Foreign Direct Investment in Latin America under a More Protectionist Landscape

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Summary

Foreign Direct Investment (FDI) to Latin America and the Caribbean (LAC) suffered a contraction in 2015 of 2% YoY and it is estimated to further decline in 2016.

Many factors influence increases and decreases in FDI flows and stocks. This paper has put its attention in two predominant drivers of FDI in LAC which are 1) the overall economic situation of the country/region highly influences FDI flows; 2) the growing nationalism/protectionism in many developed countries could lead to some trade modifications that will have long term effects on FDI.

FDI inflows to the LAC region may recover somewhat in 2017. A recovery is possible because it is expected that commodity prices increase somewhat in 2017 and the overall economic performance of LAC is projected to improve as well. While there are positive signs for the region as a whole, Mexico is an outlier to this trend as its FDI inflows are expected to decrease due to the uncertainty related with its relations with the United States and the potential changes to trade agreements between the two countries.

While the overall economic performance is expected to improve in 2017, an increase of nationalism/protectionism in developed countries could lead to more trade and investment restrictions in the medium/long term that could impact FDI inflows into the LAC region.

Although FDI's contribution to total GDP in Latin American countries is not high, there are other second tier implications that are at least as important (and probably more so) for development and economic growth. These include technology transfer, improved skills, increased knowledge, greater innovation, and FDI transfers new managerial and organizational practices to the recipient countries. FDI also creates more competition and could lead to higher productivity and lower prices.

1. Recent trends in FDI in Latin America and the Caribbean

Environment of FDI in Latin America in the 1980s-1990s

Historically, many countries in Latin America had protectionist measures in place during the 1980s as a part of their import substitution model of development and regularly faced a variety of economic crises, such as defaults on government debt obligations. During the 1990's, the region began opening up to international markets and shifted some economic decision making from the state to the private sector. As market forces became the principal driver of competition and innovation, governments lowered trade barriers, reduced price controls and relaxed capital account restrictions, opening up their economies to international financial flows, including foreign direct investment (FDI)[1]. Eventually, the region was able to largely create an environment of relative economic stability after the series of debt crises that afflicted the region in the 1980's and early 1990's. This stability allowed the region to reduce inflation and to make institutional reforms that encouraged the private sector to make investments.

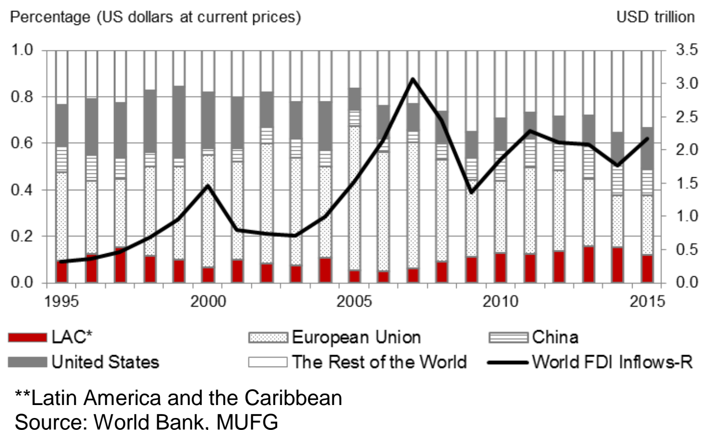
Benefits of FDI

It is known that the benefits of FDI go beyond investments in resources or capital formation. FDI also leads to technology transfer, improved skills, increased knowledge, greater innovation, and FDI transfers new managerial and organizational practices to the recipient countries. FDI also creates more competition and could lead to higher productivity and lower prices. On the macroeconomic level, FDI could have a positive impact on the balance of payments. In Latin America most FDI inflows are directed to the manufacturing and natural resource sectors, and the region has been able to underpin a pattern of international integration that has helped countries to develop their regulatory frameworks and to adopt strategies to attract FDI via the modernization and diversification of their economies.

