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European FDI Strategies in Mercosur Countries

by
Peter Nunnenkamp

May 2001

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European FDI Strategies in Mercosur Countries

Abstract

Mercosur countries have witnessed a boom of foreign direct investment (FDI) inflows since the early 1990s. However, regional integration, viewed in isolation, was not sufficient for the subregion to regain its attractiveness to FDI. FDI growth in individual Mercosur countries was closely related to reform efforts on the *national* level.The pattern of EU FDI in the subregion reveals some significant changes, notably in terms of its major sources and its sectoral composition. Furthermore, EU investors pursued strategies that differed from those of other foreign investors. Yet, the character of EU FDI has essentially remained unchanged so far. Whether efficiency-seeking FDI by the EU in Mercosur will gain prominence in the future depends critically on Mercosur's trade policy.

Keywords: Market-seeking FDI, efficiency-seeking FDI, regional integration, trade policy, EU-Mercosur relations.

JEL classification: F21, F36

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I. INTRODUCTION

Ten years after its creation, Mercosur is at the crossroads once again. The latest blow came in March 2001 from Argentina, which decided to fight recession at home by suspending Mercosur's tariff (*The Economist* 2001a). However, Mercosur's future is uncertain also because of Brazilian trade policies. On the one hand, it is mainly for Brazil that the Mercosur project is of strategic importance. On the other hand, Brazil repeatedly rebuffed its partners by insisting on relatively high common tariffs on capital goods, in order to protect its own manufacturing industries. In a recent evaluation, Preusse (2000: 2) found "evidence that the process of economic integration has slowed down in recent years". Rumors are that Mercosur might change track by giving up the idea of a customs union, and instead becoming simply a free-trade area. In the end, Brazil's neighbors may find it more attractive to strike trade deals with the United States, rather than wait for Brazil to endorse the FTAA project (Free Trade Agreement of the Americas).

Mercosur's future is relevant not only for intra- and extra-regional trade patterns. At the same time, the member countries' attractiveness to foreign direct investment (FDI) may be at stake, even though the relation between regional integration and inward FDI is not as clearcut as it is sometimes assumed. Policymakers in Latin America were quite confident that the creation of

Mercosur would provide a major stimulus to FDI flows to member countries. However, politicians may have been overly optimistic from the very beginning, given the previous experience of the EU with the Single Market Program and of Mexico with NAFTA membership (Section II). Moreover, recent trends of FDI in Mercosur are in some conflict with the view that regional integration played a dominant role (Section III).

Section IV focuses on FDI by EU countries in Mercosur and addresses several issues in some more detail:

- Earlier findings, according to which European investors were rather slow in responding to new investment opportunities in Latin America (IDB and IRELA 1998), will be reassessed. It will be shown that FDI strategies of individual EU countries differed remarkably in this respect.

- We will evaluate the widespread concern that Mercosur integration has led foreign investors to focus on Brazil, whereas the chances of small member countries to attract EU FDI have remained bleak.

- Apart from FDI volumes, the character and quality of EU FDI may have changed due to Mercosur integration. The major question in that regard is whether the motivation underlying EU FDI in Mercosur has shifted from market-seeking towards efficiency-seeking FDI. Inter alia, survey results on the perceptions of foreign investors may help answer this question.

- We will discuss whether recent patterns of EU FDI in Mercosur are likely to persist in the future. Particular attention will be paid to the role of Mercosur's trade policy in encouraging extra-regional exports by foreign investors. In this context, we will raise the question whether foreign investors are likely to support external trade liberalization by Mercosur.

Section V concludes that Mercosur integration went along with some significant changes in the pattern of EU FDI, notably its major sources and its sectoral composition. Moreover, EU investors pursued strategies that differed from those of other foreign investors. Yet, the character of EU FDI has essentially remained unchanged so far. It is open to question whether efficiency-seeking FDI by the EU in Mercosur will gain prominence in the future.

II. REGIONAL INTEGRATION AND FDI: AN AMBIGUOUS RELATIONSHIP

Policymakers in Mercosur could rely on a popular reasoning when hoping for an integration-induced increase in FDI inflows: "Economic integration increases market size and enhances economic growth. As market size and economic growth are in turn important determinants of FDI inflows, regional integration is

often expected to stimulate FDI" (UNCTAD 2000b: 21).[1] In looking for empirical support to this reasoning, the deepening of EU integration through the Single Market Program and Mexico's membership in NAFTA are typically referred to.

Both examples do not provide a completely compelling case for an integration-induced rise in FDI. The effects of integration remained temporary. In the process of completing the Single Market, the EU indeed attracted a rising share of worldwide FDI flows (Figure 1). The EU's share peaked in 1990–1992 at about 44 percent. Only shortly after the Single Market Program had been completed, however, the EU's share in worldwide FDI flows fell back to the level of the mid-1980s of somewhat below 30 percent. Mexico experienced an extremely short-lived boom in FDI when NAFTA was formed in 1994 (Figure 1). FDI flows to Mexico tripled in 1994, compared to annual average flows in previous years, but stagnated thereafter (UNCTAD 2000a). In 1999, Mexico received little more FDI than Chile.[2]

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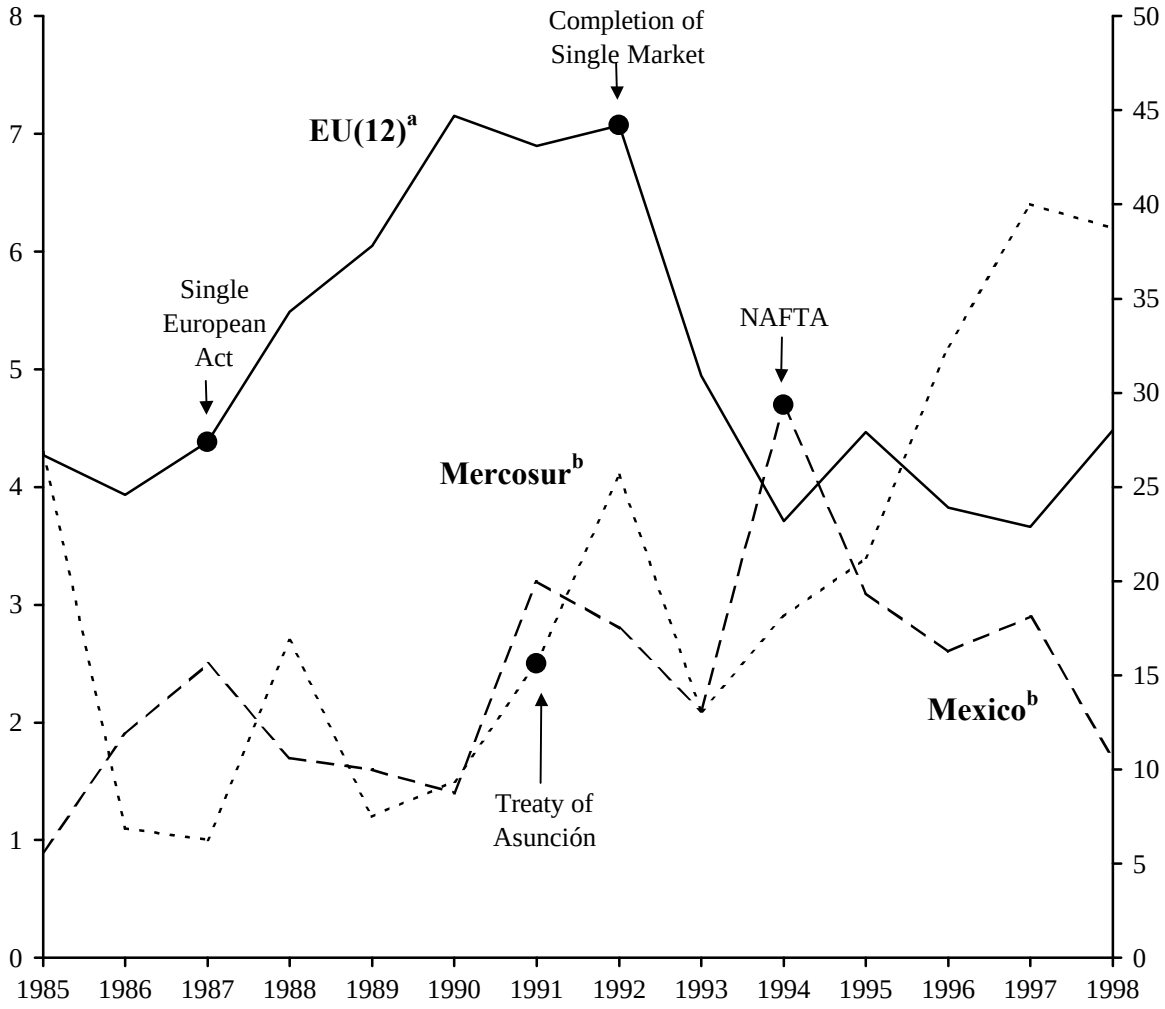
1 For a similar reasoning, see IDB and IRELA (1996: 57 ff.) and Hiemenz et al. (1994: 48 f.).

