The Economist Intelligence Unit

Latin America as an FDI hotspot

Opportunities and risks

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Contents

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Latin America has come a long way from the political and macroeconomic instabilities of the 1980s and 1990s. Fiscal consolidation, coupled with market and trade liberalisation, has boosted growth rates and consumer demand. The region also boasts abundant natural resources, sound financial systems and an important and expanding network of trade agreements. This paper will answer a number of important questions with a view to defining the attractiveness of the region for investors, with a particular focus on Chinese investors, as follows:

- What is the political and economic outlook for the region from now until 2017?
- What are Latin America's engines of growth in the context of weakening global economic conditions and commodities prices?
- What and where are the region's opportunities for foreign investors?
- How does the regional business climate fare with respect to best practices and what are the main obstacles and challenges that investors face?

Latin America and China are not traditional partners, but their relationship has become increasingly strong, with the latter developing into one of the former's major trading partners, especially in some of the commodity-exporting countries. This paper intends to provide a general idea of the potential of Latin America as an investment destination and also as a trading partner.

The list below sums up some important points and advantages for Latin America when it comes to foreign direct investment. The region, which was quite unstable both financially and politically until 20 years ago, has come a long way and is now, by and large, growing fairly steadily and showing sound economic fundamentals. It is also a combined market of around 600m people. Also the last 10 years or so have witnessed the emergence of an increasingly large middle class with growing purchasing power.

- Stable growth with relatively contained inflation
- Sound macroeconomic fundamentals
- Sound and profitable financial systems
- Combined market of around 600m people
- Favourable demographics with a booming middle class (supported by strong credit growth) feeding into growing domestic demand
- Abundance of strategic natural resources
- Strategic location + access to diversified export markets thanks to extended network of trade agreements
- Record FDI inflows (US$218bn forecast for 2017)

Latin America has made important progress towards reducing poverty thanks to a combination of social policies (including conditional cash transfer programmes contingent on the development

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of human capital), increasing minimum wages, and steady economic growth. Until now, the region has attracted China's attention because of its abundance of strategic natural resources. In fact, most Chinese investments in Latin America at the moment are concentrated in either commodities or the mining sector.

Moreover, Latin America is strategically located. Not only does it have access to the neighbouring US—including free-trade access for some of the region's countries—but it is also quite open towards the rest of the world. It is linked to several other continents by a comprehensive network of trade agreements. This means investors entering into most of the countries in Latin America have access not only to its domestic market, but also to the markets of that country's trade agreement partners as FDI inflows to the region have recently been record high by historical standards. The Economist Intelligence Unit is forecasting 2017 foreign direct investment to the region to reach a total of approximately US$200bn.

We are expecting the region to grow at an average 2.9% rate this year, similar to last year's rate. For the next four years—the rest of the forecast period—we are looking at a growth rate of around 3.7%, which remains quite good in historical terms. Again, compared with China's growth rate, this is not very impressive—but it is impressive indeed if we look at Latin America's past, which has been subject to recurring crises and recessions. We see the partial deceleration in 2013-14 as a cyclical slowdown rather than one caused by structural problems, and we expect the region to continue to grow at a sustained pace, supported by sound macroeconomic policies, resilient domestic demand and a modest improvement in general external conditions. China's continued demand for commodities (although likely marginally lower than in recent years, given the partial deceleration of its economy) will support South American commodities exporters.

One small problem with Latin America that should be acknowledged is the widening current account deficit of the last few years. This represents an element of vulnerability for the region that leaves it exposed to shifts in market sentiment. But the region is fairly well protected against such shifts by a large stock of foreign reserves (estimated at just over US$845bn in 2013), as well as by a generally sound macroeconomic framework.

The China–Latin America relationship

Latin America's relationship with China is quite recent. China has become a very important investor in the region, increasing its share of Latin American trade from 1% in the 1980s to 11% in 2011 and becoming the region's third largest trading partner after the US and the EU, which are its two traditional markets. It was the world's third largest investor in Latin America in 2010. At the moment, most FDI is concentrated in the extraction of natural resources, but Chinese investment is also diversifying into infrastructure and manufactures. This diversification is especially evident in Brazil, whose sheer size makes it an interesting market to cater for and to where restrictive requirements of local content encourage relocation of production. China is also becoming an increasing source of funding for the region.