Global Trends in FDI

Between 2011 and 2014, FDI inflows were unable to recover to the level shown before the financial crisis. However, 2015 saw an improvement in global FDI inflows and total inflows in 2015 were greater than they were in the years immediately after the financial crisis (2010-2011) (Figure 1). This result was mainly because FDI inflows into developed countries increased, principally in the United States.

Figure 1: Global FDI Inflows



**Latin America and the Caribbean
Source: World Bank, MUFG

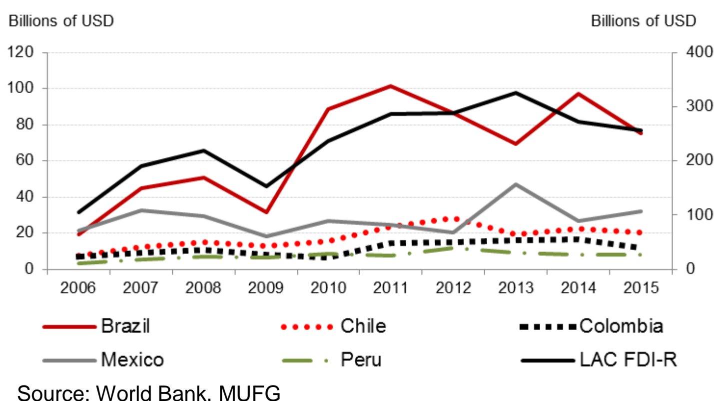
[1] Trevino, L., Daniels, J., Arbelaez, H., & Upadhyaya, K. (2002).

FDI in Latin America

The worldwide economic slowdown in 2015 and 2016, mainly caused by the slowdown in China's economy (the principal market for natural resources) and a decrease in commodity prices, has caused Latin America and the Caribbean (LAC)[2] to experience a reduction in FDI receipts of 2% in 2015 (this decrease was mainly driven by FDI inflows to Brazil, figure 2).

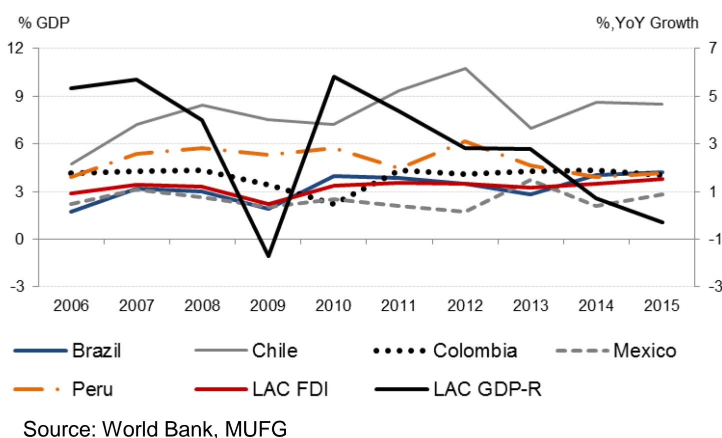
FDI inflows to Latin America remained largely unchanged over the last five years at around 3.5% of GDP (Figure 3), the distribution of world FDI flows between countries in the Latin America region was and is quite diverse. Notwithstanding these differences, countries such as Brazil, Mexico, Chile and Colombia capture most of the foreign investments in the region (Figure 4). These four countries (and the entire region more generally) share some characteristics such as an abundance of natural resources (such as oil or copper), and cheap labor. In addition, the larger countries (Brazil and Mexico) also have important domestic markets that have been attractive to foreign companies and investors. These investments have historically been focused on manufacturing activities and activities related with the extraction of natural resources.

