Euro-Latin American Forum Papers

THE EUROPEAN UNION
DIRECT INVESTMENT IN MERCOSUL

Paulo S. Wrobel

IEEI

November 1999

Euro-Latin American Forum Papers

Title

The European Union Direct Investment in Mercosul

Author
Paulo S. Wrobel
Researcher, The Royal Institute of International Affairs

November 1999

The Euro-Latin American Forum Papers are published by the IEEI, with the support of the European Commission.
The original version of this paper was written in May 1998 for the Euro-Latin American Forum, a project headed by the Institute of International and Strategic Studies (IEEI), in Lisbon, and the Institute Roberto Simonsen of the Federation of Industries of São Paulo State (IRS/FIESP).

IEEI
Largo de São Sebastião, 8 – Paço do Lumiar – 1600-762 Lisboa – Portugal
Phone: (351) 217 572 701 Fax: (351) 217 593 983 E-mail: ieei@ieei.pt

IRS/FIESP
Av. Paulista, 1313 – 01311-923 São Paulo SP
Phone: (55 11) 252 43 98 Fax: (55 11) 252 46 22 E-mail: cirs@fiesp.org.br

Contents

Introduction

Europe and the countries of South America have a long and complex history of economic relations. British financiers, added later on by French and German, were the "bankers of the world" during the nineteenth century, and played a crucial role in the nation funding and state building of the South American republics, as well as the Brazilian monarchy. Concerning trade and investment, Europe – in particular Britain – was the leading partner of the Southern American nations until well into the twentieth century when, during the 1920s, the United States became Brazil's main trading partner[1]. In the cases of Argentina and Uruguay, Britain remained their prime market and investor until after the end of the Second World War.

The history of South America's foreign economic relations after 1945 was very much influenced by the United States predominance in trade, investment and finance, reflecting its worldwide economic leadership. From the 1960s onwards, however, the economic recovery of Japan and Europe – in the case of the latter boosted by the recently formed European Economic Community – contributed to re-establish a balance between United States, Japanese and European economic interest on and partnership with the countries of South America.

This paper focus on current foreign direct investment (FDI) of the European Union in the *Mercado Comum do Sul* (Mercosul) – the economic integration process that includes Argentina, Brazil, Uruguay and Paraguay. It also intends to compare the European Union direct investment flows to the Mercosul with that of the United States, which remains the single largest investor in the area.

The study is organised in the following way: a first session discusses the prominent role of foreign direct investment flows in the global economy; a second session presents the European Union and the United States investment records in the Mercosul in recent years, and briefly analyses the current level of the European Union FDI outflows to the area; a third session deals with the forthcoming European Union agenda, and assesses the impact of the financial and currency crises in Asia, Russia and Brazil over the European Union interest on the Mercosul; a final session discusses the *Mercado Comum do Sul* as a viable project for economic integration in South America and its attraction as a destination for European Union direct investment.

1
The prominent role of foreign direct investment in the global economy

During the 1990s, an extraordinary surge in the flows of foreign direct investment took place in the world economy. From 240 billion dollars in 1990, FDI inflows reached 318 billion in 1995, 359 billion in 1996, 464 billion in 1997 and the staggering amount of 644 billion in 1998.[2] Annual global flows of FDI raised much faster than the average annual rate of growth of either GDP or international trade. Moreover, the accumulated stock of FDI in the global economy rose by 20% from 1997 to 1998, and reached over 4 trillion dollars. Foreign direct investment has a small but nonetheless important impact on capital formation, and therefore on overall economic performance. The percentage of FDI in capital formation varies significantly across countries, and according to a study conducted by the United Nations Commission for Trade and Development (UNCTAD), the average rate for 1996 was about 6%. However, in exceptional cases, such as the United Kingdom and Hungary, the rate reached about 20%[3].

One of the most interesting aspects of the surge in FDI flows is that since the mid-1980s the proportion invested in the developing nations has increased quite significantly. The developed nations, however, keep attracting the bulk of total FDI inflows. In 1997, for example, 63% of total FDI inflows was invested in developed nations, while the developing world attracted 37% of the total, that is, 173 billion dollars, a five fold increase from the amount received in 1990[4]. The proportion of inflows invested in the developing nations declined in 1998 to 26% of total FDI flows, however, reaching 166 billion dollars.

The single most important reason behind the staggering annual surge in FDI flows during the second half of the 1990s, and in particular in the last two years, has been cross-border mergers and acquisitions amongst the major transnational corporations (TNCs). The merger and acquisitions proportion of total FDI flows raised exponentially in recent years, and the total amount spent by the TNCs soared by 74% from 1997 to 1998, after raising 45% from 1996 to 1997. Cross-border merger and acquisitions hence reached the very impressive total of US$ 411 billion in 1998.

