Commercial Ties in the Atlantic Basin: The Evolving Role of Services and Investment

Background Paper

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Commerce in the Atlantic Basin presents a mixed picture. Commercial ties between the United States and Europe, for instance, are among the deepest and thickest in the world. In contrast, the linkages between the U.S. and Africa, and Latin America and Africa, while expanding, are still rather thin and underdeveloped. Trade in merchandise goods is the primary means by which the Atlantic Basin is stitched together; Lorena Ruano examines these linkages in another background paper. But regional ties are also becoming deeper via greater cross-border foreign direct investment (FDI), rising trade in services and increasing capital flows. This chapter examines these metrics.

Foreign Investment Flows in the Atlantic Basin

Of the four regions of the Atlantic Basin—defined here as North America, Latin America, Europe and Africa—direct foreign investment is primarily geared towards the developed markets of North America and Europe. This is to be expected—global foreign direct investment flows have a strong developed-nation bias given the preference of multinationals to invest in large, open and wealthy markets that adhere and uphold strong intellectual property rights and abide by a transparent rule of law. Skilled labor is another determinant of foreign direct investment, which invariably means more investment between and among the United States, Canada and Europe.

As specifically outlined and discussed in our annual survey of the Transatlantic Economy,[1] the foreign direct investment ties between the United States and Europe are the deepest and thickest in the world. Hence, FDI flows in the Atlantic Basin exhibit a strong east-west bias. However, both South America and Africa have attracted more investment from the United States and Europe over the past decade, strengthening north-south investment ties and deepening the commercial linkages of the Atlantic Basin.

Of the two regions, Latin America has attracted more investment than Africa over the past decade only because nations like Mexico, Brazil and Chile have a longer history of dealing with multinationals than many African states. Some of this history has not always been smooth, but in terms of embracing

[1] See Daniel S. Hamilton and Joseph P. Quinlan, *The Transatlantic Economy 2013: Annual Survey of Jobs, Trade and Investment between the United States and Europe* (Washington, DC: Center for Transatlantic Relations, 2013), and previous editions available at http://transatlantic.sais-jhu.edu.

globalization via greater FDI, Latin America has long outpaced Africa, which explains why the FDI stock in Latin America in 2010 ($819 billion) was roughly double that in Africa ($418 billion).

Between 2000 and 2011, U.S. FDI stock in Latin America (including the Caribbean nations) rose 212%, rising from $267 billion to $831 billion. Investment from Europe rose 185% between 2000 and 2010 (latest available), from €248 billion to €707 billion. Not expectedly, FDI investment flows between Latin America and Africa are thin and underdeveloped, with many African multinationals more interested in investing regionally as opposed to other parts of the Atlantic Basin. Meanwhile, while firms in Latin America have become more outward focused via FDI, the bulk of this capital has flowed to North America and Europe, or to wealthy and transparent markets where firms can earn a higher return on investment. Brazil firms, however, have begun to invest more in Africa's resource-related industries.

Why Latin America?

Foreign direct investment in Latin America is both market-seeking and resource-seeking, with the latter, however, emerging as a key driver of investment over the past decade. As the world's physical resources have been stretched by rising demand from China, India and other emerging markets with exploding middle class consumers, so has demand for physical commodities, necessitating more FDI in resource-rich nations.

Against this backdrop, it is little wonder Latin America, notably South America, has become a favored destination of multinationals in search of resources. In short, the region is abundantly blessed with many of the natural resources desired but sorely lacking in the rest of the world. As Exhibit XX highlights, the region is a leading global producer of many key commodities in short supply. Latin America, for instance, is an agricultural powerhouse, accounting for just over half of world soybean production. The region provides 14% of the world's production of corn, 27% of the world's production of meat and 22% of the world's production of poultry, with demand for all three products soaring off the back of rising demand in the emerging markets, notably China. Latin America is also a leading global producer of sugar cane, providing 55% of the world's production.

Water—the most precious commodity in the world—is in abundance in Latin America. The region is also the leading global producer of silver (49% of the total) and copper (46%), critical industrial inputs in demand all over the world. The region also provides 16% of the world's iron ore and 15% of the world's alumina.

In energy, the nations of Latin America are collectively among the most important producers in the world when it comes to the production of ethanol. That said, Latin America is a less significant producer of oil (10%), geothermal power (5%), natural gas (5%), and wind power (1%). While only 2% of the world's production of coal emanates from Latin America, Venezuela accounts for almost 90% of Latin America's total coal production.