Figure 2: FDI Inflows to Latin America



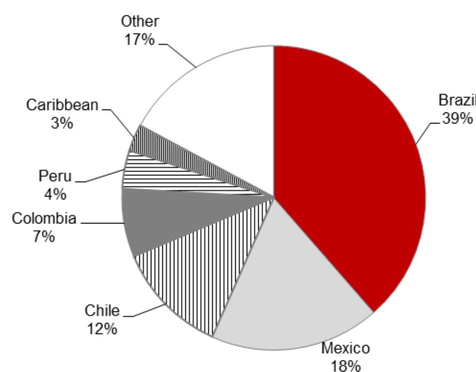
Source: World Bank, MUFG

Figure 3: FDI Inflows to Latin America and GDP Growth



Source: World Bank, MUFG

Figure 4: Distribution of Total Inward FDI to LAC, 2015



Source: United Nations Conference on Trade and Development (UNCTAD), MUFG

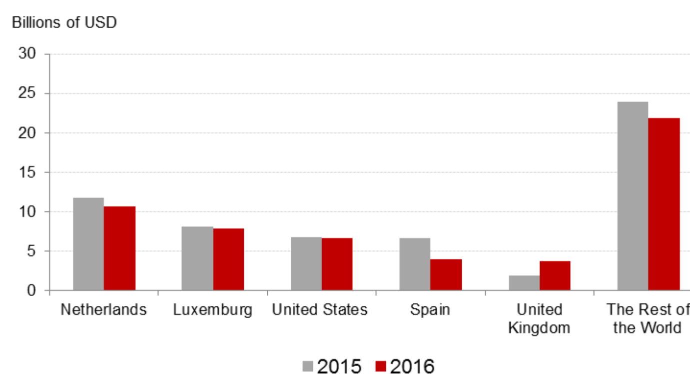
[2] Based on the World Bank classification. 28 countries are taken into account: Antigua and Bermuda, Argentina, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, St. Kitts and Nevis, St. Lucia, Suriname, Uruguay, Venezuela.

FDI in Brazil and Mexico

Almost 40% of total FDI inflows were received by Brazil (39%) in 2015, followed by Mexico with around 20% and Chile with 12%. During 2015, Brazil experienced a contraction in FDI of more than 20%, (compared to 2014) and in 2016, Brazil's FDI also decreased, but at a less dramatic pace of about 7%. These reductions in FDI to Brazil were principally the result of decreased investment from European countries, principally Spain (40%) (Spain is the fourth more important country in terms of FDI in Brazil). The United States, which is the third largest source of FDI in Brazil, also cut its FDI to Brazil in 2016 by about 2% (Figure 5). Mexico registered an increase in FDI inflows of about 20% YoY in 2015. However, the latest information available, through the third quarter of 2016, revealed that Mexico experienced a contraction in FDI inflows of about 23% YoY. This reduction was the result of a drastic reduction of 40% in new investments[3] in Mexico, with the United States reducing their flow of FDI to Mexico by almost 50% (Figure 6). This reduction is not a surprise taking into account the lackluster performance of the Mexican economy in 2016.

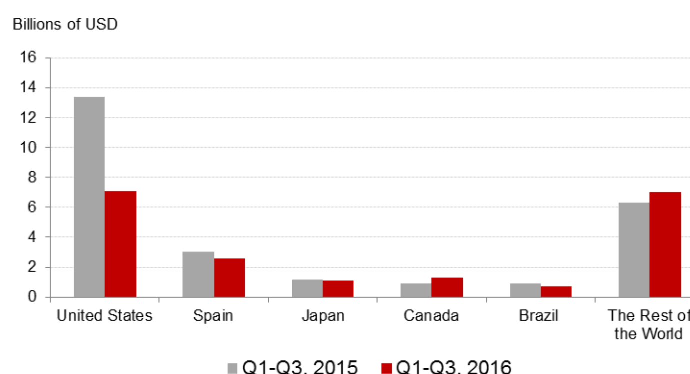
In the case of Brazil, the service sector represents a little over 45% of total FDI received, followed by industry (38%). Mexico, on the other hand, has seen its FDI inflows concentrated in the industry sector (73%) while the service sector receives only 26%. The service sector saw the greatest decline in FDI inflows in both Mexico and Brazil (Figure 7). In the case of