A sort of merger and acquisitions mania is taking place in the global economy amongst the major TNCs of the developed world, in particular in the United States and Western Europe, but it also includes a number of developing nations. It seems that the trend for huge mergers and acquisitions is continuing unabated, and perhaps has even accelerated during 1999, when a number of deals involving very large sums were announced. It has been estimated that total FDI inflows might reach over 800 billion dollars in 1999.

A series of mega-deals in mergers and acquisitions across the Atlantic explains to a great extent the staggering surge of FDI flows to the developed nations in the last two years. Amongst the developed nations, the United States remains the larger single recipient of FDI flows, attracting 193 billion dollars in 1998, followed by the United Kingdom at 63 billion. In the developing world, China kept its leading position in 1998, when FDI inflows reached 45 billion dollars, followed by Brazil at 29 billion. A remarkable feature of the recent surge in FDI inflows to developing nations has been the concentration on a small number of nations. Indeed, in 1998 for example, five developing nations were responsible for more than half of total inflows to the developing world.[5]

If the bulk of FDI is concentrated in the developed countries and a small number of developing countries, it is worth noting what seem to be the main reasons behind the transnational corporations decisions to invest abroad. According to the standard literature, the most important factors, not necessarily in decreasing order of importance, are: the size of the market and its potential for growth; access to regional or international markets for exports; an adequate infrastructure; natural resource endowments; political and economic stability, including a reliable legal framework; reasonable labour costs and flexible and skilled labour[6].

In the 1998 World Investment Report published by UNCTAD, it was noted that "the existence of created assets is of mounting significance as a magnet for FDI inflows, especially from major transnational corporations". Created assets can be tangible, such as stock of finance and physical assets, or intangible, defined as knowledge, information, skills, attitude, business culture, capabilities and relationships.

Concerning now FDI outflows, despite the growing amount of outward FDI from developing nations, both to developed and developing countries alike, the United States and Western Europe, in particular the European Union, remain by far the major sources. In contrast to the early 1990s, when it even led the league of foreign investors, Japan has scaled down dramatically its FDI outflows, given that it passed through the worse recession since the Second World War.

The leadership of the United States and Western Europe as the prime sources of FDI outflows is confirmed by the results of the annual ranking of the largest transnational corporations undertaken by the United Nations. In 1998, amongst the one hundred largest TNCs in the world, there are only two from the developing world, Petroleos de Venezuela and Daewoo of the Republic of Korea. All others ninety-eight largest transnational corporations are based in the developed world[7].

As the competition among and between developed and developing nations intensifies, the liberalisation of investment laws, rules and regulations became a pre-condition to attract FDI inflows. All over the world, nations are adopting similar liberal policies concerning the treatment of foreign capital as well as a more friendly, transparent and reliable regulatory framework.

As a result of the expanding role of FDI flows in the global economy, there has been an attempt to reach a multilateral agreement on investment rules, the Multilateral Agreement on Investment (MAI). For more than two years, under the OECD auspices, negotiations were undertaken to establish multilateral rules to regulate the flows of FDI. Despite all the efforts, no agreement was concluded in the end, and negotiations were suspended in 1998. Disputes between the United States and the European Union, concerning many contending aspects of the MAI were impossible to resolve, and it seems that the MAI is now dead [8].

Meanwhile, bilateral investment treaties (BITs) had been concluded worldwide at an amazing pace. By the end of 1998, there were almost two thousand BITs in force, and more than half of those were negotiated during the 1990s.

Moreover, in contrast with the recent past, most developing nations seem eager to accept very liberal BITs as a mean to attract large volumes of FDI.

An additional measure to attract FDI taken by many governments around the world has been through the use of public funds and subsidies. Federal or local agencies design special deals, such as subsidies, grants and tax concessions, to induce companies to settle in particular countries or regions. These policies became common among developed and developing countries alike, creating even in certain nations so-called 'fiscal wars' between states or regions. Despite all the efforts, however, there are hitherto no clear indications that these policies *per se* have been successful in attracting large inflows of capital, if other conditions are not fully met. Subsidies, grants and tax concessions might work in attracting TNCs to particular regions or countries only in combination with the overall conditions which make a certain nation attractive.

Moreover, as the international economy becomes fully global, ever more interdependent, the bulk of FDI flows are now undertaken as part of a global strategy of the transnational corporations. The decentralisation of location is then the result of the internationalisation of production through the continuous search for more competitive places for the production of goods and services. As a result, intra-firm trade, in particular in certain manufacturing activities, is now responsible for more than one third of total international trade.