2 All three NAFTA members increased their share in worldwide FDI flows from 24 percent in the first half of the 1990s to 32 percent in the second half of the 1990s, which was still significantly below the share of 40 percent of these three countries in 1984–1989 (UNCTAD 2000a).

Figure 1 — Regional Integration and Attractiveness to FDI: FDI Flows to EU, Mercosur and Mexico (share in worldwide flows), 1985–1998



[a]Righthand scale. – [b]Lefthand scale.

Source: World Bank, World Development Indicators, CD-RoM.

Apart from the duration of integration-induced effects on FDI, it is for several other reasons that "the relation between regional integration agreements and foreign direct investment is neither self-evident nor straightforward" (Blomström and Kokko 1997: 39):

- First, FDI may be concentrated in some member countries of regional integration schemes, while other member countries do not benefit. A strikingly uneven distribution of integration-induced FDI was actually observed in the case of the EU (Hiemenz et al. 1994: 51 ff.).

- Second, the enlarged market size may stimulate some types of FDI, while leaving other types unaffected. The differentiation between market-seeking and efficiency-seeking FDI appears to be particularly important in this regard.[3] An integration-induced increase in market-seeking FDI will not necessarily go along with a proportionate increase in overall FDI if the relative importance of efficiency-seeking FDI is rising in the context of globalization.[4] The positive effect of higher market-seeking FDI may even be

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3 Efficiency-seeking FDI is motivated by creating new sources of competitiveness for firms and strengthening existing ones.

4 According to UNCTAD (1996: 97), cost differences between locations, the quality of infrastructure and the availability of skills have become more important determinants of FDI, whereas market size has decreased in importance.

offset if regional integration, by raising trade barriers against non-member countries, undermines the incentives to efficiency-seeking FDI.

- Third, it is extremely difficult, if not impossible, to separate integration-induced effects from other influences on FDI (UNCTAD 1998: 251). In Latin America, regional integration was not pursued in isolation, but in combination with policy reforms on the national level. It is a matter of speculation how FDI would have developed in the absence of regional integration.

All three qualifications are highly relevant when it comes to assessing FDI trends in Mercosur, to which we turn in the next section.

III. FDI TRENDS IN MERCOSUR

The share of Mercosur in worldwide FDI flows fluctuated significantly over much of the period considered in Figure 1. Absolute FDI flows, too, have been on a clear upward trend only since 1993, when the four member countries are taken together.[5] Considering the discussion in Section II, the obvious question is

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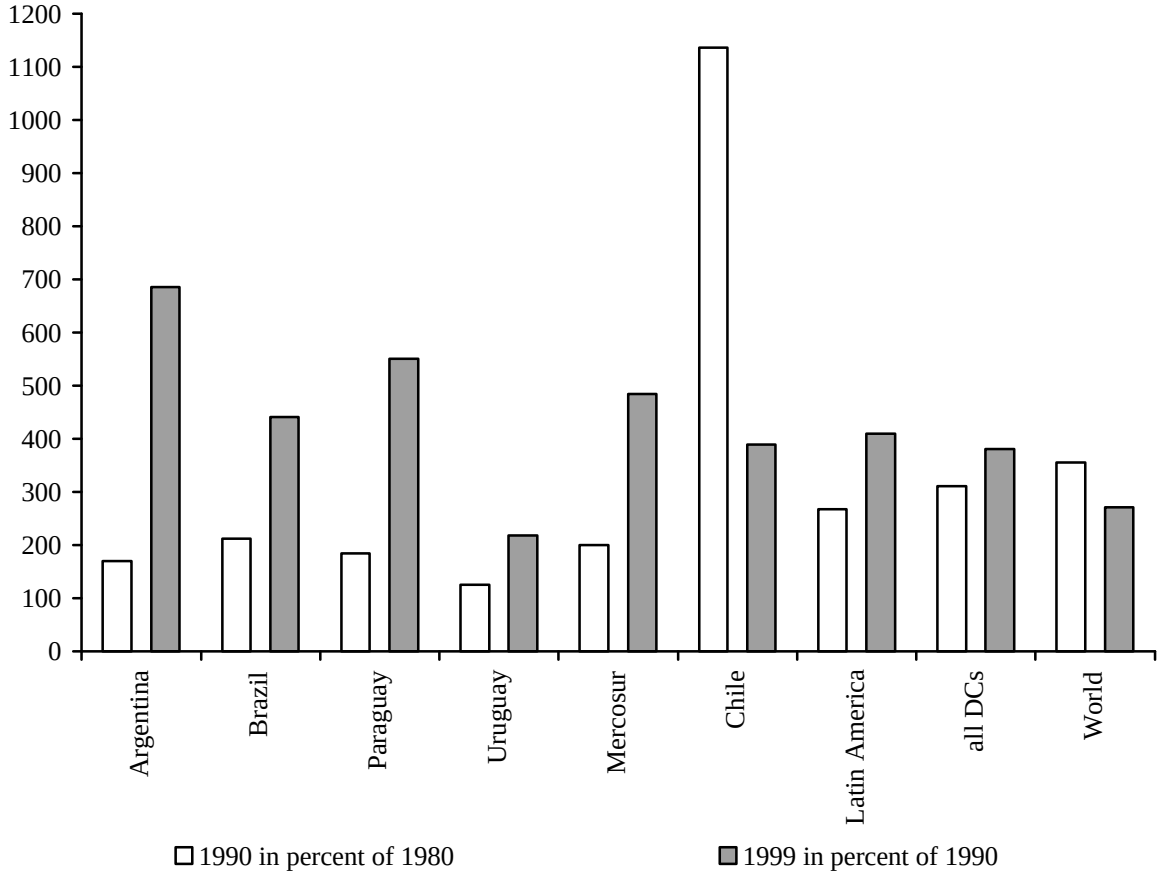
5 According to World Bank data (World Development Indicators, CD-RoM), FDI flows to Mercosur increased ninefold from 1993 (US$ 4.3 billion) to 1998 (US$ 38.5 billion). UNCTAD (2000a) reports a further increase to US$ 55 billion in 1999.

whether this trend was related to the formation of Mercosur. Some observers suggest so when they argue that "most direct investment inflows have taken place *after* the Treaty of Asunción was signed in 1991 (79 % in Argentina's case)" (IDB and IRELA 1996: 62).

At first glance, Figure 2 supports the view that the formation of Mercosur was instrumental in stimulating FDI. In the 1980s, the increase in inward FDI stocks remained low by any standards in all four Mercosur countries. By contrast, FDI stocks soared almost fivefold in Mercosur in the 1990s. With regional integration proceeding, Mercosur outperformed other Latin American economies as well as the reference group of all developing countries in attracting FDI. The boom of FDI in the 1990s was not restricted to Brazil. Rather, the increase in FDI stocks was most pronounced in Argentina and Paraguay. It was only in Uruguay that the increase in FDI stocks remained below international standards after the formation of Mercosur.