Figure 5: Brazil's FDI Inflow by Country



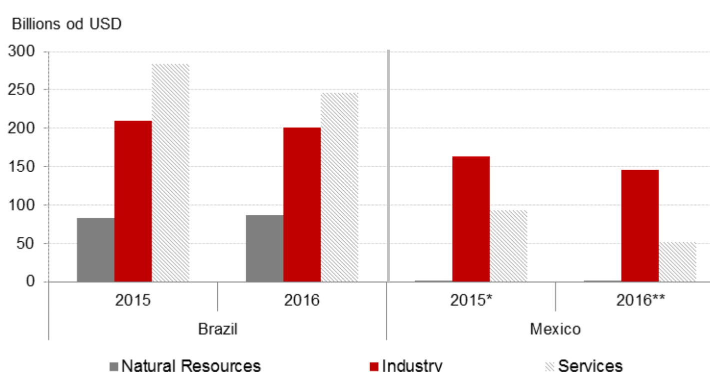
Source: Central Bank of Brazil, MUFG

Figure 6: Mexico's FDI Inflow by Country



Source: Economic Ministry of Mexico, MUFG

Figure 7. FDI Inflow by Sector, Brazil and Mexico



*From Q1 to Q3- 2015
** From Q1 to Q3- 2016
Source: Central Bank of Brazil, Economic Ministry of Mexico, MUFG

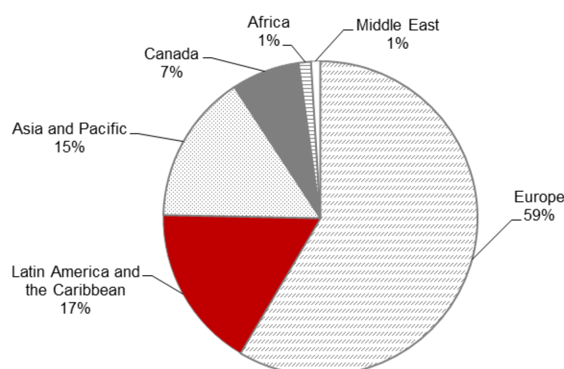
[3] FDI in Mexico is categorized by three type of investment; new investments, reinvestments of profits and transactions between companies of the same corporative group. Between the 1Q to 3Q reinvestments decreased in 20% and the transactions between companies increase 10%.

Brazil, this was because of decreased investment in electricity and utilities, telecommunications, and real estate. The decrease in Mexico's FDI in commerce and telecommunications from Q1-Q3 2015 to Q1-Q3 2016, was the principal driver in the overall decrease. As was mentioned above, Mexico's industry sector continues to benefit greatly from inbound FDI flows and, specifically, FDI inflows targeting manufacturing. The manufacturing sub-sector receives 80% of total industry FDI. Form Q1 to Q3 2016, manufacturing FDI flows decreased 11% YoY. This is likely the result of the lackluster economic activity Mexico experienced during the first three quarters of 2016, a situation that remains unchanged and will likely deteriorate in 2017.

Main sources of FDI inflows to LAC

The European Union and the United States contribute almost 60% of global FDI outflows**.** The United States, by itself, accounts for about 20% of total FDI outflows and is the largest contributor of FDI in the world. Most FDI from the United States goes to European countries (59%), and Latin American countries receive the second most FDI from the United States, with 17% of total United States' FDI going to the region (Figure 8).

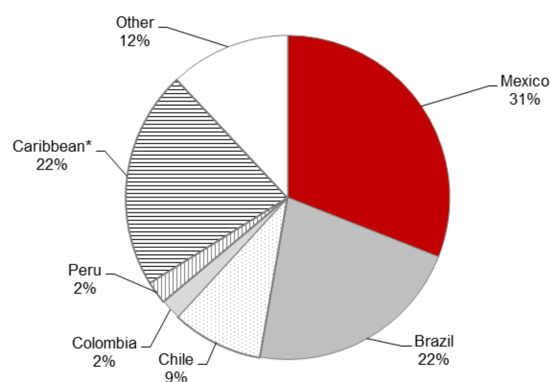
Figure 8: Distribution of US FDI outward to the World, 2015



Source: Commerce Department's Bureau of Economic Analysis, US, MUFG

In Latin America, Mexico is the country that attracts the most FDI from the United States, receiving over 30% of the regional total, followed by Brazil and Chile (22% and 9% respectively) (Figure 9). Mining, wholesale and manufacturing are the sectors in which the United States invests the most in Latin America[4].