Another significant trend in the recent surge of FDI flows is that it became less concentrated on traditional manufacturing activities. Services are growing fast as a proportion of total FDI flows[9]. Recent data released by the Brazilian Central Bank shows, for instance, that 56% of FDI inflows in 1999 was directed to the service sector, against 25% invested in the industrial sector[10]. The trend basically springs out from the fact that most services are not tradable, henceforth the producer must settle in where it seeks to provide the service and compete with local providers. It seems that there is still a great scope for expansion of FDI in services in the medium and long term.

Finally, it is worth drawing attention to the distinction between foreign direct investment and other forms of capital mobility. Alongside the extraordinary surge in FDI flows in recent years, many other modalities of international capital mobility have also soared exponentially. The deregulation and liberalisation of the financial services all over the world, and the series of new financial products on offer resulted in an expansion of capital mobility. Therefore, total international capital mobility, in particular the staggering amount in financial services such as the foreign exchange and the bond and securities markets, might disguise the precise amount of the stock and flow of foreign direct investment.

Briefly put, the distinction between foreign direct investment and other forms of capital mobility is the following: FDI is defined as an investment where the control of a company is owned by an entity established in another country. It usually involves a long-term commitment, where foreign investors, either through merger and acquisitions, a joint venture or a greenfield investment, are willing to invest in a productive activity. Meanwhile, other forms of private capital movement such as portfolio investment – securities or fixed income – and private bank lending follow different market rules. Indeed, in the latter there is not necessarily a long-term commitment to the host country, and the main motive seems medium or short-term profit making. As a result, there is much more volatility in the latter than in foreign direct investment, as recent examples all over the world have shown. For whatever reason, investors might flee a country immediately when a crisis of confidence on a certain currency takes over.

Since the Asian currency and financial crisis, and the subsequent crises in Russia, Brazil and other countries, the amount of portfolio investment, private bank lending and other financial services provided to the developing world has shrunk very dramatically. Actually, there was a massive de-investment in Southeast Asia after July 1997, and during periods of acute currency crisis all countries involved suffered a massive credit crunch. According to recent data released by the IMF, by the end of 1998, when debts repaid to creditors are deduced from total foreign investment, the net volume invested in the developing world reached only 68 billion dollars[11].

The distinction between FDI and all the different innovative instruments that the finance industry has developed in recent years is therefore very important to give a true picture of long-term, productive investment. Even taking into account that the current capital mobility is nothing new – there were other periods in modern history when similar or even a higher proportion of capital flows moved around the globe – its speed and reach are now quite unique. As a consequence of the information revolution, the markets are able to make instant decisions, while capital has shown great resilience against government's attempts to introduce tighter controls. As a consequence, an unpredictable political or economic event might sparkle a so-called herd behaviour amongst investors, and capital can rapidly flee at a massive scale (Mexico in December 1994-early 1995, Southeast Asia in July 1997, Russia in August 1998 and Brazil in late 1998-January 1999, are the obvious recent examples)[12].

The recent currency and financial crises have therefore showed the need to develop an appropriate regulatory framework to mitigate financial and currency volatility. Since 1997, however, negotiations over a 'new financial architecture' have been progressing slowly, without reaching agreements either about goals or about means. It appears that there is now a broad consensus that a better regulatory framework for international capital mobility is required, but it is unlikely that anything revolutionary will come out of the negotiations[13]. What is under discussion though is a series of incremental measures to minimise currency and financial vulnerability amongst developing nations. One main barrier so far has been the difficulty to involve governments and multilateral organisations, as well as private lenders in the solution.

The high volatility of international capital has had at least one positive effect. This is the disciplinary force that markets are exerting over governments that are fiscally irresponsible or persist in adopting badly designed macro-economic policies. A more responsible behaviour from economic authorities and better-managed macro-economic policies are needed when policy mistakes are severely punished by the markets. Developed as well as developing nations alike are learning painful lessons from their own mistakes, and governments all over the world seem now much more committed to fiscal responsibility. The disciplinary power of the financial markets though is a high but perhaps worth paying price.

2
The European Union as a main investor in the Mercosul

In 1998, the European Union as a bloc remained the largest FDI recipient in the world, as well as the number one in FDI outflows. Total EU FDI outflows soared 75% from 1997 to 1998, reaching 368 billion dollars. The United Kingdom was the leading source of FDI outflows at 114 billion dollars, followed by Germany at 87 billion, France at 41 billion and the Netherlands at 38 billion. Meanwhile, outflows from the United States reached 133 billion dollars.

During the 1990s, the establishment of a single market has contributed to concentrate the bulk of European Union investment within the EU, with few exceptions such as Britain. This trend, however, has abated to a certain extent in recent years, due to the internationalisation of production by the major European transnational corporations, as well as the extraordinary surge in mergers and acquisitions across the Atlantic. Outside European Union members, the United States remains the major recipient of EU investment outflows. In the developing world, Asia, Latin America, and Central and Eastern Europe have been, in this order, the regions that received the larger amount of FDI outflows from the EU[14].