In the light of the contrasting experience of the two smaller Mercosur countries, the widespread concern appears to be unjustified that regional integration necessarily leads to a concentration of FDI in the largest and most advanced member countries. It should also be noted that it does not make much sense to assess the issue of FDI concentration by referring to the distribution of FDI in

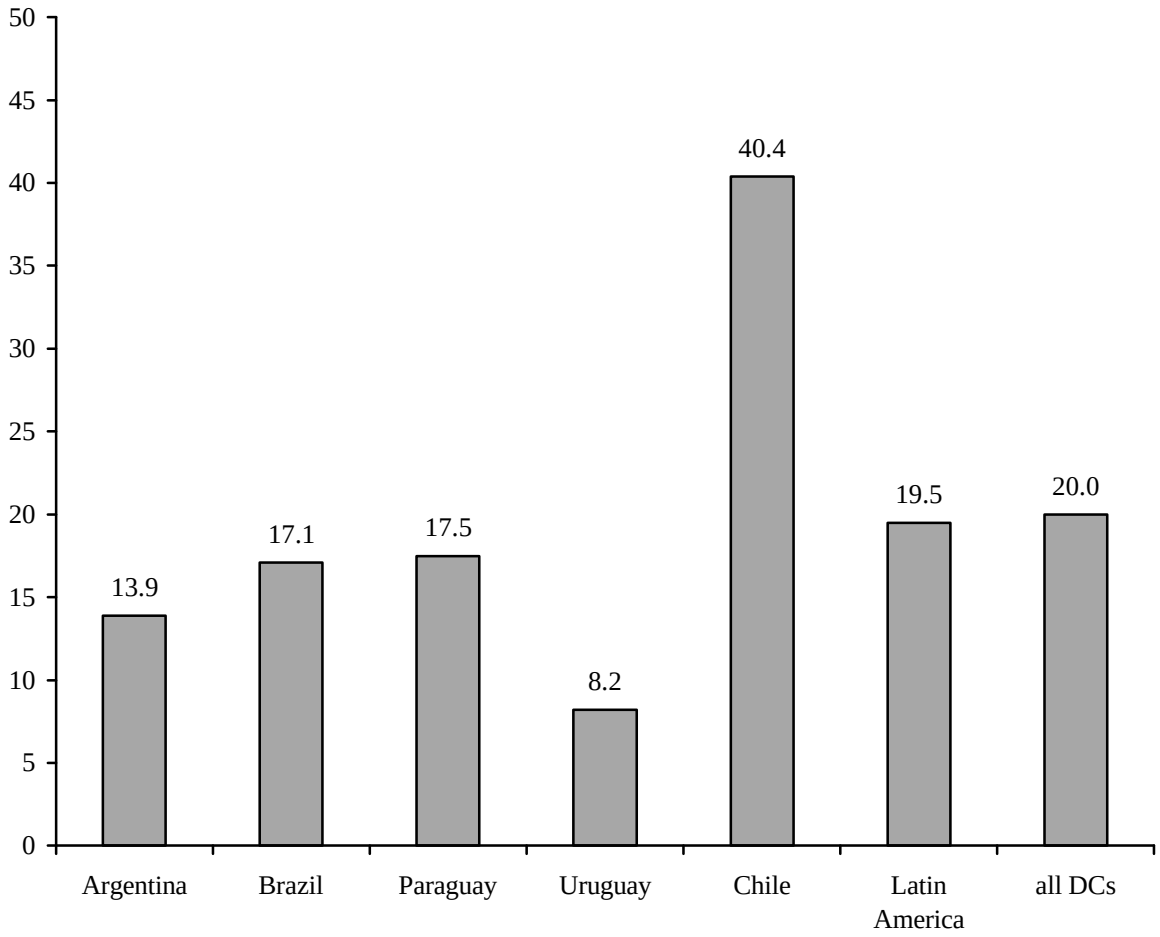
Figure 2 — Mercosur: Increase in Inward FDI Stocks, 1980–1999



Source: UNCTAD (2000a).

absolute terms. A large-country bias can only be avoided if FDI is considered in relative terms. In Figure 3, inward FDI stocks are related to the host countries' GDP. By this measure, Paraguay attracted as much FDI as Brazil, and significantly more than Argentina.

Figure 3 — Mercosur: Inward FDI Stocks in Percent of GDP, 1998



Source: UNCTAD (2000a).

The relevance of regional integration in driving FDI may be put into perspective by a closer inspection of the data. Various observations suggest that regional integration was neither necessary nor sufficient to make Mercosur countries attractive to FDI:

- Inward FDI stocks exceeded 40 percent of GDP in Chile, compared to an average ratio of 14 percent for the four Mercosur members, even though Chile did not join Mercosur (Figure 3).

- Despite the steep increase in inward FDI in the 1990s, the FDI/GDP relation remained relatively low in Mercosur by the standards of all developing countries within and outside Latin America (Figure 3).

- The time profile of FDI growth in individual Mercosur countries appears to be closely related to reform efforts on the *national* level. The case of Brazil is most revealing in this regard. Compared to its neighbors, Brazil was fairly late in implementing stabilization and structural adjustment measures (Nunnenkamp 1997a; Preusse 1996). It is unlikely to be by pure coincidence that Brazil participated in the FDI boom with a significant time lag only. Inward FDI stocks increased by 15 percent in Brazil in the first half of the 1990s, while they tripled in Argentina (UNCTAD 2000a, and earlier issues of the World Investment Report). It was only after major policy adjustments at home that Brazil regained its attractiveness to foreign investors (Nunnenkamp 1997b: 67).

This leads us to conclude that Mercosur integration was not the dominant factor underlying the recent growth of FDI in member countries. True, the formation of Mercosur gave reason to reorganize production on the subregional level.

Mercosur may also have provided an incentive to FDI in the form of mergers and acquisitions (UNCTAD 2000b: 113). Unless *national* policies are attractive to foreign investors, however, "gains from economic integration under the MERCOSUR may remain at best limited" (ibid: 115). According to survey results presented by UNCTAD, only a few multinational enterprises had added more capacity in Brazil solely because of the regional effect.

IV. EUROPEAN FDI STRATEGIES IN MERCOSUR

1. Traditional FDI Characteristics and Motivations

South American countries, notably Brazil, have since long been a focal point of FDI outside the OECD area by European companies (IDB and IRELA 1998: 49). For example, Argentina and Brazil accounted for 43 percent of German FDI stocks held in all developing countries in 1990 (Deutsche Bundesbank var. iss.). European companies have shown particular preference for the Mercosur region, "partly because of strong historic links with the subregion and because of their focus on local markets" (UNCTAD 1998: 250).

Traditionally, European FDI in the subregion was concentrated in the manufacturing sector (IDB and IRELA 1998: 49). This concentration was particularly pronounced in the case of German FDI (Nunnenkamp 1998). In 1985, German FDI in the manufacturing sector of Argentina and Brazil

accounted for 80 and 90 percent, respectively, of total German FDI in these countries. Even within the manufacturing sector, FDI patterns revealed little diversification. In Argentina and Brazil, just three manufacturing industries (chemicals, machinery and transport equipment) absorbed two thirds of total FDI stocks in manufacturing in the early 1990s (Nunnenkamp 1997b: 58 f.).[6] All three industries could be classified as relatively capital- and skill-intensive. A more detailed study on German FDI patterns also found FDI in Latin American host countries to be relatively capital-intensive (Nunnenkamp 1998).

The country- and industry-wise concentration of FDI was the result of the foreign investors' preference for large and protected markets. According to findings of IDB and IRELA (1998), companies from Germany, France and Spain had a marked orientation towards the provision of local markets. Notably in the automobile and chemical industries, the size and growth of markets provided the major stimulus to FDI in the Mercosur region. Multinational companies used FDI mainly to overcome import barriers. Cost considerations did not play a significant role in decision making by European companies with regard to FDI in Mercosur countries.

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6 This refers to FDI from all sources.

Obviously, it was not the European companies' independent choice to focus on market-seeking rather than efficiency-seeking FDI in Mercosur. The policy environment prevailing in the host countries constrained corporate internationalization strategies. The legacy of the import substitution model of economic development impaired the international competitiveness of manufacturing industries in Mercosur countries. In the light of restrictions imposed on imports of intermediate inputs and capital goods, it was no reasonable option to integrate subsidiaries operating in Mercosur countries into global sourcing and marketing networks.[7] FDI in Brazil's automobile industry exemplifies the interplay between corporate strategies and local investment conditions (Nunnenkamp 1997b: 63; IDB and IRELA 1998: 144 f.): Import restrictions made automobile production less competitive in Brazil than in Mexico or Spain. Hence, the export orientation of foreign automobile companies in Brazil remained weak. Subsidiaries in Brazil were set up for tapping the large domestic market behind protectionist walls and operated on a stand-alone basis.

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[7] In addition, high transaction costs and a relatively poor endowment of complementary factors of production impeded a closer integration of subsidiaries into globalized manufacturing (Nunnenkamp 1997b).