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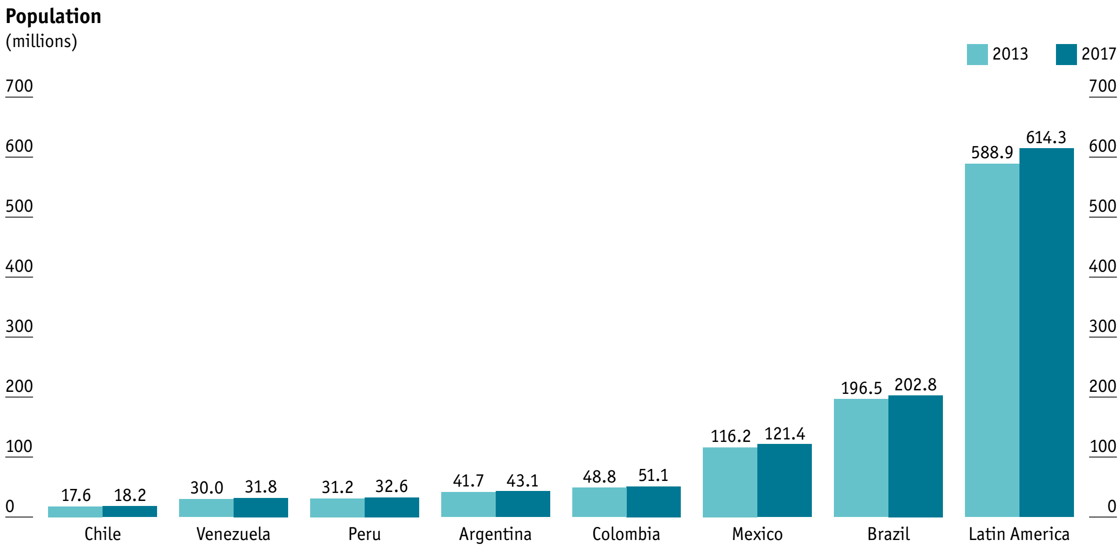
A study last year found that, from 2005 to 2012, Chinese banks had lent approximately US$75 billion to the region—more than Ex-Im Bank, World Bank and Inter-American Development Bank combined during this period. Chinese loans concentrate in oil-producing states (Argentina, Brazil, Ecuador and Venezuela), with many secured through pledges of repayment in the form of future oil shipments and some also tied, to varying degrees, to the purchase of Chinese-made products.

The opportunities

One of the region's opportunities is centred in the size of its market. The combined market in Latin America is around 600m people. Some markets are very interesting in themselves; among these are the two giants in the region, Brazil and Mexico. Also important are the very dynamic Andean economies of Peru, Chile and Colombia, which boast fairly large domestic markets with populations with increasing purchasing power (see the bar chart on the demographic dividend below).

One of the most interesting developments of past years in Latin America has been the dramatic rise of the middle class (see the bar chart below depicting the rise of the consumer market). In Brazil alone, about 62m people—roughly the same size as the entire population of Spain—have been lifted to middle-class status from 2003 to 2011. This is a striking success story in terms of reducing poverty and increasing opportunities for Brazilians. All this has been achieved not only through greater macroeconomic stability and economic growth, but also by increasing the minimum wage and through important conditional cash transfer programmes (such as Bolsa Familia in Brazil or Oportunidades in Mexico). These programmes have been pioneered in Latin America and have been extremely successful, reaching around 110m people and contributing to the drop of income inequality.

