of TNCs in the ownership of leading firms, in sales and in exports. While FDI has been credited with helping to open up new markets, speed up technological progress and increase capital formation, some factors that undermine its potential can be detected in the region.

These factors include, in particular, the enclaving of FDI and the lack of linkages between most TNCs and the rest of the region's production system. Moreover, except in Mexico, FDI has had little effect on competitiveness, measured in terms of the countries' share of world trade. The table below shows the decline in the South American countries' participation in world trade, in relation to both their share of total exports in the world market and their share of non-resource-based manufactured exports, especially high-technology products, which are the most dynamic exports in world trade. On the other hand, Mexico and the Caribbean Basin countries have gained competitiveness in the past five years, especially since Mexico joined NAFTA, but their performance cannot compare to China's achievements. This phenomenon is attributable in part to the concentration of FDI in new plants and in research and development. TNCs have not given priority to this strategy in the region.

³ See the description of the case of Chile in chapter I; the cases of Costa Rica and the Dominican Republic in the 1999 and 2000 editions of *Foreign Investment in Latin America and the Caribbean*; and the report of the ECLAC/UNCTAD regional seminar on foreign direct investment in Latin America, held from 7 to 9 January 2002 in Santiago, Chile.

⁴ The term "targeting" refers to efforts to attract specific kinds of FDI by highlighting a few activities or sectors that reflect the country's comparative advantages.

**LATIN AMERICA AND CHINA: INTERNATIONAL COMPETITIVENESS
IN WORLD IMPORTS**
(Percentages)

	1985	1990	1995	2000
Share of the world market				
Total exports				
China	1.60	2.81	4.80	6.12
South America	3.40	2.76	2.76	2.62
Mexico and Caribbean Basin	2.39	1.96	2.40	3.35
Non-resource-based manufactures ^a				
China	1.47	3.41	6.11	7.83
South America	1.24	1.14	1.12	1.03
Mexico and Caribbean Basin	1.34	1.55	2.33	3.57
High-technology manufactures ^b				
China	0.36	1.35	3.63	5.98
South America	0.47	0.36	0.29	0.45
Mexico and Caribbean Basin	1.66	1.40	1.91	3.19

Source: TradeCAN software, 2002 edition, ECLAC. Merchandise categories based on the Standard International Trade Classification (SITC, Rev. 2).

^a Includes 120 groups representing the sum of activities in the textile and clothing, paper products, glass and steel and gems sectors and groups in the automotive, processing and engineering industries, namely the electronics group plus other pharmaceutical products, turbines, aeroplanes and instruments.

^b Includes the engineering industry: the electronics group plus other pharmaceutical products, turbines, aeroplanes and instruments.

FDI in Argentina

Argentina was one of the leading FDI recipients in the 1990s. The privatization of State holdings, the introduction of a fixed exchange rate as a means of controlling inflation (Convertibility Act) and efforts to revitalize the regional integration process, especially with Brazil, in the framework of MERCOSUR facilitated the operations of foreign firms, enabling them to expand their activities into many areas that had previously been restricted. This occurred primarily in the areas of infrastructure and public services, in which the privatization programme had a decisive influence. First, foreign firms, together with local groups and international banks, acquired the vast majority of the State holdings offered for sale. Subsequently, international operators increased their shares in the ownership of privatized firms, displacing local groups and foreign banks. This gradual concentration of ownership took place through an intensive process of mergers and acquisitions, in which TNCs were once again the big winners.

TNCs were the most dynamic engine of Argentina's economic restructuring process in that period. They benefited, to greater advantage than most domestic firms, from the new conditions of competition and the incentives implicit in the structural reform programme. The FDI flows that Argentina received in the last decade radically changed the country's business landscape. Foreign firms increased their share of the sales of the country's 100 biggest firms from just over 24% in 1991 to nearly 50% in 2000. A sizable proportion of this increase was achieved through the purchase of existing assets, which did not result in the broadening of the country's productive capacity. Nonetheless, these investments undeniably helped to improve many of the services that were privatized, thereby enhancing Argentina's systemic competitiveness.

Until 1998, before the Asian crisis, Argentina offered foreign investors a highly favourable environment in which to carry out their activities, beyond the

opportunities opened up by the economic reforms, particularly the price stability and exchange-rate security provided by the convertibility regime. Macroeconomic conditions then deteriorated, shaking the confidence of economic agents, as shown by the imposition of high risk premiums for external financing and a sharp contraction in private investment. In these circumstances, the presence of numerous foreign firms and their particular sectoral distribution became part of the problem.

First, the concentration of FDI inflows in the purchase of existing assets in non-marketable services sectors had the effect of limiting the authorities' flexibility in managing external imbalances. Initially, the purchase of firms by foreign investors helped to narrow the external gap, but as the investments matured the foreign firms located in Argentina began to demand a large volume of foreign exchange for the remittance of profits and capital abroad. This problem was rooted in the operating conditions negotiated in the process of privatizing public service and infrastructure enterprises. It is now clear that these agreements were unsustainable for purposes of maintaining the country's competitiveness, since the fact that rates were set in dollars prevented the firms that used these services as inputs from implementing a consistent cost policy.

Following the severe blow dealt to the Argentine economy by the Mexican peso crisis of late 1994, the authorities encouraged large-scale foreign investment in

the banking sector with a view to preserving the system's stability and preventing additional capital flight and massive bank withdrawals. The theory was that this would result in a transnationalized, well capitalized banking system with an international lender of last resort: the home offices of the banking subsidiaries operating in Argentina. However, in late 2001, expectations of devaluation brought about a sudden drop in international reserves, the breakdown of the convertibility regime and a new and intractable financial crisis.

Meanwhile, foreign investment in marketable activities, particularly in manufacturing, suffered the rigours of the convertibility regime, with the result that the corresponding output lost much of its competitiveness in international markets. Many plants closed or confined themselves to supplying the domestic market, thereby increasing the difficulty of reducing the Argentine economy's external shortfall.

In brief, FDI flows have had ambiguous effects at both the macroeconomic and the microeconomic level. On the one hand, these inflows alleviated the country's external account imbalances in the short term, but led to tighter constraints in the long term as a result of increasing profit remittances. On the other hand, in the area of production, these inflows brought about rapid modernization, but with few linkages and little diffusion to the rest of the local economy; in the area of services, their effects reflected the inconsistency between rate-setting formulas and systemic competitiveness.

FDI in the European Union

The European Union has become one of the world's leading markets, with nearly 400 million high-income residents, some 300 million of whom share a common currency. Its population is slightly smaller, but has a per

captured 13.5% of investments made outside the European Union and 6.5% of the latter's total investments. Within the region, the main recipient of this capital was MERCOSUR.

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