2. European Responses to Changing Conditions in Mercosur

The policy environment for FDI in Latin America has changed substantially during the last decade or so. Apart from macroeconomic stabilization, structural reforms such as privatization of state-owned enterprises offered new FDI opportunities. Trade policy reforms encouraged a stronger outward orientation of Latin American economies, including Mercosur countries. While the timing and scope of reforms differed across countries, reforms appear to have acquired "full and generalized force in the late 1980s and early 1990s" (Edwards 1995: 8).

Especially since Brazil embarked on major reforms, FDI has boomed in Mercosur (Figure 1). Arguably, not only the overall amount of FDI has increased, but also the nature of FDI has changed. According to press reports, Campinas in the Southeast of Brazil emerged as an IT-center, having attracted FDI in the order of US$ 15 billion in 1998–2000 (*Financial Times Deutschland* 2000). Foreign telecommunication companies such as Ericsson from Sweden are setting up major R&D facilities in Campinas. This raises the question whether it is no longer true what IDB and IRELA (1998: 17 f.) found out only a few years ago, namely that European investors (notably French, German and UK companies) proved to be "unresponsive to the positive developments in the region" and "showed little interest" during much of the 1990s.

Several aspects of this question will be addressed in the following. First, we will assess the distribution of EU FDI among major Latin American recipients and its relevance for individual Mercosur countries. Second, we will show that the strategies pursued by investors from major EU countries differed considerably. Third, we will check whether there is more than anecdotal evidence that the nature of EU FDI has changed. Specifically, we will evaluate the proposition that, with greater outward orientation of Mercosur economies, the motivation of EU FDI in these countries has shifted from market-seeking to efficiency-seeking FDI.

a) Stronger Focus on Mercosur

In the 1990s, Latin America as a whole hosted only 6 percent of worldwide FDI stocks held by major EU countries,[8] compared to about one fifth of US FDI (Table 1). This difference is partly because EU FDI is concentrated within the EU.[9] At the same time, the distribution of EU FDI among Latin American

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8 Note, however, that Spain is not included in Table 1 as comparable data were not available; for the relevance of Spain, see further below.

9 In 1997, EU partner countries accounted for almost half of total FDI stocks held abroad by the EU investors listed in Table 1 (OECD 2000). Consequently, the share of Latin America in *extra*-EU FDI stocks was about 12 percent.

Table 1 — EU and US Investors: Relative Importance of Major Latin American Host Countries (percent of FDI stocks held in Latin America), 1990 and 1998

	EU		US	
	1990[a]	1997[b]	1990	1998
Argentina	5.7	9.6	3.5	5.8
Brazil	24.7	31.0	20.1	19.2
Chile	3.0	3.8	2.7	4.6
Mexico	8.1	8.5	14.4	13.2
Memorandum:				
Latin America (percent of stocks worldwide)	6.1	6.1	16.6	20.1

[a] Sum of France, Germany and United Kingdom. No comparable data available for other EU countries. – [b] Sum of Austria, Finland, France, Germany, Netherlands, Portugal and United Kingdom.

Source: OECD (2000).

economies differed considerably from the distribution of US FDI. While the latter was distributed among a wider range of Latin American countries, more than half of FDI flows from Europe to Latin America went to Mercosur in the 1990s (IDB and IRELA 1998: 50). Moreover, stock data reported in Table 1 reveal that major EU investors have strengthened their focus on Mercosur since the early 1990s. Argentina and Brazil[10] hosted more than 40 percent of EU FDI

[10] Comparable data were not available for Paraguay and Uruguay.

stocks in Latin America in 1997, up from 30 percent in 1990. By contrast, the share of the two large Mercosur members in US FDI stocks remained constant at about 25 percent.

b) Increased Importance of EU FDI in Argentina and Brazil

Tables 2–4 portray the relative importance of FDI from EU countries in total FDI from all sources in three Mercosur countries.[11] Taken together, EU investors were more important than US investors in Argentina (Table 2) and Brazil (Table 3). In both countries, EU investors held about 35 percent of FDI stocks in the first half of the 1990s. Moreover, recent data on FDI flows indicate that EU FDI has gained prominence in the two large Mercosur countries. EU FDI contributed more than half to accumulated flows in both countries.

The increased importance of EU FDI in Argentina and Brazil is in striking contrast to the contribution of major source countries to FDI in Paraguay (Table 4). While the EU and the United States accounted for a similar share in FDI stocks in 1995, subsequent FDI flows to Paraguay originated mainly from the United States. In terms of accumulated flows in 1996–1999, EU investors

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[11] Uruguay is not considered because comparable data were not available.

ranked only third, substantially behind the United States and Paraguay's Mercosur partners. This provides a first indication that EU investors differed from other foreign investors in that they concentrated their presence in the large Mercosur countries and paid less attention to the small ones.

Table 2 — Argentina: FDI from Major Sources (percent of total FDI), 1992–1999

Source countries	Stocks 1992	Accumulated flows 1992–1999
France	7.4	7.0
Germany	5.1	2.1
Italy	7.1	2.4
Netherlands	6.8	7.3
Spain	5.6	31.8
United Kingdom	4.0	4.4
Sum of 6 EU countries	36.0	55.0
Other Europe	5.7	1.3
United States	29.8	21.1
Chile	3.5	4.1
Other Latin America	14.9	12.6
Rest of world	10.2	5.9

Source: Direccion Nacional de Cuentas Internationales (www.mecon.gov.ar/download/cuentas_int/inversion.doc).

Table 3 — Brazil: FDI from Major Sources (percent of total FDI), 1995–2000

Source countries	Stocks 1995	Accumulated flows 1996–2000
Belgium	1.3	1.6
France	4.8	7.6
Germany	13.7	1.6
Italy	3.0	1.6
Luxembourg	1.0	1.7
Netherlands	3.6	9.3
Portugal	0.3	7.3
Spain	0.6	20.8
Sweden	1.3	1.5
United Kingdom	4.2	2.0
Sum of 10 EU countries	33.8	55.0
United States	25.5	23.7
Japan	6.3	1.4
Rest of world	34.4	19.9
(thereof: Argentina and Uruguay)	(3.0)	(1.0)

Source: Banco Central do Brasil (www.bcb.gov.br)

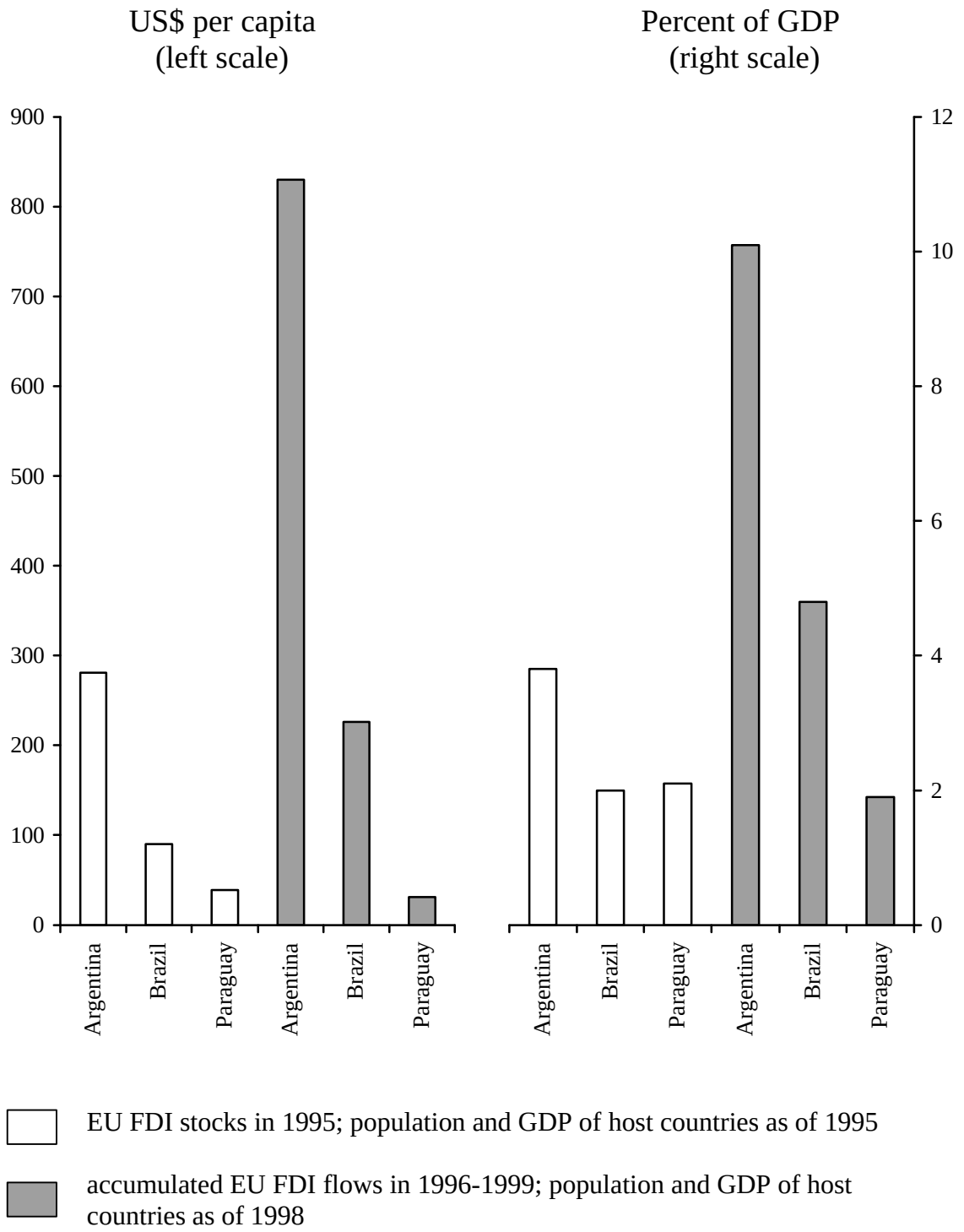
Table 4 — Paraguay: FDI from Major Sources (percent of total FDI), 1995–1999