Because of these developments, the Gini index—a measure of income inequality—has been falling steadily for Latin American countries, although it still remains quite high compared with other regions



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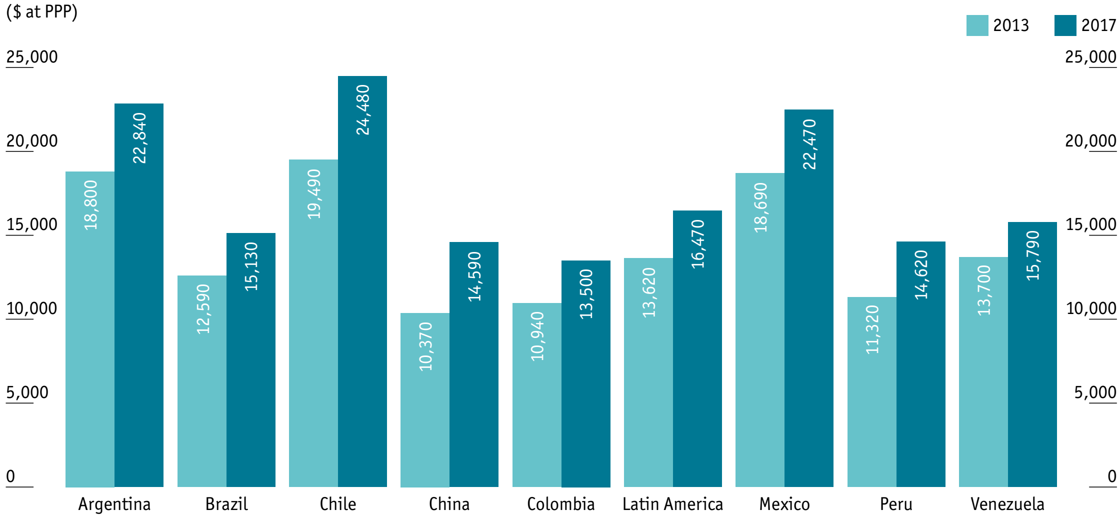
of the world, In Latin America, 41m and 18m people have been lifted out of poverty and extreme poverty, respectively, in the last 10 years. The region's population is very young compared not only with that of developed countries but with some developing ones as well. In Brazil, for example, the average age is less than 30 years old; 30% of the population are 14 years or younger. These demographics indicate something quite interesting about the country's potential going forward. Furthermore, the urbanization rate is up throughout the region, and the thriving domestic market provides an opportunity in itself.

Interestingly, the current forecast for private consumption per head for 2013 and 2017 is much higher for Brazil and Mexico, or even Peru and Colombia, than for India and China. In terms of general size and GDP, Latin America is smaller than China, but in terms of purchasing power and consumer power it is quite large.

When considering settling in Latin America or gaining access to the Latin American markets, one should take into account the region's changes in trade policy over the last 20 to 30 years. It is now, with a few exceptions, a very open region both with respect to the rest of the world and also internally. The region is integrated internally by a series of trade agreements, including Mercosur in the southern cone of Latin America; the Andean community in the Andes; and the Pacific Alliance, which is an interesting new-generation agreement that puts together the Pacific countries of Latin America, Mexico, Chile, Colombia and Peru to develop a regional value chain and also to project the group towards Asia, which can be seen as a natural regional partner.

The region is also projecting itself towards the rest of the world, including the US—a natural market for Mexico, Central America and the Caribbean, which are linked to the US by a series of trade agreements, including the North American Free Trade Agreement, or NAFTA (Mexico) and the CAFTA-DR (Central America and the Dominican Republic) among others. And last year the US signed agreements with Chile, Colombia and Panama. Thus Latin America, especially Mexico, is quite thoroughly integrated into the global value chain of the US.

GDP per head
($ at PPP)



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The region is also reaching out to the Asian markets. Not only are most of the Pacific countries of the region part of APEC (see the table below), but they also are part of the new generation trade agreement—the Trans-Pacific Partnership, or TPP—currently in the process of being negotiated. Chile, Peru and Mexico are part of the Pacific Alliance and also members of bilateral free trade agreements with other countries in Asia.

Opportunities by country

Brazil

Brazil is part of the group of countries known as the BRICs, but it seems to have lately lost some of its shine (see the table below). Last year, growth was only 0.9%, its second worst performance after the crisis. This year, we have already revised the forecast downward twice and are expecting a growth of 2%—not really impressive. However, the country remains a very promising market for foreign direct investment, and not only because of the sheer size of the domestic market. Brazil also presents important opportunities for investors given its extensive endowment of strategic natural resources, including oil: if the auction for the new oilfield in the pre-salt part of offshore Brazil, in the states of Espirito Santo and Santa Catarina, are awarded, Brazil has the potential to increase its oil reserve to 80bn barrels. This is an area where Brazil is welcoming foreign direct investment in order to explore all these opportunities.