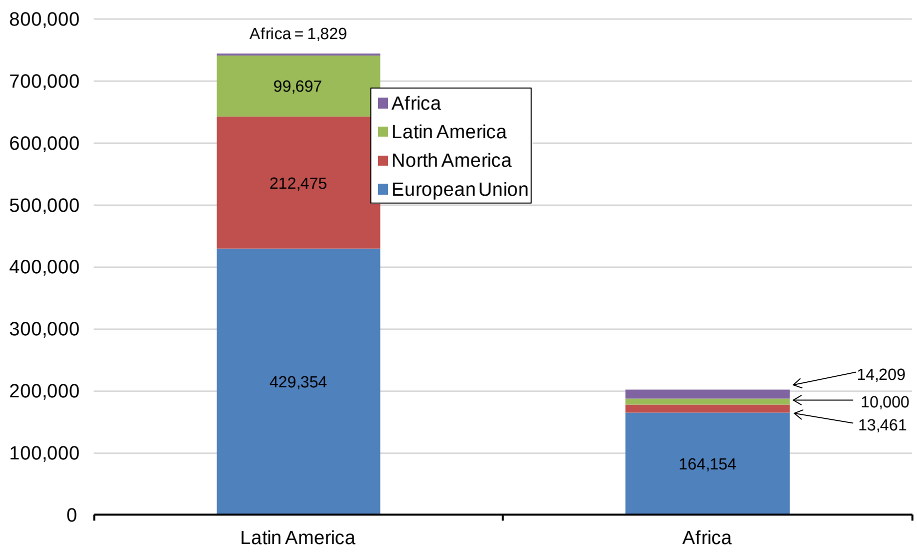
Beyond its natural endowments, other factors favor Latin America, notably the region's economic and political stability, with prudent and conservative economic policies resulting in improved government finances, reduced external debt levels, stronger currencies, lower inflation, and strengthened financial institutions. In a macroeconomic sense, this isn't your father's Latin America.

Another favorable factor at work: a budding middle class in Latin America, with nominal personal consumption expenditures approaching $3 trillion in 2011, double the level of consumer spending in the Middle East and Africa and nearly one-third larger than spending in central Europe. While grinding poverty remains acute in some parts of the Western Hemisphere, poverty rates in Latin America declined by over 10% between 2002 and 2010, pulling over 40 million people out of poverty, according to the

World Bank. The World Bank also notes that income inequality has been greatly reduced over the past decade. Finally, the region is highly urbanized, a signpost of modernization and middle class formations.

Against this backdrop, after North America and Europe, Latin America is the next important node in the Atlantic Basin configuration. Economic regional dynamics have greatly improved over the past few decades, helping to precipitate more cross-border commerce between other Atlantic basin partners. The holds true for Africa, which has also made significant strides in becoming more globalized over the past decade, a trend not only manifested in rising trade in goods but also increasing cross-border FDI and portfolio inflows.

EU Investment Surges Back into Latin America - Foreign Direct Investment: Inward, 2010
(Millions of $)



Source: International Monetary Fund: *Coordinated Direct Investment Survey*

Why Africa?

African economic growth and the spread of democracy is attracting ever rising levels of capital from multinationals. While the region has not been spared the global trauma of the past few years, the IMF expects real GDP growth in Africa to accelerate to 6.8% in 2012 and clock in at 5.2% in 2013.

Over the medium term, accelerating economic growth and governments focused on privatization and attracting FDI are luring foreign dollars to the oft-neglected continent. Also at play: soaring consumption among Africa's rising middle class, supported by rising disposable incomes and easier access to living style-changing devices like mobile phones and the Internet.

More African telephone subscribers have cell phones than in anywhere else in the world. In 2006, 87.1% of African callers were cellular, versus the global average of 67%. Nigeria — Africa's most populous nation, with 134 million inhabitants — had just half a million telephone lines in 2001. Now it boasts more than 30 million wireless subscribers. The rise in efficient communication has undoubtedly narrowed information barriers and opened doors for healthy economic growth prospects in the African continent. This trend is key in developing a more integrated Atlantic Basin for the future.

Like Latin America, FDI in Africa has been both market-seeking and resource-seeking. Regarding the former, Africa is home to 15% of the world's population and the fastest growing emerging consumer class on the planet. In terms of natural resources, Africa is home to nearly 10% of the world's proven oil reserves and produces nearly 10 million barrels per day, or 12.5% of total global oil output. It also produces 6.5% of the world's natural gas and boasts 8.2% of global gas reserves Additionally, the continent leads the world in the production of several categories of metals and minerals, ranking in the top three worldwide for its share of bauxite, gold, diamonds, cobalt, platinum group metals and zirconium reserves, according to the U.S. Geological Survey.

In the years ahead, market- and resource-seeking investment flows will continue to rise in Africa, although whether or not these inflows originate from within the Atlantic Basin remains unclear. Africa, as well as Latin America, now looms large on the radar screens of both China and India, Asia's twin giants in dire need of a steady supply of secure resources. Significant parts of the Atlantic Basin, in other words, are in play, and are not the exclusive preserve of the United States and Europe.