Source countries	Stocks 1995	Accumulated flows 1996–1999
France	3.9	0.6
Germany	0.3	0.1
Italy	3.0	0.2
Netherlands	7.6	13.3
Portugal	3.2	0.2
Spain	6.4	3.0
Sweden	0.0	0.6
United Kingdom	4.5	3.1
Sum of 8 EU countries	28.9	21.1
United States	29.9	41.4
Japan	0.0	1.5
Rest of world	41.2	36.0
(thereof: Mercosur countries)	(35.5)	(29.3)

Source: Banco Central de Paraguay (www.bcp.gov.py)

Another indication to this effect is revealed when FDI is considered in relative terms. As mentioned in Section III, Paraguay proved most attractive among Mercosur countries after correcting for the large-country bias in the distribution of overall FDI in absolute terms. EU investors, however, had a preference for the large Mercosur countries not only in absolute terms, but also in relative terms (Figure 4):

Figure 4 — EU FDI in Mercosur Countries in Relative Terms



Source: See Tables 2–4; World Bank, World Development Indicators CD-RoM.

- EU FDI stocks in 1995 were biased in favor of Argentina, irrespective of whether stocks are related to the host countries' population or GDP. Brazil ranked second in terms of EU FDI stocks per capita, while the ratio of EU FDI stocks to GDP was similar in Brazil and Paraguay.

- Measured by recent FDI flows, the bias in favor of Argentina was even stronger. Furthermore, EU investors clearly preferred Brazil over Paraguay in the second half of the 1990s. In per-capita terms, EU FDI flows to Brazil exceeded EU FDI flows to Paraguay by a factor of seven.

c) Major Shifts Between EU Countries

The increased importance of EU FDI in Argentina and Brazil masks striking differences among EU investors. EU countries which had traditionally been leading investors lost significantly in importance and were surpassed by newcomers. In Brazil, for example, Germany owned 40 percent of EU FDI stocks in 1995 (Table 3). However, Germany's contribution to FDI flows to Brazil in 1996–2000 was marginal. In Argentina, two major EU investors until the early 1990s, namely Germany and Italy, became considerably less important thereafter (Table 2).

In both Argentina and Brazil, Spain emerged as the most important EU investor by far in recent years. Spain accounted for almost 60 percent of EU FDI flows to Argentina in 1992–1999, and for almost 40 percent of EU FDI flows to Brazil in

1996–2000. Another newcomer, i.e. Portugal, ranked fourth among EU investors in Brazil in recent years. As it seems it is mainly because the newcomers focused on the two large Mercosur economies that the structure of FDI in Paraguay shifted towards non-EU sources.

d) Different Strategies: Spain versus Germany

The strategic responses to changing investment conditions in Mercosur can best be exemplified by contrasting the FDI patterns of the old and the new number one among EU investors, i.e. Germany and Spain. As concerns Germany, there is some argument about the "true" value of German FDI stocks in Mercosur countries (Rösler 2000).[12] However, different statistical sources have in common that the growth of German FDI stocks in Mercosur remained substantially below the growth of FDI stocks from all sources in Mercosur. While German FDI stocks increased by 20–80 percent (depending on the source

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12 According to Bundesbank data (Deutsche Bundesbank var. iss.), German FDI stocks in all four Mercosur countries added up to DM 19 billion at end–1998. Rösler (2000) presents a figure, based on data provided by German Chambers of Commerce in Latin America, which is almost 50 percent higher. This discrepancy is attributed, inter alia, to the statistical treatment of depreciation and exchange rate fluctuations. Moreover, Rösler argues that reinvested earnings and indirect German FDI (e.g. via offshore centers) go partly unreported in Bundesbank statistics.

and currency denomination) in 1989–1998, the total inward FDI stock of Mercosur soared almost fivefold in the 1990s (UNCTAD 2000a).

This huge discrepancy supports the view that German investors "proved to be very unresponsive" (IDB and IRELA 1998: 17) to new investment opportunities in Latin America. German companies were hardly involved in privatization programs, possibly because "there may have been a lack of competitive German bidders for service companies to be privatized in Latin America" (Nunnenkamp 1998: 28). As a consequence, German FDI stocks in Argentina and Brazil continued to be concentrated in a few, relatively sophisticated manufacturing industries (notably chemicals and transport equipment).[13] Expansion programs in these industries were mainly financed through reinvested earnings of well established Latin American subsidiaries, rather than outright capital transfers from German parent companies (Rösler 2000). Taking into account that reinvested earnings go partly unreported in official statistics, the decline of Germany as the leading EU investor in the region may be a statistical artifact to some extent. However, inflexibility in grasping new investment opportunities outside the traditional domain of German companies in manufacturing appears

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[13] In Brazil, four manufacturing industries (chemicals, machinery, electrical equipment and transport equipment) accounted for 70 percent of total German FDI stocks at end-1998 (Deutsche Bundesbank var. iss.).

to be the major reason for Germany having been surpassed by other EU countries recently. In Brazil, for example, Germany ranked only fifth among all foreign investors at end-1999, behind the United States, Spain, the Netherlands and France (Rösler 2000, on the basis of Brazilian stock data).

By contrast, it was largely due to Spanish FDI that the sectoral composition of FDI in Mercosur countries shifted towards the service sector.[14] FDI strategies of Spanish companies were peculiar in several respects:[15]

- International expansion through FDI was concentrated in a single region, i.e. Latin America, which accounted for more than 70 percent of Spanish FDI in 1998.
- Mercosur, Chile and the Andean Community have been the main focus of attention. Among Mercosur economies, Argentina was the major target until recently. In 1998, however, Brazil attracted more than half of Spanish FDI

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14 Mortimore (2000) lists banking, telecommunication, retail trade and electricity as focal points of FDI in Argentina and Brazil in the 1990s. The service sector as a whole accounted for two thirds of overall FDI flows to Brazil in 1990–1996 (UNCTAD 1998: 255 f.). In Paraguay, more than two thirds of inward FDI stocks were placed in the service sector in 1999 (Banco Central de Paraguay 2000).

15 The subsequent characterization of Spanish FDI draws heavily on Mortimore (2000: chapter III).

flows to Latin America. In the two small Mercosur countries, the Spanish engagement seems to be limited to FDI in banking.

- The service sector accounted for almost all Spanish FDI in Latin America in 1993–1998. Moreover, FDI activity was confined to a small number of investors (according to Mortimore, no more than ten companies, most of which have recently been privatized in Spain) in just a few service industries (transport, telecommunication, banking and energy).
- Spanish investors pursued a strategy of acquisitions and were deeply involved in Latin American privatization programs.