Latin America and the Caribbean have made a tremendous progress as a destination of FDI inflows during the 1990s[15]. Total net inflows to Latin America and the Caribbean countries, including financial centres in the Caribbean Basin, soared from over 9 billion dollars in 1990 to 68 billion in 1997 and 72 billion in 1998[16]. In the case of Argentina, inflows raised from 1.8 billion dollars in 1990 to 6.6 billion in 1997 and 6.4 billion in 1998. At the end of the first semester of 1999, FDI inflows reached the staggering amount of 19.1 billion dollars, as a result mainly of the 12.3 billion acquisition of the Argentine oil company YPF by the Spanish oil giant Repsol.

Meanwhile, in Brazil inflows jumped from less than 1 billion dollars in 1990 to 17 billion in 1997 and 29 billion in 1998, and it is expected that it is going to reach around 25 billion in 1999. The other two members of Mercosul, Uruguay and Paraguay, received together around 500 million dollars in 1998[17]. Within Latin America though, Mercosul consolidated its position as the main destination of FDI inflows during the 1990s, while Mexico remains the second largest recipient after Brazil.

Europe has a long history of direct investment in South America, in particular in Argentina and Brazil. This is demonstrated by the large FDI stock owned by European companies in the area. Indeed, European Union FDI stock in Brazil reached 46% of total stock in 1998, at over 62 billion dollars. Meanwhile, the stock owned by US companies in Brazil corresponded to 30% of total, at almost 39 billion dollars by the end of 1998[18].

The volume of EU direct investment in Argentina and Brazil during the 1990s was much higher than that of the 1980s. It is worth remembering that the 1980s is known throughout Latin America as the 'lost decade', a very serious economic downturn that started after the Mexican debt crisis of 1982. During the 1980s, production stagnated and standards of living declined in almost every Latin American country. Total direct investment to the region was very low, and the European Union direct investment for the whole decade reached only 6 billion dollars in Argentina and 13 billion dollars in Brazil.

Since the early 1990s, however, radical and painful economic reforms were introduced, first in Argentina and then in Brazil. The re-negotiation of foreign debts under the Brady Plan, successful macro-economic stabilisation programmes, the radical opening up of the economies to foreign trade, investment and finance, as well as the large scale privatisation of publicly owned companies are among the major reforms that allowed the resumption of foreign investment.

Argentina opened the way to resume the attraction of FDI to the area[19]. Between 1990 and 1998, Argentina received over 36 billion dollar inflows of FDI. There were two remarkable phases in Argentina's attraction of FDI: the first lasted between 1990 and 1993, and the second from 1994 onwards. In the former, the main reason for FDI inflows was the massive sale of state owned companies. The privatisation of public utilities, in particular in the telecommunications, energy and transportation sectors, attracted a large amount of investment from the United States, Spain, Italy, Chile, France, Canada and the United Kingdom.

In the second phase, the acquisition of local private companies by foreigners became the main source of FDI. In this period, the United States led the way, followed by Spain, France and the Netherlands. In recent years, however, Chile became a major investor in Argentina. It is interesting to note that similar to the Brazilian case, services are now the main sector attracting foreign direct investment, in particular the financial services, energy and telecommunications. In banking, for example, Spain has been very aggressive in recent years, and in 1997 Spain alone was responsible for 40% of total FDI inflows in Argentina, as a result of the acquisition of major Argentine banks by Spanish banks.

In manufacturing, the automotive and auto parts sectors have been the most dynamic in attracting foreign capital. In this sector, the EU has been the major player. Sales of European Union auto companies in Argentina in 1997 reached over 6.6 billion dollars, against 2.8 billion by United States auto companies. Indeed, there has been a staggering surge in the auto sector production in Argentina – from over 80 thousand in 1990 to over 360 thousand in 1997, and 455 thousand in 1998 – and this is partially the result of the access to the huge Brazilian market. Well over 40% of Argentina's auto production in 1998 was exported, 90% of which to Brazil[20].

After Argentina completed the privatisation of its publicly owned companies, a second wave of privatisation took place in Brazil. Indeed, Brazil started selling its publicly owned companies later and more cautiously than Argentina, and it was only after 1995 that privatisation gained momentum. Nevertheless, the scale of privatisation in Brazil has been much larger than in Argentina, and government's receipts reached 86 billion dollars from 1991 to 1998, when 117 companies had been sold. By the end of 1998, the United States has been the main investor in the Brazilian privatisation process, at 33% of total, followed by Spain at 27%.

