Special Report
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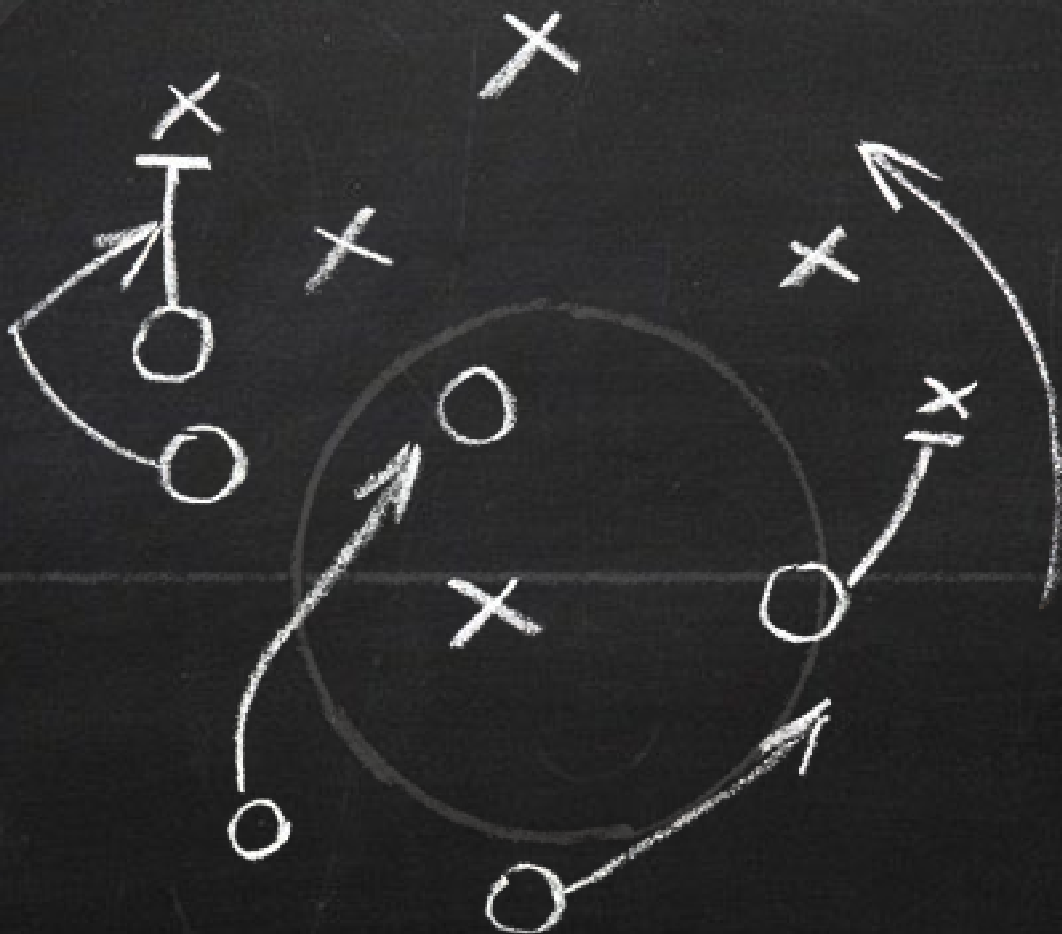

Strategist's Note

Foreign Direct Investment in Latam – some progress, but still a long way to go.

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Foreign Direct Investment in Latam – some progress, but still a long way to go

Against a backdrop of a deeply interconnected and globalized world, the influence that some countries may have on the development of others is playing a more significant role by the day. Thus, we deemed it fit to delve deeply into the current stance of foreign direct investment, how it has developed specifically in Latin America, and what its implications could be going forward.

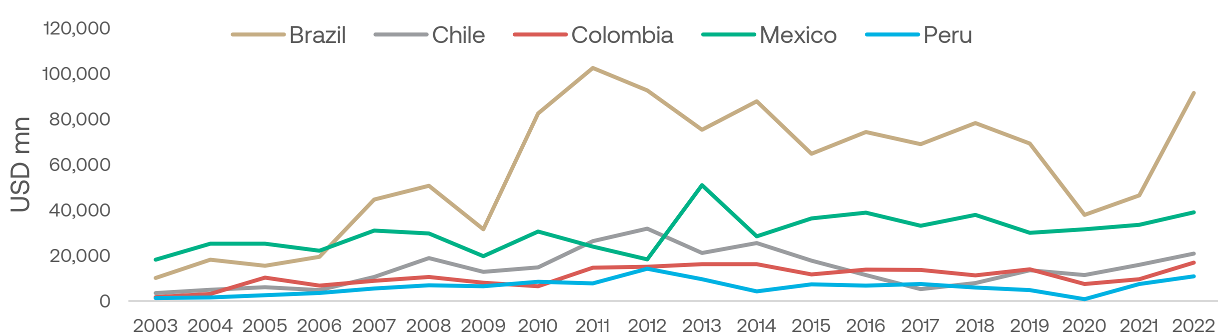
The OECD defines foreign direct investment, more widely known as FDI, as "a category of cross-border investment in which an investor resident in one economy establishes a lasting interest in and a significant degree of influence over an enterprise resident in another economy." This concept has increased in importance as countries become more dependent on each other while facing headwinds such as geopolitical conflict or potential uncertainties surrounding the financial stability of the different trading partners.