As a result, some Spanish companies emerged as key players in recently liberalized service industries of Mercosur countries. In sharp contrast to their German counterparts, Spanish companies made extensive use of new investment opportunities. Yet there is one thing which Spanish and German investors had in common: Both groups of investors aimed at penetrating Mercosur markets. Put differently, Spain contributed significantly to the recent boom of FDI in Mercosur and to changes in the sectoral structure of FDI, while the market-seeking character of EU FDI in the subregion was basically left unchanged by Spain's engagement.

e) FDI Strategies in Argentina: EU Investors versus Other Investors

A data base of the Argentine Ministry of Economics, covering 44 major FDI projects in Argentina in the 1990s, provides further insights into the FDI strategies of EU companies.[16] The total sum of investment in these projects amounted to US$ 19 billion, of which slightly more than one third originated from EU investors.[17] Among EU investors, Spain was clearly dominant; Spain accounted for half of the 14 EU FDI projects listed in the data base, and for 40 percent of the volume of EU FDI. The United Kingdom ranked second among EU investors (with three projects and 26 percent of the volume of EU FDI). The remaining four EU FDI projects were from France (automobiles and water distribution), Germany (chemicals) and Italy (automobiles).

EU and non-EU investors pursued strikingly different FDI strategies in Argentina.[18] Major differences relate to the sectoral focus of FDI and the mode

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16 The data are accessible online under www.mecon.gov.ar/index/cabinet/update/bulletin1/cuainv.htm.

17 For details, see Annex Table.

18 North American companies dominated among direct investors from non-European countries. US and Canadian companies accounted for 21 of 30 non-EU FDI projects and 64 percent of the volume of non-EU FDI.

of investment (i.e., acquisitions of existing enterprises or greenfield investments). Almost half of EU FDI was undertaken in the tertiary sector and two thirds were acquisitions of Argentine enterprises (Figure 5). By contrast, non-EU FDI was concentrated in manufacturing and the bulk of it was in the form of greenfield investments.

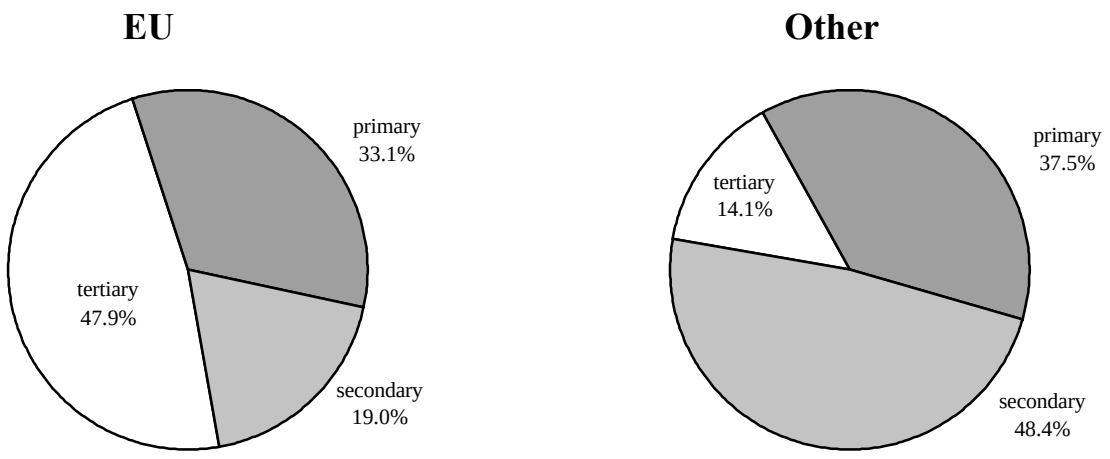
Some interesting details are as follows:

- The relative importance of resource-seeking FDI in the primary sector of Argentina (mining, petroleum, gas and electrical power) was similar for EU and non-EU investors. However, EU FDI in this sector was largely through acquisitions, whereas non-EU FDI was exclusively through greenfield investments.

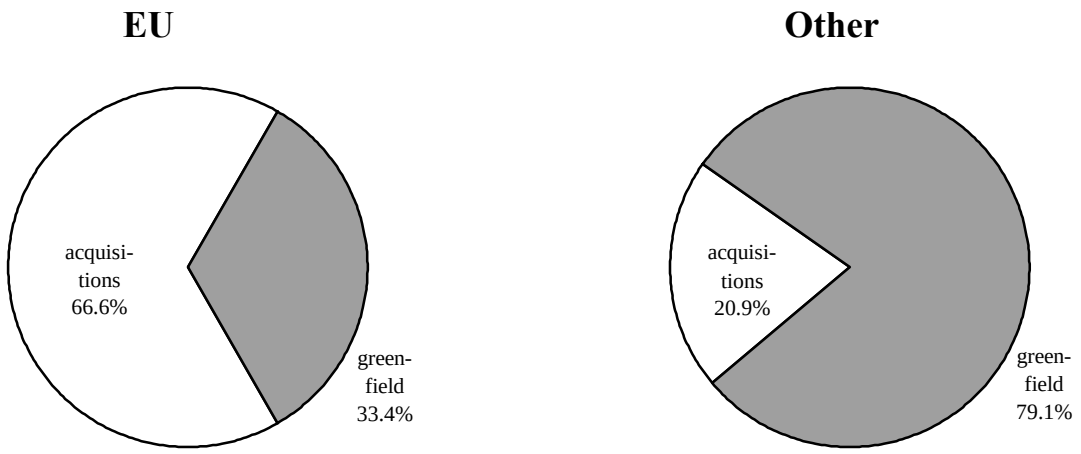
- Greenfield investment by EU investors in the tertiary sector was absent, whereas it accounted for almost two thirds of non-EU FDI in the tertiary sector. Nevertheless, EU investors contributed more than 60 percent to total FDI in this sector. This prominent role was mainly because of Spanish and UK acquisitions of financial institutions in Argentina. The engagement of non-EU investors in the tertiary sector, though less voluminous, covered a broader range of service industries (banking, telecommunication, retail trade, hotels).

Figure 5 — EU Investors vs. Other Investors: FDI Strategies in Argentina in the 1990s (percentage of total FDI by EU and other investors, respectively)

a) Sectoral focus



b) Mode of investment



Source: Annex Table.

- It was only in the secondary sector that greenfield investments by EU companies figured prominently. Yet, EU companies contributed less than 20 percent to total FDI in the secondary sector. Moreover, just two EU projects in Argentina's automobile industry (by France and Italy) represented almost all EU FDI in manufacturing. As in the tertiary sector, the engagement of non-EU companies in Argentine manufacturing was more diversified (number of projects in brackets): food and beverages (6), automobiles (4), chemicals (2), paper and wood (2), and capital goods (1).

All in all, EU FDI in Argentina was predominantly market- or resource-seeking. EU FDI was shaped by some large acquisitions in the tertiary sector, undertaken in the context of privatization programs.[19] It may even be argued that efficiency-seeking FDI was completely absent among the EU projects included in the data base. EU FDI in manufacturing, i.e., the sector in which efficiency-seeking FDI is to be sought in the first place, was concentrated in Argentina's automobile industry. As pointed out by Mortimore (2000), FDI in the manufacturing of automobiles was of a market-seeking character in Argentina (as in Brazil, but in contrast to Mexico).

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[19] The average size of EU projects in the tertiary sector was US$ 620 million (non-EU projects: US$ 220 million).

3. What May Change in the Future

a) Survey Results on Future FDI Strategies[20]

European FDI strategies in Mercosur countries are unlikely to change fundamentally in the short to medium run,[21] if survey results based on responses by 20 German companies provide a reasonable yardstick. The group of German respondents may not be representative for various reasons. First, as shown before, German FDI strategies differed from the strategies pursued by investors from other EU countries. Second, the sample of German respondents is very small, considering that about 2000 German direct investors are present in Latin America (Rösler 2000). Third, the sample is biased towards fairly large companies, with two thirds of respondents employing more than 10 000 persons. Nevertheless, it may be useful to summarize some relevant findings.

Latin America as a whole will remain at least as important an investment location for German companies as in the past five years. Actually, an increasing

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20 The subsequent paragraphs draw on a survey on investment strategies of European companies in Latin America carried out by the Inter-American Development Bank. Note that only the responses provided by German companies were available to the present author. The complete survey results will be published by the Inter-American Development Bank in 2001.