It is curious to note that the first public utilities and minority or majority shares sold by the Brazilian government to the private sector attracted mainly the interest of domestic investors. Foreign investors became gradually more interested, specially after more attractive assets in areas such as telecommunications, energy and oil became available. In recent years, telecommunications, energy, oil and the financial sector have attracted large sums of money from European and United States companies alike.

Up to 1995, Germany was by far the largest investor in Brazil among the European Union members, followed by France, Italy, the Netherlands and Britain. In recent years, however, Spain and Portugal became aggressive investors, and at the end of 1998, Spain was the leader amongst the EU members, and ranked second in FDI stock after the United States. Amongst the European Union countries, Spain reached over 8% of total FDI stocks, at 11 billion dollars, followed by Germany at 10.5 billion, France at 8.6 billion, Britain at 6.3 billion, Italy at 6.1 billion and the Netherlands at 5.7 billion, while Portuguese FDI stocks reached 5.5 billion dollars. The United States remains by far the largest single holder of foreign direct investment stock in Brazil, with 30% of total at 38.5 billion dollars, while Japan is the fourth largest holder at 8.7 billion dollars. Spanish companies invested heavily in the last two years in the privatisation of energy and telecommunications, as well as in the banking sector.

The two other countries of Mercosul – Uruguay and Paraguay – have not undertaken privatisation programmes at the same scale as Argentina and Brazil. In the case of Uruguay, a referendum in 1994 ruled out continuing the initial steps already taken to privatise public utilities, and in Paraguay the small number of publicly owned companies sold were acquired by domestic investors, while foreign investors did not demonstrated much interest.

Apart from the privatisation processes in Argentina and Brazil, the areas that attracted so far the large amount of foreign investment to Mercosul are the automobile and auto parts sector, the oil and petrochemical industries and the financial services. In all these sectors, European countries have been heavily involved. In banking, the United Kingdom has been the prime investor, alongside Spain. In the case of Spanish banks, they have been consolidating a leading position in retailing banking throughout Latin America, particularly in Mercosul and Chile.

Finally, in the automobile and auto parts sectors, Germany, Italy, France and Sweden have all invested to enlarge their existing production capacity or in greenfield plants to meet the huge increase in demand. Actually, the auto and auto part sectors have been a special case so far as FDI is concerned[21]. As a result of the important role these sectors play in manufacturing and exporting in the Mercosul, Argentina, Brazil, Uruguay and Paraguay decided to establish a common *regime automotivo*, responsible for regulating every aspect of production as well as intra and foreign trade in the auto and auto parts sectors. Despite the difficulties in reaching a conclusion, the four members have until the end of 1999 to meet the deadline set forward by the World Trade Organisation. It is expected that this common *regime automotivo* enters into force by 1 January 2000.

3
The European Union agenda: new challenges for the Mercosul

China and Southeast Asia have been the main developing areas which attracted European Union outflows of FDI during the 1990s, but this situation began to change after the Asian currency and financial crises. There has been de-investment in a massive scale in Asia following the depreciation of their currencies and the deterioration of economic conditions. This has been the case specially in portfolio investment and private bank lending, not as much in terms of FDI, where total outflows to Asia decreased from 96 billion dollars in 1997 to 85 billion in 1998[22]. Indeed, a survey conducted in February 1998 by UNCTAD and the International Chambers of Commerce with 198 transnational corporations demonstrated that, despite the financial turmoil, most of the TNCs remained committed to investing in Asia. Amongst European TNCs, 34% responded positively over their intention regarding Asia.[23]

The other main area where European Union direct investment increased significantly during the 1990s is the transitional economies of Central and Eastern Europe. After the demise of communism, the market reforms introduced by virtually all the nations in the area attracted a quite substantial amount of FDI, around 60 billion dollars for the period 1989-1997. Germany is the largest investor in Central and Eastern Europe while Hungary, Poland and the Czech Republic are the main recipients of European Union FDI outflows. Therefore, the EU enlargement might be a cause of concern for Mercosul given that, as new members, the Central and East European nations will have free access to the EU market, though perfectly located to attract large amounts of investment from EU companies. There are now twelve postulants for European Union membership, plus Turkey.

Another item in the agenda of EU-Mercosul relations concerns the results brought about by monetary union to the flow of FDI and other forms of capital flows to Mercosul. Here there are three main issues. One concerns the euro as an international currency reserve, and it seems that it is in Mercosul's interest to diversify their foreign currency reserves from the prominent role played by the US dollar. There is scope to keep a larger volume of euro as foreign reserves in the case that the euro turns out to be a strong and successful currency[24].