Agribusiness is also very important for Brazil, but from an FDI perspective, infrastructure is probably the most interesting sector at the moment. Not only is Brazil preparing itself for two major sports events—the World Cup in 2014 and the Olympics in 2016—but the government, as part of its efforts to reactivate growth and ensure sustainable growth going forward, is focusing on removing bottlenecks to competitiveness. One of the country's main bottlenecks is the state of its infrastructure. To address this issue, the government is investing heavily in infrastructure and has recently set up a US$190bn private concessions programme for the construction/upgrading of roads, railways, ports and airports until 2015 to prepare for hosting the Olympics (it is uncertain whether these projects will be completed in time for the World Cup in 2014).

Brazil and China face many of the same challenges going forward. Brazil needs to increase its productivity to be able to grow sustainably. The areas related to what we call the "Brazilian cost"—the poor state of the country's infrastructure, its burdensome fiscal system, and the onerous red tape

Brazil at a glance: Key Indicators

Country	GDP growth, 2013	GDP (2012 growth)	FDI US$ bn, 2013	FDI (% growth)	Public sector balance, 2013 % of GDP	Public sector balance, 2012 % of GDP	Disposable income per capita 2013, US$	PDI real % growth, 2013	Domestic credit growth 2013	Domestic credit growth (av 2014-2016)	Retail sales US$ bn, 2013	Retail sales, 2013 (% growth)
Brazil	2.0	0.9	58.75	-10.0	-3.10	-2.40	1,401,000	1.60	13.70	13.37	499,800	7.60

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among others—make conducting business in Brazil unnecessarily complicated. These areas all need to be successfully tackled for Brazil to be able to achieve sustained growth rates in the medium to long term.

However, because Brazilian elections will take place next year, the political scene has already shifted towards the election while the legislative agenda will focus on addressing the causes of mass protests that swept the country in June. Therefore President Dilma Rousseff's government is not expected to make much progress in tackling these problems, which are structural and require politically difficult and unpopular reforms.

Mexico

The next country considered in this paper is Mexico. For a short time, Mexico appeared to become an investors' dream the way Brazil was two years ago. But more recent economic data have tempered that assessment, although the country's medium-long term prospects remain positive. Mexico has been following a different model from Brazil. Brazil has been quite closed to trade, and only 20% of Brazil's GDP is accounted for by trade; for Mexico, trade accounts for 60% of the country's GDP (see the table below).

Mexico at a glance: Key Indicators

Country	GDP growth, 2013	GDP (2012 growth)	FDI US$ bn, 2013	FDI (% growth)	Public sector balance, 2013 % of GDP	Public sector balance, 2012 % of GDP	Disposable income per capita 2013, US$	PDI real % growth, 2013	Domestic credit growth 2013	Domestic credit growth (av 2014-2016)	Retail sales US$ bn, 2013	Retail sales, 2013 (% growth)
Mexico	1.2	3.6	34.35	155.7	-2.60	-2.62	787,500	3.20	9.90	15.47	364,921	2.60

Mexico has followed an export-oriented and very open development model in the past few years. It has become one of the most important, lowest-cost component manufacturers in the world. It is also very strategically located, adjacent to North America and bordering the Pacific and Atlantic oceans as well as North and South America. The country is linked by an extensive network of free-trade agreements with over 40 countries in three continents, for a potential market of 1bn consumers, or 60% of the world's GDP. In the last few years, Mexico has adopted many macroeconomic reforms that have put the country on a very good footing going forward.

Moreover, the administration of President Enrique Pena Nieto has moved at a striking pace in its first year and made important progress in tackling important competitiveness shortcomings in the country's business environment. The outlook appeared bleak when the party that had been in power for 60 years before the last 12 years was elected in Mexico last year. But the new president has been very successful thus far in designing and implementing a structural agenda for reforms. His government has effectively reached out to the opposition and some very important reforms that had been blocked for years—such as education reform, telecommunication reform, and financial market reform—have now been adopted. This is a welcome break with the last 12 years, where the government was unable to

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push through many reforms against a backdrop of an obstructionist opposition.