Making Room for China and India?

While the United States and the EU still exert a powerful influence over its partners in the Atlantic Basin, it is important to note the increasing role being played by both India and China in Latin America and Africa. In effect, the depth and thickness of Atlantic Basin commercial ties will be influenced, if not diluted, by the growing presence of India and China in both regions. This section briefly summarizes this dynamic.

For starters, whereas for decades the bulk of foreign direct investment (FDI) flowed to and from the developed nations, today a rising global share of FDI emanates from the developing nations. Global FDI increasingly bears the hallmark of global-minded corporate giants from Brazil, China, Russia and India. And where trade and investment ties, and bank lending, between these nations and Africa and Latin America were once shallow and underdeveloped, such linkages are now thicker, more robust and more sophisticated.

A significant challenge to the notion of an integrated Atlantic Basin is this: the expanding commercial ties of two of the largest emerging economies in the world, China and India, with two of the largest emerging regions of the world, Africa and Latin America. In summary, commercial linkages between the two parties have soared over the past decade, but from a low base. Africa has attracted the most attention and capital of India and China relative to Latin America. Resource-seeking investment has been a prime motivator of China and India, but their investment in both Africa and Latin America extends well beyond energy/mining. Further deepening and integration is expected in the future, challenging the stakes of the United States and Europe.

In a major shift from the past, outward foreign direct investment has become an important economic dimension for both China and India. Indeed, in the past ten years, Chinese and Indian firms have become more globally-minded, with companies, motivated by market conditions and government policies, becoming more embedded in the global economy via foreign direct investment. Globally shy no more, China's outward FDI stock, totaling just $4.4 billion in 1990 (or 1.3% of GDP), spiked to $28 billion in 2000 before soaring to roughly $365 billion in 2011 (or greater than 5% of GDP). The surge reflects soaring annual FDI outflows, with outflows totaling $69 billion in 2010 and $65 billion in 2011; comparable levels in 2000 and 2001 were just $900 million and $6.9 billion, respectively.

Outward flows from India, while not as large as China's, have been just as robust given the lower starting point. Annual FDI outflows were less than $1 billion in 2000 but peaked at $20 billion in 2007, prior to the financial crisis. Outflows totaled roughly $15 billion in 2011, pushing India's outward FDI stock to $111 billion last year, more than 5% of GDP and a 65-fold increase from the beginning of the century. The combined outward FDI stock of China and India was roughly 5% of the global total in 2011, up from 0.1% in 2000. Last year, China was the 14th largest outward investor in the world, while India ranked 27th.

As Chinese and Indian firms have burrowed deeper into Africa, policy makers in the developed nations have become increasingly concerned and alarmed by the spread of China's and India's global footprint, notably in regions of the world like Africa that have long been under the West's sphere of influence. As a pointed jab at China, Secretary of State Hillary Rodham Clinton warned in a June 2011 speech in Zambia of 'new colonialism" threatening the African continent.[2]

Despite these worries, what is driving both nations overseas are the same variables that have long influenced and spurred U.S. and European firms to invest abroad. To this point, resource-seeking Chinese energy firms are emulating the corporate strategies of American and Japanese energy giants in the 1950s and 1960s. Where the difference lies, and where there are lingering potential areas of conflict with the United States and Europe, pivots around China's more government-led and more geo-strategic investment in Africa.

As part of China's "going out" strategy (*zou chuqu*), a key priority of Chinese foreign direct investment is securing strategic assets and natural resources to fuel the industrialization, motorization and urbanization of the Middle Kingdom. Thanks to these tectonic economic trends, China's demand for global commodities has been nothing short of stunning. The nation is now the second largest consumer of oil after the United States, and presently devours 25% of the world's soybeans, 20% of the world's corn and 16% of the world's wheat. The mainland also accounts for nearly 25% of world rubber consumption. Name the commodity and there is a good chance China is among the largest consumers in the world.

China's secular rise in commodity demand, juxtaposed against a steady decline in arable land, mounting deforestation, rising water scarcity, and herculean environmental challenges at home makes the nation fanatically focused on food and energy security for its 1.3 billion population. Hence Beijing's unstinting support to state-owned Chinese firms investing overseas in commodity-rich Africa, a strategic target of China.

There is a direct link between China's resource-seeking FDI in Africa and the nation's energy security policies. Hence, a great deal of China FDI to Africa is bundled, and includes bilateral aid and grants, low cost loans and other preferential financing arrangements provided by China's so-called policy banks—all competitive metrics that could put U.S. and European firms at a competitive disadvantage in Africa and Latin America for that matter.