21 The survey results (of the Inter-American Development Bank) on future strategies refer to the next five years.

number of companies considered Latin America to be an investment location of high or even top priority in the future. Basically the same applies to Mercosur. Not surprisingly, Brazil will continue to be the most important investment location within Mercosur, even though a declining number of companies granted top priority to Brazil. However, Mexico may replace Brazil as the Latin American investment location with the highest strategic importance in the years to come (measured by the percentage of German companies giving high or top priority to these two countries).

The survey results suggest that the motivations underlying German FDI in Mercosur countries will essentially remain unchanged. As a first indication to this effect, the expansion of existing capacities will be the dominant strategy in the future (even more so than in the past). Furthermore, all respondents stressed the size and growth of markets in Argentina and Brazil as important determinants of investment decisions. More surprisingly perhaps, only a minority of respondents conceded that seeking efficiency gains in the context of global corporate strategies is no important factor for FDI in Argentina and Brazil.

As concerns the importance of Mercosur integration, survey results are ambiguous. The group of German companies is equally divided between those who considered Mercosur membership to be relevant for their investment

decisions in Argentina and/or Brazil, and those who did not.[22] This is in some contrast to survey results presented by UNCTAD (2000b: 112), according to which almost all companies with FDI experience in Brazil underscored the importance of Mercosur.[23] Respondents to UNCTAD's survey mentioned more important markets (in terms of size and growth potential) as well as better chances to optimize production arrangements, when asked to specify the relevance of Mercosur.

Yet, both surveys indicate that market-seeking FDI will continue to be the dominant type of FDI in Mercosur. According to UNCTAD (2000b: 114), foreign investors in Brazil assigned highest importance to the liberalization of *intra*-Mercosur trade, rather than to lowering trade barriers against non-members. This implies that respondents rated the penetration of regional markets higher than cost-efficient global sourcing and international competitiveness of their local operations. It fits into this picture that, in the IDB survey, almost all German investors serving local markets in Argentina and/or

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22 The same applies with regard to Mexico's membership in NAFTA.

23 However, UNCTAD (2000b: 112) adds: "The interpretation of what investors really mean when they rate the importance of regional developments is by no means straight forward. For some it can ... serve to reinforce the wisdom of their earlier judgement and makes no difference in terms of actions."

Brazil recorded exports to other Mercosur countries, whereas only a few of them recorded exports to Europe and/or North America.[24]

b) Export Potential of FDI in Mercosur: The Role of Trade Policy

The survey results reported above do not reveal the quantitative importance of exports by foreign investors in Mercosur countries. However, evidence available for the mid-1990s points to a low export propensity[25] of foreign companies operating in Argentina and Brazil (UNCTAD 1998: 254 ff.).[26] More strikingly perhaps, trade liberalization and regional integration do not appear to have increased the export propensity of foreign companies in Argentina and Brazil until the mid-1990s.

The future export performance of foreign investors in Mercosur countries, notably their extra-Mercosur exports, depends on various factors. First, the

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24 Exports to neighboring Mercosur markets were reported in 20 cases out of 24 observations; exports to Europe (United States and Canada) were reported in 6 (8) cases.

25 Exports in percent of total sales.

26 In both countries, the export propensity of affiliates of US companies (19 percent in Argentina and 15 percent in Brazil) was substantially below the average export propensity of US affiliates in Latin America as a whole (let alone Asia, where the export propensity of US affiliates exceeded 50 percent in 1995). The export propensity of foreign companies among the top 100 companies in Brazilian manufacturing was 5–6 percent.

export propensity is likely to rise if the expectation of IDB and IRELA (1998: 20 f.) proves correct that FDI will shift back from services towards manufacturing in coming years. The export orientation of FDI in the service sector is typically low as most services are not tradable.[27] Second, FDI may become more world-market oriented if Mercosur governments prevent currency misalignments and exchange-rate volatility, which impaired export production in the past.

Third, and most interestingly in the context of EU-Mercosur negotiations, future trade policy has an important impact on whether European companies will integrate their operations in Mercosur countries more closely into globalized sourcing and marketing networks. Principally, both sides of the pending EU-Mercosur trade agreement matter for extra-Mercosur exports of European investors in Mercosur countries. However, as argued in the following, trade concessions made by the EU will probably be less relevant than opening Mercosur markets to competition by non-members, including the EU.

The EU has relatively little to offer to Mercosur in terms of better access to EU markets in manufacturing industries. For the bulk of manufactured goods, access

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[27] This is not to ignore that FDI in the service sector may support exports indirectly, e.g., by providing manufacturers with more efficient business-related services and thereby improving the international competitiveness of manufacturers.

to EU markets was not restricted for Mercosur suppliers in the past already.[28] This implies that the poor performance of Mercosur countries in EU markets for manufactured goods, e.g. compared to the favorable performance of Asian competitors, is to be attributed to supply constraints within Mercosur, rather than protectionist import policies of the EU (Nunnenkamp 2000). It is mainly in agriculture where Mercosur's exports to the EU are seriously constrained by EU protectionism. If the EU were to make significant trade concessions in agriculture, this would have little effect on the exports of EU investors in Mercosur countries, however, as EU FDI in agriculture will probably remain of marginal importance compared to EU FDI in services and manufacturing.

Hence, it is up to Mercosur's own trade policy to promote the international competitiveness of local production, including local production by EU investors. For future extra-Mercosur exports, it would help considerably to avoid the so-called *Our Market Is Large Enough* syndrome (Bhagwati 1992: 28 f.), which tempts large countries or country groups to be more inward-looking. In other words, integration schemes such as Mercosur must not rely primarily (or even exclusively) on an *intra-regional* division of labor for achieving efficiency gains

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28 About 60 percent of Latin American exports of processed and semi-processed goods to the EU could actually enter EU markets duty-free or with reduced duties under the Generalized System of Preferences.

and economies of scale. The strategy of promoting intra-regional trade, while maintaining high barriers against imports from non-members, runs the risk that an important source of cost savings, namely inputs supplied at world prices, goes unexploited and that specialization will remain limited.

Preusse (2000: 19 f.) argues that trade restrictions of Mercosur against outsiders have indeed conserved an industry structure which is in conflict with Mercosur's comparative advantages. Despite an enormous increase in trade volume, the structure of intra- as well as extra-Mercosur trade hardly changed during the 1990s. Preusse (2000: 19 f.) concludes: "For a large part of the industrial sector in Argentina and Brazil ... the old structures inherited from the import substitution era are still alive."

It is thus not surprising that FDI in Mercosur continued to be market-seeking, instead of turning more efficiency-seeking as in Mexico (Mortimore 2000). The reorganization of production systems induced by Mercosur integration is still largely confined to the subregion. For instance, multinational automobile companies operating in Argentina and Brazil took advantage of the potential of a division of labor *within Mercosur*, whereas the same companies operating in Mexico pursued a more *global* strategy, by using Mexico as a production base for supplying developed country markets (UNCTAD 1998: 258 and 262).

It is in this context that the proposal of a FTAA involves critical policy choices for Mercosur, notably for Brazil. The dominant Mercosur country has so far shown little enthusiasm for FTAA (*The Economist* 2001b). However, the third Summit of the Americas in Quebec in April 2001 principally agreed to get FTAA stated by 2006. If Brazil were to continue its blockage in FTAA talks, its neighbors, including Mercosur partners, would probably strike bilateral trade deal with the United States. As a result, Mercosur may become marginalized. Brazil's attractiveness to FDI may suffer considerably, as neighboring countries would offer better investment conditions for efficiency-seeking FDI.

In Quebec, Brazil has responded to this challenge by agreeing to the FTAA project, if the United States dismantle existing protectionist measures (e.g. anti-dumping duties and farm subsidies), and if labor and environmental standards are not misused as new protectionist devices (*The Economist* 2001c).

It is certainly reasonable to demand from the United States a liberal treatment of Mercosur exports. However, Brazil's bargaining power appears to be limited given its neighbors eagerness "to seek the best possible deal with the United States" (*The Economist* 2001b: 22). Hence, Brazil has l ittle choice but to prepare for changing trade conditions within the Americas restructuring non-competitive industries.