Figure 9: Distribution of US FDI Outward to LAC, 2015



*Bermuda and United Kingdom Islands were not part of the FDI Caribbean calculation
Source: Commerce Department's Bureau of Economic Analysis, US, MUFG

In the case of the European Union countries, both Brazil and Mexico are included in the top 10 recipients of their FDI outflows. The latest data shared by Eurostat are for 2014, and then, 6% of total FDI went to Brazil and 2.1% went to Mexico. In both cases, FDI experienced strong growth of 24% YoY for Brazil and 9% YoY for Mexico

[4] This analysis excludes some investments the US does in holding and finance in the Caribbean countries because they are not commonly thought of as FDI.

over the past three years (through 2014). In general terms, the European Union directs its investment flows to the service (57%), manufacturing (28%) and mining (11%) sectors.

2. FDI's Determinants

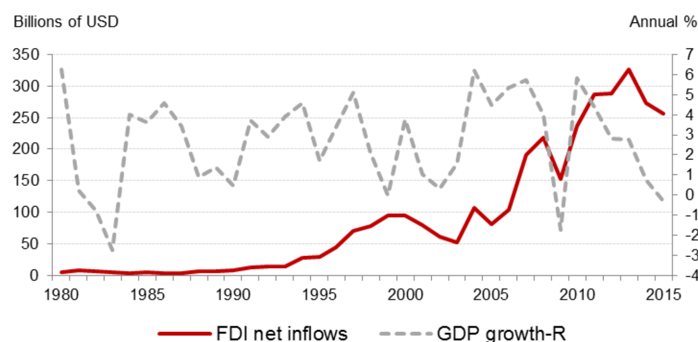
In general terms, there are two main factors that affect, either directly or indirectly, FDI inflows to the Latin American region.

a) FDI associated with economic situation

General Background

During the 1980's and 1990's, the policy measures implemented by governments in the region (mentioned above) incentivized FDI, whose inflows in the region became more and more significant. These increases in FDI inflows were somewhat related with GDP growth. When these economies sent signals of economic strength and stability, FDI tended to increase, and when GDP growth declined or became negative, FDI likewise tended to decrease (Figure 10). The prices of commodities can also be an important driver of FDI flows to the region. In 2016, the low price of many commodities, coupled with the slowdown of the Chinese economy, led to the estimated 8%[5] decline in FDI in the region.

Figure 10: FDI Inflows and GDP, Latin America and the Caribbean



Source: World Bank, MUFG

Outlook

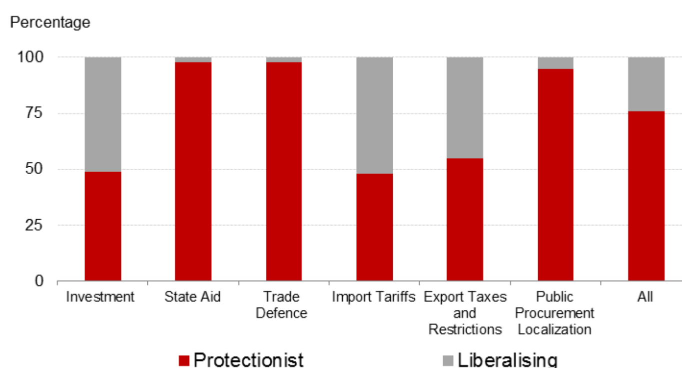
Prospects for the region in 2017 look a bit brighter, with prices for base metals strengthening and economic activity projected to pick up in 2017. Most Latin American countries are expected to experience an increase in their FDI inflows. However, uncertainty surrounding the policy stance of the incoming United States administration is having a negative impact on the Mexican economy in general and FDI inflow more specifically. In 2017, Mexico is expected to have a difficult year, with weak economic activity causing FDI inflows to decrease.