The second issue concerns trade. Mercosul's foreign trade is more or less evenly distributed between the countries of ALADI, NAFTA, the European Union and, in a less scale, Asia. Nonetheless, trade is very sensitive to currency fluctuations and, as the case of Argentina demonstrates, a currency regime pegged to the US dollar can be very detrimental to foreign trade. Argentine products are now much less competitive, in particular after the devaluation of the Brazilian real in January 1999. In the medium and long-term, a strong euro, despite the weakness showed in the first months of coming into force, might well play a significant role in stimulating more trade between the European Union and the Mercosul.

The third important issue for the Mercosul that might result from a successful monetary union is the role played by a stable euro, within a strong European economy, as a source of funding. A stable euro can facilitate lending to Mercosul governments and private borrowers, reducing the spreads, and contributing to consolidate Europe as a main provider of funding to Mercosul. It could also give an additional boost to the European bond market. Indeed, both Argentina and Brazil have already issued bonds denominated in euro.

To conclude, it is important to mention the role played by European Union official institutions in the economic co-operation with Mercosul. There are three main programmes at the moment: first, there is AL-INVEST, which seeks to encourage industrial co-operation and boost EU direct investment through the promotion of activities between the private sectors of both regions; second, there is the European Community Investment Partners (ECIP), led by the European Commission, which aims to stimulate joint ventures and associations between small and medium sized enterprises; and thirdly, the European Investment Bank (EIB), which has recently decided to finance projects of co-operation involving European Union and Latin American and Asian companies. The financing of companies intending to invest in the Mercosul is under consideration, and a visit by the head of the EIB to Brazil – the first visit to a country outside the EU – took place in 1998.

All these programmes of co-operation must be seen under the umbrella of the framework agreement for economic co-operation between the European Union and Mercosul concluded in December 1995. Since then, negotiations have evolved slowly but steadily. The European Commission's granting of a mandate to start negotiations for a free-trade area between the EU and Mercosul on the eve of the Rio de Janeiro Summit in June 1999 demonstrated resolve and political will. A successful free-trade agreement between the two most advanced regional integration processes is still a long-term goal, but closer political and economic relations are an incentive to investment. In the end, investment is purely a private business decision, but well equipped agencies and well-designed policies certainly contribute to provide better information and promote stronger business links.

4
Mercosul as a stable area for European Union investment

The 1990s dramatic surge of European Union and United States FDI outflows to Mercosul is a result of the radical economic changes that occurred in the area, brought about by two main initiatives: the opening up of the South American economies to foreign trade and investment and the successful stabilisation programmes implemented by Argentina and Brazil.

Alongside virtually all over Latin America, Mercosul needs foreign investment to complement their low level of domestic savings and relatively weakly developed capital markets. Direct and portfolio investment, lending from multilateral financial institutions and private banks, as well as access to other forms of funding through the international capital market have been historically important to Latin America. Foreign funding has also been fundamental to finance current account deficits and to service foreign and domestic debts. Concerning capital formation, it seems still rather small the proportion of FDI in capital formation, but it is growing fast, and some recent investments in highly intensive technological sectors such as telecommunications, are bringing in managerial skills and sophisticated technology that will certainly boost productive capacity in the area[25].

For all these factors, Mercosul should be understood not only as a sub-regional free trade agreement and a customs union in the making, but as an attempt to create an attractive investment area. Mercosul is well placed to compete with developed and developing countries alike as a prime destination for FDI. The nations of Mercosul have an extensive experience dealing with foreign companies, it is a relatively large market of more than 200 million people with an average annual *per capita* income approaching the 5,000 dollars. It also has a skilful, young and relatively well-educated working population, with competitive labour costs[26].

After the crisis and demise of decades of inward-looking development, based on protectionism and import substitution, the area liberalised its trade regime and opened up for foreign competition. The Argentine and the Brazilian economies have been successfully stabilised after years on the brink of disaster, while democracy seems stable alongside a required legal framework that works relatively well by international standards.

Argentina has one of the most liberal foreign investment regimes in the world, while Brazil is catching up, opening up its most dynamic sectors to foreign investment. A "Protocol on Promotion and Protection of Investments coming from States not Parties to Mercosul" was concluded and signed in August 1994.[27] The Protocol created a common regime for foreign investment[28]. The extensive series of reforms on foreign investment laws lifted the remaining bias against foreign ownership in dynamic sectors such as mining, oil, telecommunications and finance, traditionally considered as pertaining to the state under the argument of strategic national interest.

Another less noted, nonetheless significant, aspect that has been happening in the area is the increase in intra-regional direct investment. Argentina's investment in Brazil in 1997 reached the mark of half a billion dollars, while roughly the same consisted in Brazil's FDI in Argentina. Sectors such as beverage, processed foods and dairy products top the list of new investments. There are at the moment hundreds of joint ventures between Argentine and Brazilian private companies in the agriculture, manufacturing and service sectors. Moreover, Argentine private utilities became involved, usually as partners, in Brazil's privatisation programme.