[2] Dambisa Moyo, "Beijing, A Boom For Africa," *The New York Times*, June 28, 2012, p. A27.

Government-led support for Chinese investment in Africa includes formal arrangements, with China launching the Forum on China-Africa Co-operation (FOCAC) in October 2000 to facilitate greater multilateral economic cooperation among key African states. This development is another way of saying that the Atlantic Basin will continue to have a strong Chinese influence. To this point, China's trade and investment with Africa has soared over the past few years. For instance, between 2000 and 2011, China's exports to Africa soared from just $5 billion at the start of the century to nearly $73 billion last year. South Africa, Nigeria and Egypt ranked as the three largest African export markets for China; South Africa alone accounted for nearly one-fifth of total exports.

Chinese imports from Africa, meanwhile, rose by a comparable amount as exports. Imports tallied just $5.5 billion in 2000 but exceeded $77 billion last year; reflecting China's need for resources and China-related investment in Africa's energy infrastructure, the bulk of imports was comprised of oil and other commodities. Africa provides China with 30% of its tobacco, 25% of its pearls and precious metals, 20% of its crude oil and cocoa, 10% of its ores, and 5% of its iron and steel. Surging trade flows reflect in large part the widening presence of Chinese FDI in Africa, with the stock of outward Chinese FDI to Africa soaring from $491 million in 2003 to over $13 billion in 2010, more than a twenty-five fold increase.

Meanwhile, Indian FDI outflows to Africa totaled $9.3 billion over 2002-09 versus just $750 million over 1996-02. Of the $9.3 billion total, roughly two-thirds was invested in Mauritius, a critical offshore financial center for Indian firms. Bilateral trade between India and Africa has increased dramatically over the past decade as well. Indian exports to Africa rose more than 10-fold between 2000 ($2.2 billion) and 2011 ($23.5 billion). Imports from Africa illustrated a similar trend, surging from $3.2 billion in 2000 to roughly $39 billion in 2011. India posted a trade deficit of $15.4 billion with Africa last year; China's deficit was much smaller -- $4.7 billion.

Like Africa, Latin America has become more important to both China and India over the past decade as both as a source of raw materials and a new market for manufactured goods. China's soaring energy and agricultural needs account for China's rising investment profile in Brazil, Peru and Venezuela, the top destinations for Chinese foreign direct investment excluding the mainland's investment in the offshore centers of the Cayman Islands and the British Virgin Islands.

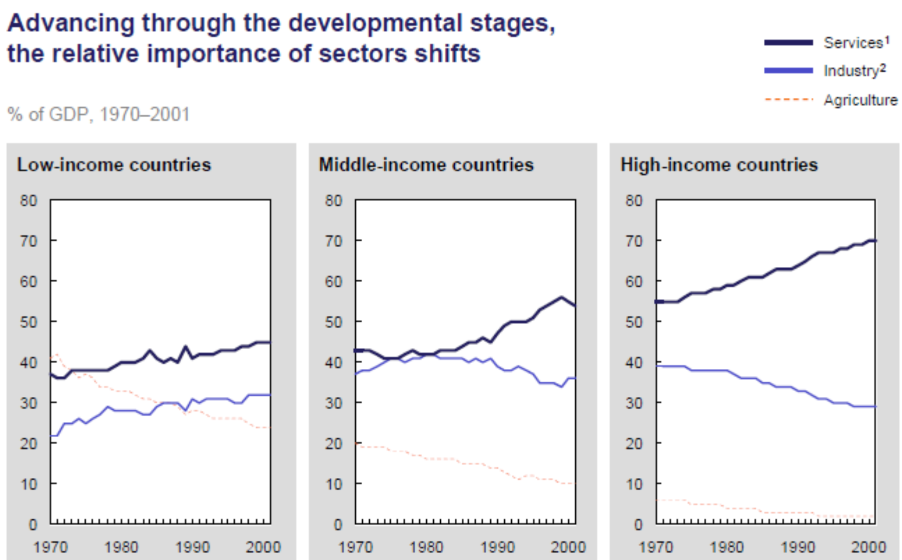
Latin America has been at the receiving end of many large Chinese loans to help finance natural resource-based deals and infrastructure spending. To this point, the Inter-American Dialogue notes that China loan commitments of $37 billion in 2010 were more than those from the World Bank, Inter-American Development Bank and U.S. Export-Import Bank combined.

Against this backdrop, heavy financing from Chinese banks have underwritten rising trade and investment flows between China and Latin America. In particular, the last decade has seen sharp spikes in Chinese investment in Brazil, with China's FDI stock rising from just $79 million in 2004 to $923 million in 2010, Peru (from $126 million in 2004 to $655 million in 2010) and Venezuela, where China's FDI stock soared from just $47 million in 2004 to $417 million in 2010. As a large investor in Panama's transportation sector, Chinese FDI stock in the strategically-important nation totaled $236 million, larger than China's investment position in Mexico ($153 million).