To give a general overview of how FDI is looking in global terms, it is worth highlighting that, according to a research publication by the Economic Commission for Latin America and the Caribbean – ECLAC –, the main recipients of FDI in the period between 2018 and 2022 were China and the US, with the European Union registering negative inflows for 2022. Moreover, despite the challenging backdrop that 2022 entailed with the Russian invasion of Ukraine and tighter monetary policy conditions starting to become the new normal, FDI announcements, which are equivalent to future investment plans in a given economy, increased in 2022, mainly due to the renewed interest in renewable energy projects. Furthermore, investment announcements in the coal, oil, and natural gas industries were the second largest sector in terms of projects announced, followed by the semiconductors industry.

According to research by the IMF, FDI flows tend to cluster in geopolitically aligned countries, especially in strategic sectors, such as semiconductors. This situation has been exacerbated by the resurgence of political tensions between the US and China since 2018, which are still relevant. If we turn our attention to Latam, it is relevant to highlight that the region had a record rebound of FDI in 2022, a year in which FDI rose to 3.9% of GDP. As previously mentioned, this occurred amid a renewed interest in the hydrocarbon sector and a marked interest in services.

Switching our focus to specific countries, Brazil stands out as the leading destination of FDI until 2022, with Mexico in 2nd place and followed by Chile. It is relevant to highlight that, according to the ECLAC data, Latin America and the Caribbean reported a record rebound of FDI in 2022, with the inflows to the region rising to 4.0% of GDP. The observed trend came amid higher commodity prices while also helping to boost the return on the investments made in the region. The ECLAC data shows that the average return on FDI for 2022 was north of 6%, a level not seen since the early 2010s. Moreover, it is important to note that the FDI components with the strongest annual growth for 2022 were reinvested earnings and intercompany loans. When we zoom in on the intercompany loans, some analysts like the Economist Intelligence Unit – EIU – are estimating that the type of transactions may decline in the near future, considering the beginning of the easing cycle in most of Latam's economies, which contrasts with the "higher for longer" stance that is being penciled in the US, hence making investments in the latter more attractive.

Amid an FDI boom in Latam, Brazil remains the favorite destination



Source: CELAC

Even if Brazil was the leading FDI destination in 2022, its dominance may be nearing its final stages with the rapid rise of a new favorite destination: Mexico. According to figures from the ECLAC, Mexico had 41 FDI projects announced in 2022, a relevant increase from the 17 registered in 2021 and a noticeable advantage from Brazil's mark of 18. The explanation behind this booming trend lies behind the phenomenon called nearshoring, one we have discussed on previous occasions for being a situation that should benefit Mexico in the near to medium future.

As we have highlighted on previous occasions, Mexico has benefited from the nearshoring phenomenon, with several US companies preferring to bring parts of their supply chains a bit closer to home. This beneficial view has propelled investment in the northern part of Mexico, especially in sectors that require more skilled labor, eventually leading to Mexico being the US' main trading partner with a total trade figure of USD 63.85bn as of June 2023, according to data compiled by Bloomberg. However, according to several analysts, the positive influence of nearshoring in the Mexican economy seems to be only anecdotal, as the majority of FDI registered in 2022 to Mexico was reinvestment of profits, not new projects.

Still, one business division could reap the benefits from the nearshoring phenomenon, and that is the real estate market, with its effects being more visible within the REITS, or FIBRAS, as they are known in Mexico. According to a report from Bloomberg Linea, this nearshoring would not only benefit the industrial arm of the FIBRAS but would also favor others with a focus on hospitality and housing. However, this development will only reap benefits if the other areas that need focus on – such as utility market improvements, land developments, skilled labor force, among others – improve, and the effects of the exchange rate movements keep favoring the Mexican economy.

Even if the initial picture seems positive for the region, we should remember that the political factor continues to play a key part in determining where the FDI flows will land. Against the backdrop of more left-leaning governments, politics play a crucial role when choosing investment partners. This becomes even more relevant when some administrations, such as Chile or Colombia, have threatened to adopt unfriendly policies towards foreign investment. In the case of Argentina, the current presidential race and the uncertainty surrounding the election poses a risk to potential FDI developments.

Moreover, even if the US and Europe are expected to remain the main FDI sources for Latam, the region has started to look for alternative funding sources. Recently, the Latin American Development Bank – or CAF, for its Spanish acronym – announced its intention to add new members who can contribute to the bank and finance additional projects in the region. The CAF hosted conversations with several countries, including Saudi Arabia, Qatar, India, and Korea, to join the existing 21 CAF members. This step is relevant against a backdrop of finding alternatives to US financing, since the US has historically preferred to direct its investments into the region via the World Bank or the InterAmerican Development Bank.

In sum, it would be remiss to deny that Latam has made significant progress in attracting FDI; nonetheless, the boom seen in 2022 and, to some extent, at the beginning of 2023 should not be taken for granted. The region needs to focus on improving several of its shortcomings in terms of infrastructure and how easy it is to do business in the region. If international investors cannot find adequate conditions to establish their facilities or subsidiaries in Latam, that initial interest may lose its shine.

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