Thus we have a positive outlook for Mexico, despite a disappointing estimated 1.7% growth this year. We still expect Mexico to grow at an average rate of 3.7% over the 2014-17 period. Moreover there are upside risks to this forecast because telecom and energy sectors have been quite closed to competition until now. The opening of those sectors is likely to significantly boost FDI and growth. Even telecom reform alone is expected to add a full percentage point to GDP growth, underscoring the country's promise.

In the last few years, Mexico has become more competitive vis-à-vis China as an investment location given its closeness to the US and the fact the margin between labour costs in the two countries has been shrinking (with Mexican labour cost currently only around 30% higher). This represents a risk for China, especially because China and Mexico have very similar industrial structures so they compete for the same market.

Mexico, in any case, is reaching out to China. President Pena Nieto has recently been to China to try and develop bilateral relations, including through increased trade and foreign direct investment. The Chinese can use Mexican proximity to the US market to serve those markets.

Colombia

Colombia is another success story. It is not by chance that Colombia is the C of CIVETS, our acronym for the next group of most promising emerging markets after the BRICS (CIVETS comprises Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa). Only 10 years ago, Colombia had serious problems in terms of political stability to the point that it was almost considered a failed state in the midst of a civil war. The country has changed completely in 10 years. It is now one of the most open and most business-friendly countries in Latin America. Areas of interest for investors are infrastructure, financial services and the mining sector; the country also has a strong tradition of respect for intellectual property with comprehensive regulations to protect it. New opportunities are opening up for foreign investors, particularly in hydrocarbons and mining, construction, and electricity, and there is free-trade access to the US market (see the table below).

Colombia at a glance: Key Indicators

Country	GDP growth, 2013	GDP (2012 growth)	FDI US$ bn, 2013	FDI (% growth)	Public sector balance, 2013 % of GDP	Public sector balance, 2012 % of GDP	Disposable income per capita 2013, US$	PDI real % growth, 2013	Domestic credit growth 2013	Domestic credit growth (av 2014-2016)	Retail sales US$ bn, 2013	Retail sales, 2013 (% growth)
Colombia	4.0	4.0	15.98	1.0	-0.30	0.45	272,300	2.60	14.50	16.20	115,125	2.70

With an election next year in Colombia, the main hurdle at the moment is the peace talks between the government and the left-wing FARC guerrillas currently on-going. A stable and durable solution to the negotiation would be extremely important for Colombia going forward because that would ensure that the country is stable both politically and in terms of security.

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Peru

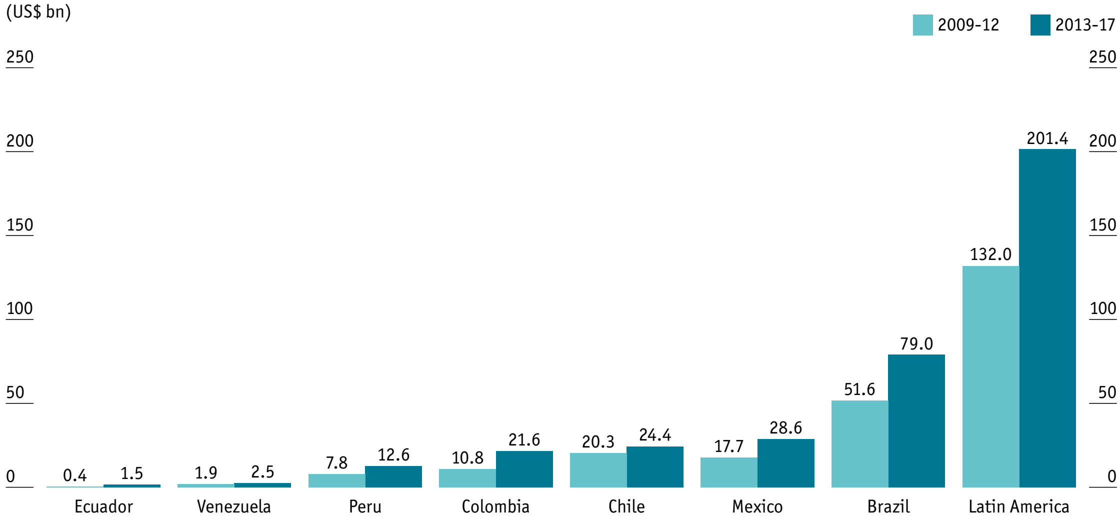
Peru is another of the Andean tigers, expected to have among the highest growth rates in the Latin American region in the next five years (see the table below). Similar to Colombia, it has plenty of investment opportunities. In mining, Peru claims the world's largest reserves in silver, copper, and zinc, as well as in renewable energy, where the wide availability of water and natural resources is a tremendous advantage. Peru's agribusiness is robust, and the country is a major exporter of fresh and processed products; it had among the best agricultural yields in 2010. The government is also updating the country's infrastructure with an investment of US$2.4bn in the portfolio of investment promotion agency Proinversion. Furthermore, Peru boasts an extensive network of free trade agreements with numerous countries in three continents, for a potential market of more than 4bn people with a GDP of US$56bn.