Clearly, Chinese investment flows are ramping up, with China's investment in Latin America totaling nearly $1 billion in 2010—the largest annual increase on record, with Brazil accounting for half of the total. Indian investment has lagged behind but is expected to accelerate in the coming decade as India seeks to tap into Latin America's abundant fresh water supplies and agricultural/energy resources.

Atlantic Basin Trade in Services

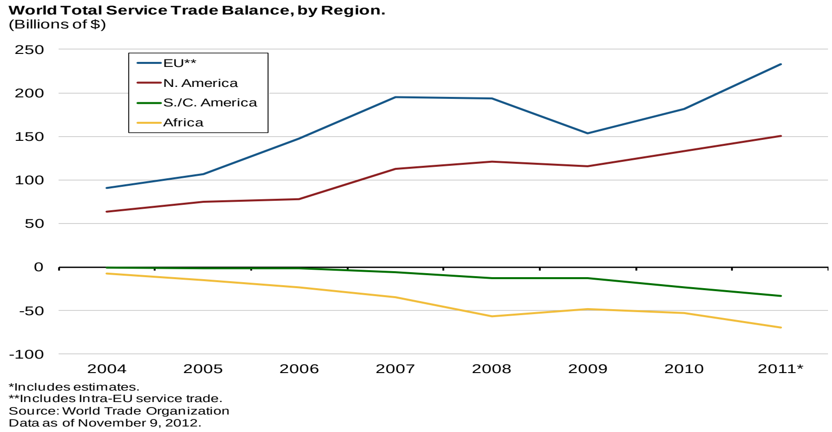
In general, as income per capita increases for a country, demand for services increases across various sectors like health care, education, entertainment, insurance, telecommunications and finance. Conversely, low-income countries are heavily reliant on industry and exhibit more demand for material goods rather than services. That said, it's no surprise that nearly all services trade in the Atlantic Basin flows through two main regions—North America and Europe—which coincidentally have the highest incomes per capita.



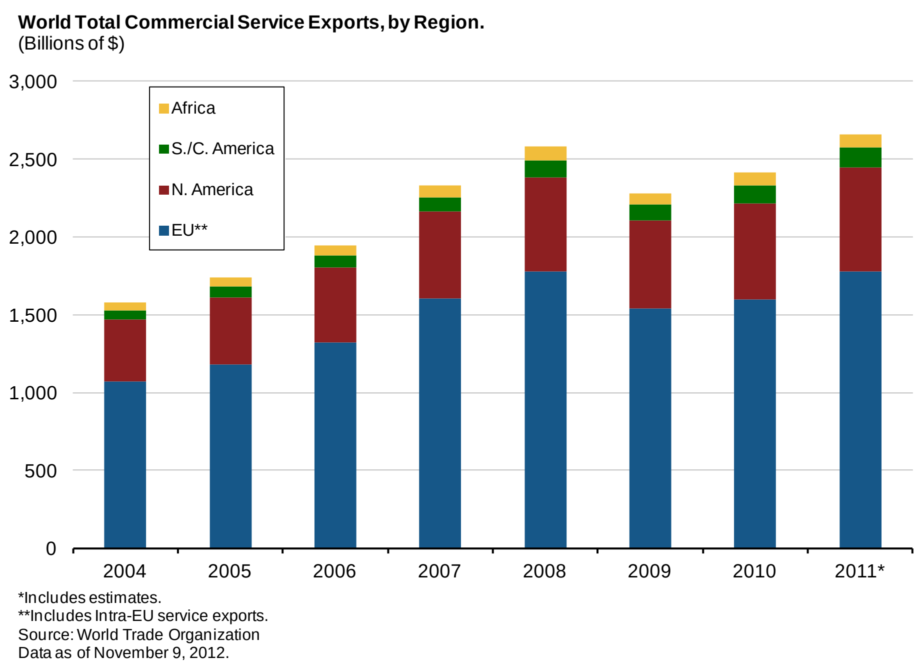
1 Industry: manufacturing, mining, and construction; services: personal, professional, and public-sector services and utilities.
2 The World Bank defines middle-income economies as those with per capita GNI in 2003 between $766 and $9,385 measured with average exchange rate over past two years.