FDI inflows may indeed help restructuring if economic policy provides better conditions for efficiency-seeking FDI. By contrast, Mercosur integration along the lines preferred by Brazil in the past is highly unlikely to do the trick.

c. External Trade Liberalization: Divergent Interests among Foreign Investors

By promoting international competitiveness of local manufacturing, Mercosur governments may provide foreign investors with greater opportunities to integrate manufacturing affiliates into global networks of parent companies. The completion of a customs union with low external tariffs would help achieve this objective. However, as mentioned in the Introduction, it is questionable whether Mercosur will follow this route. Furthermore, as argued in the following, a bold move towards lowering external protection may not only be resisted by short-sighted politicians, but also by an important group of foreign investors.

From a political economy point of view, import liberalization is always difficult to undertake. The benefits of liberalization are widely distributed among consumers who are hardly organized to fight for their interests, and among potential exporters (depending on cost-efficient inputs) who may not even exist when trade policy decisions are made. By contrast, economic agents who are negatively affected by import liberalization are typically well prepared to defend their interests. Strong opposition against import liberalization is to be expected

from companies set up under conditions of import protection; for these companies, liberalization means either market exit or costly restructuring.

Import liberalization may be opposed not only by national producers in Mercosur countries, but also by foreign investors established there since long. As argued above, various multinational companies used FDI to overcome import barriers of Mercosur countries, especially in capital- and skill-intensive manufacturing industries in which Mercosur lacked comparative advantage. Import protection supported high rates of return so that the efficiency and international competitiveness of market-seeking FDI was not a major concern of investors (UNCTAD 1998: 253). Market-seeking foreign investors, concerned about integration and economies of scale solely within Mercosur, are thus likely to join protected national producers in resisting external trade liberalization (UNCTAD 2000b: 114).

This is not to say that all established foreign investors will lobby against external liberalization. Support for external liberalization may come from multinational companies considering Mercosur markets still too narrow to reap economies of scale, and seeking to develop specialized production patterns on a worldwide scale, including existing affiliates in Mercosur. For instance, an automobile company operating in Brazil commented in a survey (UNCTAD 2000b: 115): "Brazil must open up its market-place more. Until we are confident

that we can develop specialized production and integrate trade with local production, we will not invest more in Brazil."

Furthermore, it can reasonably be assumed that support for external liberalization prevails among potential newcomers, i.e., foreign investors not yet present in Mercosur countries. UNCTAD (2000b: 112) found that non-established multinational companies regarded Mercosur integration to be considerably less important to their investment strategy than established companies. Put differently, the former seem to be more interested in integrating their operations across regional boundaries and to lower global, not only regional, costs.

In summary, Mercosur's external trade policy is likely to divide the opinions and actions of foreign investors. On the one hand, purely market-seeking FDI may be discouraged by external trade liberalization. On the other hand, "if intraregional efficiencies are being gained by methods that seriously hinder the creation of globally integrated production networks, this would seriously diminish the attractiveness of Brazil [and Mercosur as a whole] to efficiency-seeking investors" (UNCTAD 2000b: 114; insertion in brackets added). In the short run, the net effect of external liberalization on overall FDI in Mercosur is open to question. In the longer run, however, it may be a serious failure to rely

primarily on market-seeking FDI, as efficiency-seeking FDI is widely believed to gain relative importance in the process of globalization.

V. SUMMARY

Investment conditions have improved in Mercosur countries since the early 1990s or so. At the same time, the subregion witnessed a boom of inward FDI. It is a matter of speculation how FDI would have developed if Mercosur countries had not embarked on regional integration. It can safely be concluded, however, that Mercosur integration, viewed in isolation, was not sufficient for the subregion to regain its attractiveness to FDI. FDI developments in individual member countries, notably in Brazil, were closely related to reform efforts on the national level, which is in some conflict with the widely held view that regional integration was the dominant factor driving FDI.

Recent patterns of FDI by EU countries in Mercosur suggest that earlier verdicts, according to which EU investors proved unresponsive to positive developments in Latin America, have to be qualified in several respects. It turned out that EU investors, in contrast to direct investors from other countries, have strengthened their focus on Mercosur countries since the early 1990s. Moreover, EU investors revealed a strong preference for the two large Mercosur member countries.

Further differences between EU investors and non-EU investors relate to the sectoral focus of FDI and the mode of investment. A detailed analysis of FDI projects in Argentina indicates that FDI from all EU countries taken together shifted from its traditional focus on manufacturing to the service sector. At the same time, acquisitions (e.g. of privatized companies) played a dominant role in EU FDI, whereas greenfield investment figured more prominently in non-EU FDI.

The increased importance of EU FDI in Argentina and Brazil masks striking differences among EU investors. Traditionally leading EU investors, notably German investors, were surpassed by relative newcomers. Spain emerged as the most important EU investor in both Argentina and Brazil. These shifts were associated with different FDI strategies pursued by traditional EU investors and newcomers. German FDI in Mercosur continued to be heavily concentrated in a few capital- and skill-intensive manufacturing industries, as German companies were hardly involved in the privatization of service industries in Mercosur countries. In sharp contrast, Spanish companies made extensive use of new investment opportunities. Consequently, it was largely because of Spanish FDI that the sectoral composition of FDI in Mercosur shifted towards the service sector.

Yet, old and new EU investors in Mercosur have one important thing in common: Both groups of investors aimed primarily at penetrating Mercosur markets. This implies that the market-seeking character of EU FDI was basically left unchanged. Among EU projects in Argentina in the 1990s, efficiency-seeking FDI appeared to be completely absent.

According to survey results, FDI strategies of EU investors in Mercosur are unlikely to change substantially in the short to medium run. Furthermore, survey results support the proposition of an ambiguous relationship between regional integration and FDI. In particular, it is open to question whether extra-Mercosur exports of EU investors will gather momentum in the future. The pending EU-Mercosur trade agreement is unlikely to have a significant impact on extra-Mercosur exports of EU investors, unless Mercosur's own trade policy avoids the so-called *Our Market Is Large Enough* syndrome and helps promote the international competitiveness of local production, including local production by EU investors.

In order to provide stronger incentives to efficiency-seeking FDI, a clear commitment of Mercosur to the completion of a customs union *with low external tariffs* seems to be warranted. Notably Brazil is under pressure to prepare for more liberal trade conditions within the Americas by restructuring non-competitive industries. However, a bold move towards lowering external

protection is contentious not only among Mercosur governments; such a move may also be resisted by established national and foreign producers whose traditional rents are threatened by import liberalization. By contrast, external liberalization tends to be supported by foreign investors aiming at specialized production patterns on a worldwide scale and seeking to integrate locations in Mercosur into global corporate strategies.

In deciding on trade policy, policymakers in Mercosur should take into account that the relative importance of efficiency-seeking FDI is likely to increase with economic globalization proceeding. Further integration within Mercosur should therefore go hand in hand with external liberalization, in order to promote the international competitiveness of local production, provide foreign investors with better opportunities to integrate affiliates in Mercosur countries into global production networks, and thus enhance the attractiveness of Mercosur to efficiency-seeking FDI.

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Annex Table — Major FDI Projects in Argentina in the 1990s[a]

Source country	Sector	Acquisitions		Greenfield investments[b]	
		number	US$ million	number	US$ million
France[c]	Automobiles			1	500
	Water services	1	1000		
Germany	Chemicals			1	26
Italy	Automobiles			1	640
Spain	Petroleum	4	1145		
	Banking	3	1460		
United Kingdom[d]	Petroleum			1	1000[e]
	Food	1	65		
	Banking	1	650		
United States and Canada[f]	Mining			2	1300
	Gas/electr. power			2	1025
	Food	2	296	3	1163[g]
	Automobiles			2	1400
	Chemicals	1	500	1	570
	Banking	1	180		
	Telecom	1	340	1	975
	Retail trade	1	54	1	100
	Real estate[h]	2	76	1	34
Other countries[i]	Mining			2	1670
	Electr. power			1	700
	Food			1	140
	Paper	2	1170		
	Automobiles			2	220
	Capital goods			1	600

[a]The time period in which FDI projects were undertaken or initiated is not clearly specified in the source. – [b]Including expansion of existing FDI project. – [c]Including Lyonnais des Eaux (French/Spanish JV). – [d]Including Unilever PLC and Royal Dutch-Shell (UK/Dutch JVs). – [e]Five-year plan. – [f]Including IRSA (US/Chilean JV). – [g]Including investments planned over five years. – [h]Including hotels. – [i]Australia, Brazil, Chile, Japan and Korea.

Source: Ministerio de Economía (www.mecon.gov.ar/index/cabinet/update/bulletin1/cuainv.htm).