There has also been a substantial increase in Chilean investment in Mercosul, in particular in Argentina. In 1998, Chile has been the second largest single investor in Argentina, where almost four hundred projects are now under development. Between 1990 and 1998, Chileans invested over 9 billion dollars in Argentina, almost 40% of their total direct investment in Latin America. Brazil is the third largest destination of Chilean direct investment in Latin America, at 2.8 billion dollars for the period between 1990 and 1998, with 12% of the total. The surge in Chilean FDI, alongside the equally impressive surge in trade between Chile and Mercosul, explain why Chile became an associate member of Mercosul in June 1996, and decided in December 1997 to deepen its involvement. It is probable that Chile is going to apply for full Mercosul membership in the near future.

After all the changes introduced during the 1990s, the record of new FDI inflows to the area seems very encouraging. Nevertheless, there are some worrying signals related to the surge in foreign investment. First, the radical lowering of tariffs and the virtual abolishing of non-tariff barriers allow new investors to import a large volume of capital goods, equipment and other high tech goods needed to support greenfield investments as well as the modernisation of privatised companies. This process has resulted in a surge in intra-firm trade and substantial trade and current account deficits. In particular in areas such as energy, telecommunications and oil, high tech equipment has been imported in a substantial scale.

Moreover, questions remain about the role of foreign funding in the new development strategy of Mercosul. Certainly most of the reforms implemented during the 1990s, regarding the opening up of the area for trade and investment, radically reforming and shrinking the state, and creating a more attractive environment for business and private enterprise, seem the best way to lead the area to the direction of sustainable growth. Nevertheless, the result brought about by the Mexican devaluation, in particular in Argentina, and the subsequent recessions in Argentina and Brazil following the Russian and Brazilian crises, attest the vulnerability of the area to international financial turbulence. In these circumstances, an excessive reliance on foreign capital might be a risky strategy.

After July 1997, virtually all the countries of South America were not able to repeat the impressive average rate of growth reached by Latin America and the Caribbean in 1997 – 5,2% – the best in the last 25 years. It was also the lower average rate of inflation, at 11%. The average rate of growth decreased in 1998 to 2.3%, when the Brazilian economy reached virtually zero growth. In 1999, both Argentina and Brazil are in recession.

Despite the fluctuations in growth rates resulted by unpredictable events, it is worth noting the low impact of the Asian, Russian and Brazilian financial and currency turmoil on the inflow of new investments to Mercosul, in particular to Brazil. Apart from the postponement of some projects by Korean auto companies in Brazil, there has been no major cancellation of FDI as a consequence of the international financial turmoil. In the case of Argentina, the situation deteriorated after the

Brazilian devaluation, in particular in the auto industry, where new investments were put on hold. However, in terms of portfolio investment, private bank lending and other financial instruments, there has been a remarkable decline and costs have soared.

One should therefore conclude with a note of caution. The excessive reliance on foreign funding to finance fiscal and current account deficits, and as a source of capital formation, or the reliance on portfolio investment for short term needs might be risky as a strategy for sustainable development in the Mercosul. The economic history of Latin America since independence is partially a story of financial booms and bursts, the result of an excessive reliance on foreign borrowing. Therefore, foreign direct investment should be encouraged as a form to bring in new resources, managerial skills and high technology, preparing the area to compete more efficiently in the world market. Nonetheless, consisted policies should also be implemented to raise the level of domestic savings and to improve domestic capital markets, in particular reducing domestic interest rates to international level.

The 1980s debt crisis brought about declining living standards and virtually closed the access of the region to the international capital markets for almost a decade. Furthermore, recent developments in the international capital markets must make one very cautious. The staggering amount of volatile capital seeking short-term high rates of return evaporates when the sentiment of the market changes. The scale of the financial turmoil that started in Southeast Asia remind us though that long-term foreign capital is welcome, but the need to establish a reliable and stable domestic system to finance sustainable growth and development must also be a priority to Mercosul.

Notes

[1] See: R. Graham (1968), *Britain and the Onset of Modernization in Brazil,* Cambridge University Press; and R. Downes (1992), "Autos over rails: How US business supplanted the British in Brazil, 1910-28", in *Journal of Latin American Studies,* no. 24 (3).

[2] According to: UNCTAD (1999), *World Investment Report 1999: Foreign Direct Investment and the Challenge of Development,* United Nations Publications (Geneva). See also: WB (1998), *Global Development Finance 1998,* The World Bank (Washington DC), March 1998; and IMF (1999), *Annual Report 1999,* International Monetary Fund (Washington DC), September 1999.