SOURCE: World Development Indicators, World Bank; McKinsey Global Institute analysis

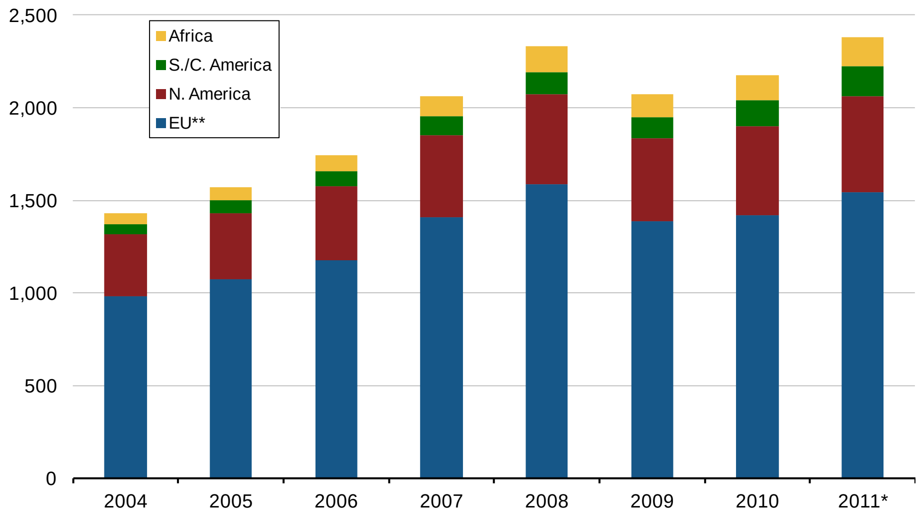
According to figures from the WTO, world total extra-EU services trade (imports + exports) was $1,429 billion in 2011, ahead of North America ($1,191 billion). Total Latin American ex. Caribbean services trade ($292 billion) was roughly $51 billion larger than African trade ($241 billion) in 2011. While both Latin America and Africa have low volumes of services trade, growth in Latin American services trade has outpaced that of Africa over the last several years. This can mostly be attributed to Latin America's higher income per capita and deeper commercial ties with North America, particularly the U.S. To the latter point, U.S. services trade with Latin America totaled nearly $80 billion in 2011, compared to Africa's $20 billion. When Caribbean countries are added to the mix, the Latin America total more than doubles to $162 billion, over eight times the Africa total. With a more sophisticated financial sector and wealthier population, Latin America's demand for services, not surprisingly, is greater than Africa's.



When it comes to the European Union, more services trade is conducted among its 27 member countries than with the rest of the world. Intra-EU services exports totaled €729 billion in 2011, while extra-EU exports totaled €579 billion. The same goes for imports, as intra-EU exports were €663 billion in 2011, while extra-EU imports were €454 billion. Outside the EU, North America is the most important services trading partner of the EU in the Atlantic Basin -- and in the world. To this point, North America receives 65% of the EU's service exports; however, this is down from a share of 75% in 2004. This can be attributed to Latin America and Africa having deepened their commercial ties with Europe over the years, thus grabbing a greater share of the EU's service exports.



World Total Commercial Service Imports, by Region.
(Billions of $)



*Includes estimates.
**Includes Intra-EU service imports.
Source: World Trade Organization
Data as of November 9, 2012.

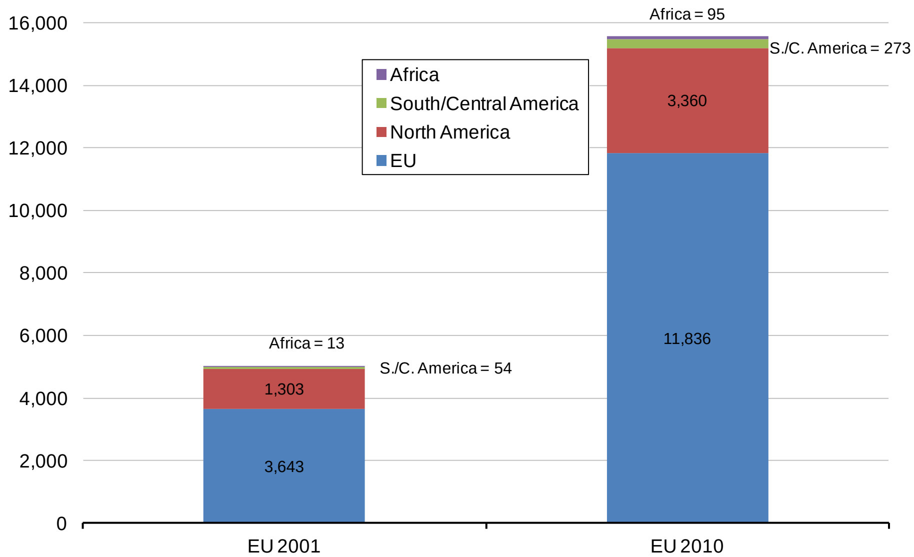
Changing the focus to North America, the region has the largest services trade surplus in the Atlantic Basin—Latin America and Africa actually run services trade deficits. This is largely due to the U.S., which runs a private services surplus of $194 billion.[3] The largest services export industries for the U.S. include business, professional and technical services, royalties and license fees, travel and financial services. Like the EU, the U.S. has recently seen an increasing share of its services trade conducted with developing regions like Latin America and Africa over the years. This trend will continue in years to come as U.S. multinationals continue to tap developing markets for growth opportunities and as more services-related activities expand in both Latin America and Africa, notably the latter.