Peru at a glance: Key Indicators

Country	GDP growth, 2013	GDP (2012 growth)	FDI US$ bn, 2013	FDI (% growth)	Public sector balance, 2013 % of GDP	Public sector balance, 2012 % of GDP	Disposable income per capita 2013, US$	PDI real % growth, 2013	Domestic credit growth 2013	Domestic credit growth (av 2014-2016)	Retail sales US$ bn, 2013	Retail sales, 2013 (% growth)
Peru	5.4	6.3	13.07	6.2	1.00	2.15	93,500	4.70	12.10	6.97	73,817	5.20

A quick look at the annual average FDI inflows to the region for the past five years and projections for the next five shows that the numbers are increasing substantially. The average FDI inflows from 2013 to 2017 for the region are higher than the flows we estimate for China; although still lower than those forecast for the US, nevertheless it will be a very impressive performance.

Annual average FDI inflows
(US$ bn)



Source: Economist Intelligence Unit, CountryData.

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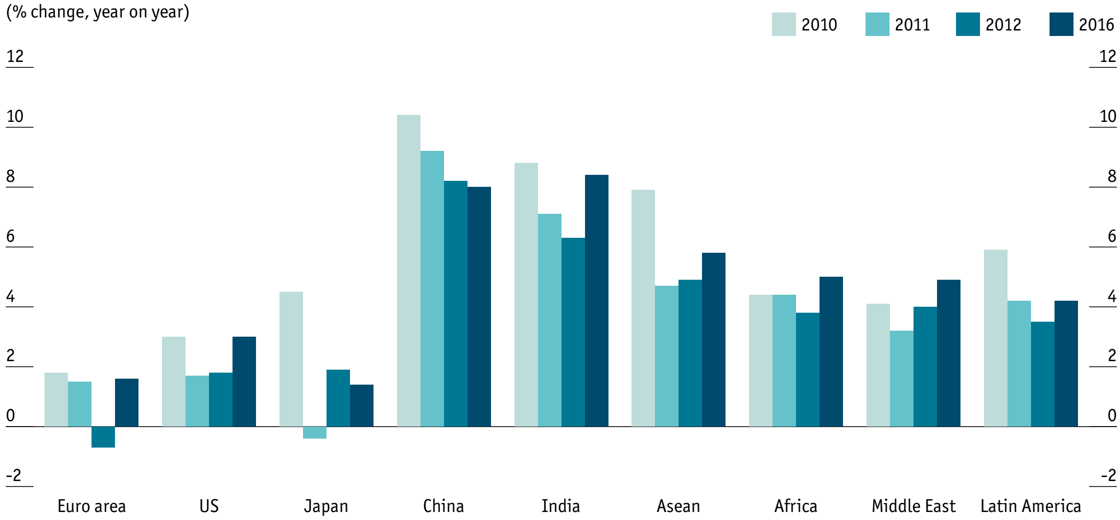
Challenges

One of the big challenges for the region as a whole is that it will grow less than some other emerging areas of the world. Global growth is going south, but this trend is not so evident in Latin America.

Why is that? The reason has to do with structural reforms and structural impediments to economic growth. This is seen from some data from our business environment rankings.