[5] Economic Commission for Latin America and the Caribbean

b) FDI associated with policy measures under a more protectionist landscape

General Background

Figure 11: Implemented Trade Measures by G20 (2009-2015)



Source: Global Trade Alert Report

One of the main challenges FDI is facing is the continued increase of policies measures (of all types) implemented by governments around the world. The latest edition of the Global Trade Alert[6] details Foreign Direct Investment policies among the G20[7]. There, it is interesting to see that since 2008, a total of 554 policy measures related with investment and trade have been implemented; of those, the G20 is responsible for almost 60%. Around 50% of the total number of measures were implemented just after the financial crisis. In 2015, a total of 51 investment policy measures were implemented. Of course, not all these measures harmed investment; in fact, less than 50% of these policies where intended to restrict investment. If we compare this percentage with other protectionist policies countries implemented, investment is the least affected (Figure 11) in terms of restrictions. Although the restriction instruments that were used the most were the ones related with trade, it is known that these policies have knock-on effects for incentives to provide FDI.

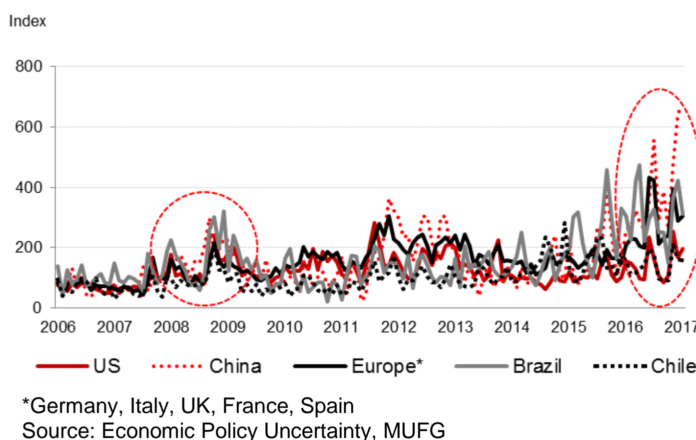
The increased implementation of these policies is the result of government's shifting their outlook on trade and global integration. As populism/nationalism is becoming more popular among many developed countries (immigration and terrorism- are principally the reason of this new trend in these countries), these countries are implementing new policies that are more inward looking, a stark change from the trade and investment policies of the past decades. The United Kingdom and the United States are examples in which the more populist/nationalist position/candidate won (a vote in favor of Brexit in the case of the United Kingdom and Donald Trump in the case of the United States). Other European countries are holding elections throughout 2017 and candidates that align themselves with this populist rhetoric are seeing their chances of winning increase. If these candidates are victorious, it could lead to more strict immigration policies. Although these policies are not directly related to trade, it could be expected that some trade modifications take place that may affect Latin America.

[6] Simon Evennet and Fritz (2016).

[7] The G20 is an international forum for the governments and central bank governors from 20 major economies. It was founded in 1999 with the aim of studying, reviewing, and promoting high-level discussion of policy issues pertaining to the promotion of international financial stability. The countries are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States of America.

Currently, based on the economic policy uncertainty index[8], the private sector faces elevated levels of policy induced risk when compared to the years of the global financial crisis (Figure 12). As was mentioned before, 50% of the measures implemented were trade or investment policies implementing immediately after the financial crisis. The high levels of economic policy uncertainty are related with the weak economic performance of some countries such as China, Brazil and some European countries. In addition, the uncertain social and political environments in many of these countries have added an extra layer of uncertainty surrounding possible policy changes and risk. The clearest case of this uncertainty in Latin America is Brazil, a country that has been in turmoil over the last year due to a series of political scandals that have shaken the government and led to high levels of risk regarding economic and social stability.

Figure 12: Economic Policy Uncertainty Index



*Germany, Italy, UK, France, Spain
Source: Economic Policy Uncertainty, MUFG

Outlook

The short to medium term outlook for FDI is uncertain. Mexico in particular, could see a fall in FDI if the Trump administration follows through on many of its campaign promises. A resurgence of resource nationalism and unfavorable annulment or changes in the terms of foreign investment could pose a challenge to foreign investors seeking to invest in the region. This is what is currently happening between the United States and Mexico. The United States is threatening Mexico with the cancellation of NAFTA and also threatening to place tariffs on goods imported from Mexico. These threats have had an immediate and detrimental effect on the Mexican economy and FDI inflows[9] and if these threats turn into actual policies, the negative effects would increase.