Atlantic Basin Portfolio Flows

The EU leads the way in the Atlantic Basin for most portfolio investment assets held at the end of 2010, with $18,384 billion in assets. This is a 220% increase in world total portfolio assets held in 2001. EU portfolio assets held in the Atlantic Basin region totaled $15,564 billion in 2010 and represent 85% of total EU portfolio assets. Over three-fourths of those Atlantic Basin assets are from other EU countries, with 22% from North America. It is clear that the EU favors purchasing equity and debt assets from other developed capital markets as 83% of its total portfolio assets are from the EU or North America. This reflects the developed-nation bias of investors, preferring safe haven status markets like the United States or Europe, in contrast to the underdeveloped financial markets of many African and Latin American states.

[3] U.S. Bureau of Economic Analysis.

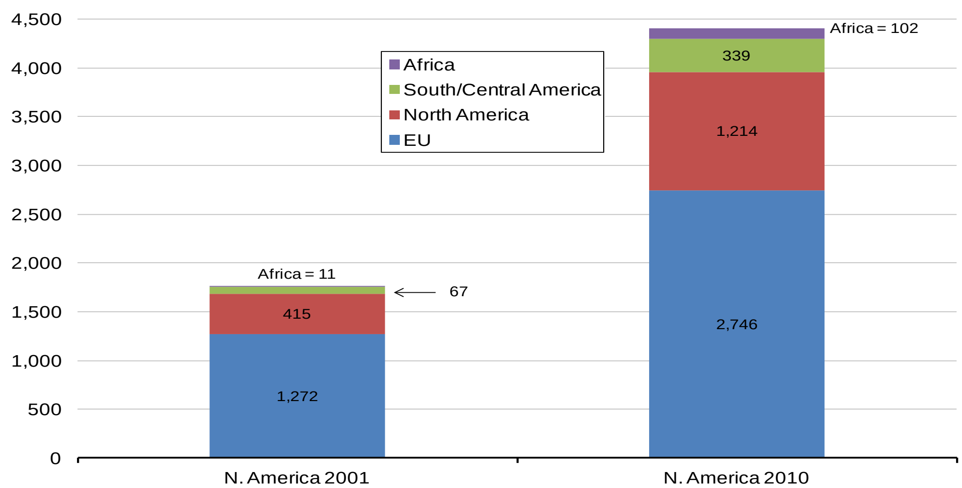
Regional Composition of EU Portfolio Assets
(Billions of $)



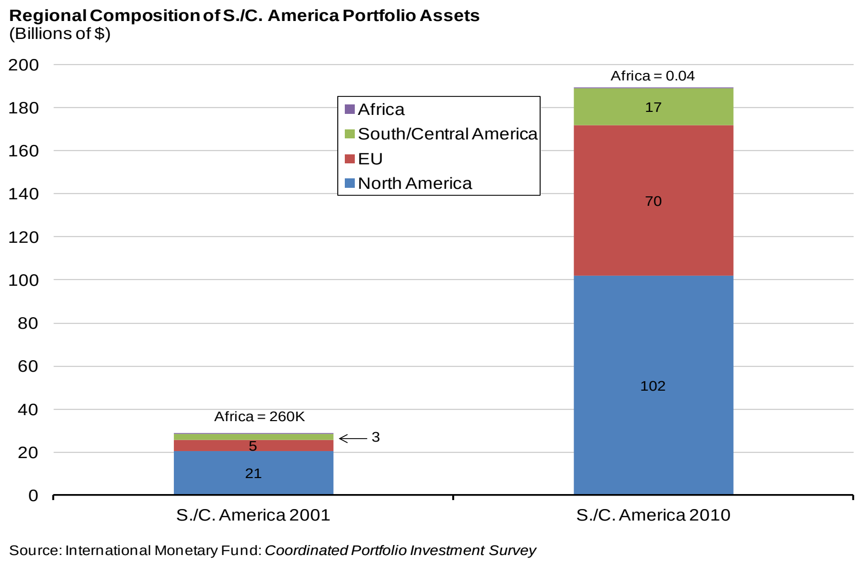
Source: International Monetary Fund: *Coordinated Portfolio Investment Survey*

North America owns the second most portfolio assets in the Atlantic Basin, with $7,413 billion in total assets. North America's portfolio asset composition differs from the EU, because its Atlantic Basin-owned assets make up a smaller percentage of its total portfolio asset holdings (59%, as opposed to the EU's 85%). This reflects the larger percentage of portfolio assets that are held in other regions, namely Asia. Between 2001 and 2010, North America's portfolio assets owned in the Atlantic Basin have increased nearly 150%, with the fastest growth exhibited in Latin America and Africa, albeit from low bases. As a result of North America diversifying its portfolio holdings, its ownership of portfolio assets held in the EU has fallen as a percent of its total assets held from 50% in 2001 to 37% in 2010.