Real GDP growth
(% change, year on year)



Source: Economist Intelligence Unit, CountryData.

The business environment rankings are a very useful comparative tool developed by the Economist Intelligence Unit. The index assesses the attractiveness of the business environment of 82 countries around the world by looking at different aspects of it, including market opportunities, policy towards enterprises and foreign direct investment, foreign trade, infrastructure, education, availability of talent and so on. The change in score—which is the measure of the absolute performance of the region with respect to the other regions—is quite disappointing: Latin America is the emerging area of the world that is going to make the least progress towards a better business environment in the forecast period.

The region's progress in improving its business environment (captured in the score of the index) will be equivalent to that of North America, which, being an established market, is not bound to exhibit much dynamism. However, it will be much less than the dynamism exhibited by fellow emerging markets Eastern Europe and Asia. Poor infrastructure is among the most problematic areas for doing business in Latin America, and the region is currently investing around 2% of GDP on average on infrastructure as compared to 10% in China or 6% in India. A study from the UN Economic Commission of Latin America found that, for the region to be able to continue to grow, at least 5% of GDP has to be invested in infrastructure. There is quite a big gap to reach those levels.

Labour markets are very rigid in the region. This is a problem overall, with the exception of

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	2008-12	2013-17	change
North America	8.12	8.30	0.18
Western Europe	7.41	7.42	0.01
Asia & Australasia	5.99	6.34	0.35
Eastern Europe	6.55	6.93	0.38
Latin America	5.81	6.02	0.21
Middle East & Africa	5.50	5.81	0.31
World average	6.56	6.80	0.24

Among the problematic areas: poor infrastructure, rigid labour markets, insufficient financing, cumbersome fiscal systems, availability of skilled labour, poor competition, red tape.

The EIU business environment rankings measure the attractiveness of the business environment in 82 countries worldwide, based on the market opportunities, policy toward enterprises and FDI, foreign trade and exchange controls, taxes, financing, infrastructure among others.

Source: Economist Intelligence Unit, CountryData.

Chile. The fiscal system is another problem. It is a system that relies heavily on indirect taxes. Tax revenue is very low as a percentage of GDP (under 20%, compared with 34% in OECD countries). The region displays poor competition conditions in most of the key markets and is bogged down with red tape and a lack of skilled labour, an issue connected to the quality of the education in the region. Latin America, unfortunately, continues to perform among the last in the OECD's Programme for International Student Assessment (PISA), which evaluates education systems worldwide by assessing the competencies of 15 year olds in reading, mathematics and science.

To sum up the investment pros and cons: among the pros are the region's prudent fiscal and monetary policy; its growing domestic market, which is in itself a success story; its heavy investment in infrastructure, which results in plenty of opportunities for foreign investors; and a sounder and well-functioning banking system (interestingly, the Spanish banks that invested in Mexico last year have made most of their revenue there). Together these pros show a dynamic private sector, and also deeper south-to-south trade and investment links.

Among the cons is a shortage of skills, which is connected to the poor level of education; a rigid labour market; inefficient bureaucracy and underdeveloped infrastructure. Crime and corruption also remain a huge problem in the region.

With respect to the challenges and opportunities inherent in the relationship between China and Latin America, especially the challenges for Latin America, it is useful to note that, so far, Latin America has been running quite a big trade deficit with China. Also, the type of trade relationship between China and Latin America follows more of a north-to-south pattern whereby China exports manufactures to Latin America, and Latin America imports commodities to China. If this is convenient for China, which needs commodities to fuel its development, it is far from an ideal situation for Latin America, which should make an effort to further diversify trade towards more value-added products. This could have positive implications for China as well because it would also be a way to develop joint initiatives to promote intra-industry trade. It is also an opportunity for more cooperation and innovation in human capital, which is important for both parties.

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We can identify obstacles your company may face from exposure to new markets and new opportunities in a comparative framework that sets unfamiliar markets and situations alongside places and activities you already know. We can provide country-specific, operational and financial risk ratings to help you to make informed decisions on a number of different indicators, including early warning of possible market and industry threats in areas such as security, tax policy, supply chain, regulatory, creditworthiness and labour markets.

Find out more by reading this case study.

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