[3] UNCTAD (1997), *World Investment Report 1997: Transnational Corporations, Market Structure and Competition Policy,* United Nations Publications (Geneva).

[4] UNCTAD (1998), *World Investment Report 1998: Trends and Determinants,* United Nations Publications (Geneva).

[5] The concentration of FDI flows in a small number of countries is even greater when one includes developed and developing countries. Then, the ten largest recipients of FDI inflows account for well over two-thirds of overall FDI inflows. In 1997, the ten largest developing counties hosting inward FDI were: China, Mexico, Malaysia, Argentina, Brazil, Indonesia, Hungary, Thailand, South Korea and Taiwan.

[6] A recent example is: S. Jackson and S. Markowski (1997), "The attractiveness of countries to foreign direct investment: Implications for the Asia-Pacific region", in *Journal of World Trade*, October 1997. See also: J. H. Dunning (ed.) (1998), *Globalization, Trade and Foreign Direct Investment,* Elsevier Science (Oxford).

[7] UNCTAD (1999), op. cit.

[8] A good assessment may be found in: D. Henderson (1999), *The MAI Affair: A Story and its Lessons,* The Royal Institute of International Affairs (London). See also: M. Daly (1998), "Investment Incentives and the Multinational Agreement on Investment", in *Journal of World Trade,* vol. 32 (2), April 1998.

[9] UNCTAD (1999), op. cit.

[10] *O Estado de Sao Paulo*, October 19, 1999.

[11] IMF (1999), op. cit.

[12] The literature on the recent financial and currency crises is now very vast. I found useful: S. Page (1998), "Measuring direct effects of the Asian crisis on other developing countries", Overseas Development Institute (London), mimeo.

[13] See: S. Griffith-Jones (1998), *Global Capital Flows: Should They Be Regulated?,* MacMillan (Basingstoke); and B. Eichengreen (1999), *Toward a New Financial Architecture: A Practical Post-Asia Agenda*, Institute for International Economics (Washington DC).

[14] Statistics on FDI are famous for their unreliability. I am using data from UNCTAD, EUROSTAT, IMF and ECLAC.

[15] BID/IRELA (1998), *Inversión Extranjera Directa en America Latina: La Perspectiva de los Principales Inversores*, Banco Interamericano de Desarrollo and Instituto de Relaciones Europeo-Latinoamericanas (Madrid).

[16] The most complete data and analysis on FDI in Latin America and the Caribbean is the annual report *Foreign Investment in Latin America and the Caribbean* published by ECLAC in Santiago de Chile. I am using the 1998 annual report.

[17] INTAL (1998), *Informe Mercosur,* no.3, July-December 1997, INTAL (Montevideo).

[18] I am relying on data elaborated by the Banco Bilbao Vizcaya, São Paulo, June 1999.

[19] D. Chudnovsky, A. Lopez and F. Porta (1995), "Mas allá del flujo de caja: El *boom* de la inversión extranjera directa en la Argentina", in *Desarrollo Económico,* vol. 35, no. 137, April-June 1995.

[20] ECLAC (1998), *Annual Report 1998,* op. cit. See also: IDB/IRELA (1996), *Foreign Direct Investment in Latin America in the 1990s,* IDB and IRELA (Madrid).

[21] ECLAC (1998), op. cit.

[22] According to: UNCTAD (1999), op. cit.

[23] UNCTAD/ICC (1998), *Special Business Survey* (Geneva).

[24] Literature on the euro is already vast and expanding every day. A useful early piece is: C. Wyplosz (1997), "EMU: Why and how it might happen", in *Journal of Economic Perspectives,* vol. 11 (4), Fall 1997.

[25] See: R. Bauman (1998), *Foreign direct investment in Brazil and the international financial markets*, paper presented at the conference "Brazil in the World Context" (London, February 1998), mimeo; and R. Bonelli (1998), *A note on foreign direct investment and industrial competitiveness in Brazil,* paper presented at the conference "Globalization and Industrial Competitiveness in Brazil" (Oxford, June 1998), mimeo.

[26] R. Roett (ed.) (1999), *Mercosur: Regional Integration, World Markets,* Lynne Rienner Publisher (Boulder).

[27] SAM (1994), *Protocolo sobre Promoción y Proteción de Inversiones Provenientes de Estados no Partes del MERCOSUR,* Secretaría Administrativa del MERCOSUR (Montevideo), December no. 11/93, mimeo.

[28] Details on the legal aspects of investment and other rules are in: M. Rowat, M. Lubrano and R. Porrata Jr. (1997), *Competition Policy and MERCOSUR,* World Bank Technical Paper no. 385, The World Bank (Washington DC).