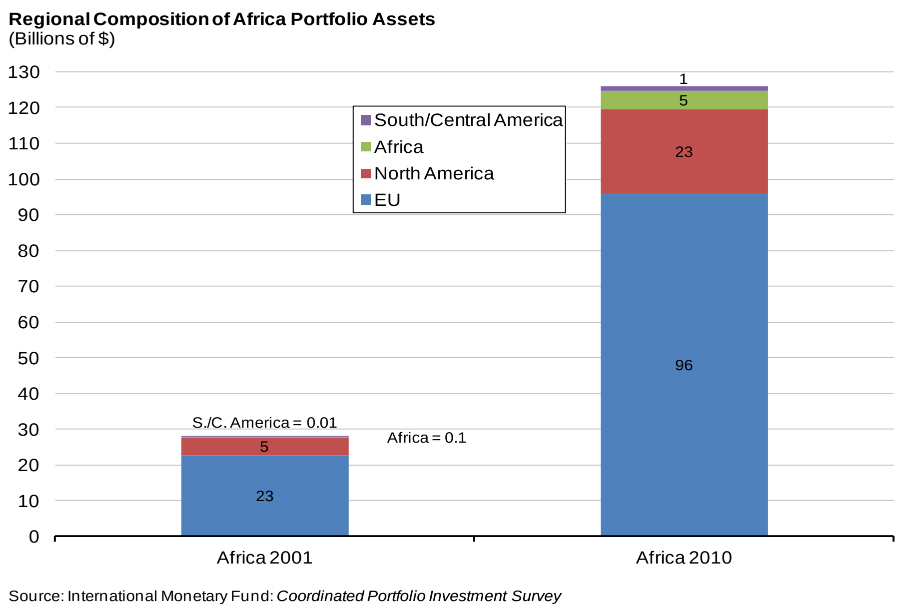
Regional Composition of North America Portfolio Assets
(Billions of $)



Source: International Monetary Fund: *Coordinated Portfolio Investment Survey*



As expected, the portfolio holdings of Latin America and Africa are rather thin; this is expected given that capital-generation in both regions, which in turns leads to capital accumulation, remains nominal as this juncture. Sustainable economic growth, more developed capital markets, clearer financial rules and regulations, more middle class savings—the development of these variables are needed to bolster the portfolio holdings of both Latin America and Africa.



Yet all of the above is underway and gaining traction thanks to the steady expansion of the Atlantic Basin. The latter is a relatively new geographic concept, but one likely to gain more attraction this decade.

Given the ageing populations and declining labor forces of the U.S. and Europe, more firms from both regions are, not surprisingly, looking beyond the traditional transatlantic markets and keen on tapping the resources of both Latin America and Africa. It is not that the U.S. and Europe are turning their backs on each other, far from it. The commercial artery linking the U.S. and Europe is the largest in the world. Rather, continued growth on the part of U.S. and European firms mandates strategies that tap the virgin markets of the developing nations.

For years, the focus of many large European multinationals has been on central and eastern Europe, in addition to the large developing markets of Asia—think India and China. U.S. firms, meanwhile, have also been quite active in developing Asia, as well as in Mexico through the North American Free Trade Agreement.

The focus has expanded, however, to include more and greater participation in the entire Atlantic Basin, with many firms now envisioning a squared or four-cornered Atlantic Basin strategy that leverages the resources and strengths of each node. Greatly helping matters is the willing participation of Latin America and Africa in this regional configuration.

Yes, India and notably China loom large in both Latin America and Africa, and represent a competitive threat to many U.S. and European firms. However, Chinese and Indian investment in both regions of the world has helped improve the infrastructure of Latin America and Africa, facilitating more global trade and investment ties in general. In addition, various states view the U.S. and Europe as strategic counterweights to the expanding influence of China, and will therefore continue to view the evolution of the Atlantic Basin as a positive economic development.

In the end, the next phase of globalization will be spurred on by greater participation among the developing nations. Traditional trade and investment flows will be complemented by new and dynamic flows of commerce helping to knit the world closer together. The emerging Atlantic Basin is just one clear and important manifestation of this trend.