Any abrupt policy changes can handicap the productivity and profitability of foreign investment. For example, if the United States attempts to impose tariffs on goods coming from Mexico, this could easily result in companies deciding to shift production from Mexico to another country. As a result, the potential "new" investment is put on hold or outright cancelled. A final challenge facing future FDI inflows to the region is that the threat of protectionist policies, such as the annullment of the NAFTA agreement, could hurt the profitability of companies that have alredy invested in Mexico. These companies cannot easily move and the sunk cost to withdraw investments can, in many cases, be extremely high.

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[8] The Economic Policy Uncertainty Index, measure policy-related economic uncertainty, it is based on three types of underlying components. One component quantifies newspaper coverage of policy-related economic uncertainty. A second component reflects the number of federal tax code provisions set to expire in future years. The third component uses disagreement among economic forecasters as a proxy for uncertainty. This index is calculated by Economic Policy Uncertainty.

[9] Please refer to Box 1 for some examples

In the medium to long term, increased uncertainty is expected as a result of the potential political changes in Europe that could bring with them new policies restrictions. If European countries implement increased trade and investment restrictions, this could reduce the number of investors seeking to invest outside their home countries. The political landscape at the beginning of 2017 is uncertain. As elections take place in Europe throughout 2017 and the policies of the new administration in the United States become clearer, this uncertainty will possibly decrease during 2017 and a clearer picture on the medium to long term prospects for Latin America to attract FDI could be available by the end of 2017.

Conclusion

It is estimated the FDI inflows in 2016 will decrease. However, the prospects for the region in 2017 look a bit brighter, with prices for commodities strengthening and economic activity projected to pick up in most Latin American countries. As a result, almost all countries in the region expect to experience an increase in their FDI inflows. The lone exception to this general positive outlook is Mexico. Due to the uncertainty surrounding the policy stance of the incoming United States administration, the Mexican economy is suffering, generally, and FDI inflows have taken a substantial loss. In 2017, Mexico is expected to have a difficult year, with weak economic activity causing FDI inflows to decrease.

The medium to long term outlook for FDI inflows to the region is uncertain, with a downside risk coming from two places: first, the long-term economic performance of countries in the region, and second, the impacts of increased protectionist policies in developed countries that could lead to new economic policies and a rethinking of these countries' participation in the international trade system. These changes would possibly lead to more restrictive trade and investment measures that would likely reduce FDI flows to the Latin American region as the trade restrictions would make exports from LAC less competitive and more expensive.

BOX: Reaction of some companies in Mexico to Trump's victory in the United States' presidential election

Trump ran a presidential campaign that focused on returning jobs to the United States and viewed NAFTA and similar free trade agreements as one of the principal culprits of the decline of manufacturing jobs in the United States. The possibility of the United States implementing a more protectionist trade policy against Mexico has generated an uncertain environment for investors in Mexico. Many of these investors have either decided to put some investment plans on hold while the Trump administration more clearly defines its trade policy objectives or have cancelled planned investments entirely.

In the meantime, some companies, like Ford and Carrier, decided to cancel plans to invest in Mexico and to increase their investment in manufacturing facilities in the United States. The decision of just these two companies led to a loss of over 1.6 billion USD and the elimination of almost 3,000 jobs in Mexico.

The Mexican Industry Association, via a survey among its partners shortly after Trump won the election, found that about 40% of projects were put on hold until investors gained more clarity on the direction of United States' trade policy. Other important companies, such as Codan Rubber, a Mexican hose manufacturer for the automotive industry, and Agro Groppo, a potato producer, said that any new investments are on hold due to the current uncertainty.

These are just a few of the many examples of how the investment climate has changed due to the increased uncertainty. Until the United States and Mexico reach an agreement on trade, it is expected that FDI will continue to stagnate and more and more companies will pull their investments from Mexico. The Mexican Government expects FDI inflows to drop by 8% in 2016, when final figures are published. However, the situation could further deteriorate and cause additional companies to change their investment plans, putting Mexico at a disadvantage in the global competition for capital.

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