The Karol Adamiecki University of Economics
in Katowice

Volume 5 2009

Journal of
Economics &
Management

Diego Fernando Téllez Falla
Lilian Carol Bohórquez Olarte
Jesús María Godoy Bejarano

FOREIGN DIRECT INVESTMENT IN LATIN AMERICA AND ITS EFFECTS OVER DEVELOPMENT 1990-2006

Introduction

In the last decades, the international movement of capital known as foreign direct investment (FDI) has become one of the most remarkable economic phenomena due to the considerable expansion of multinational enterprises and the tendency to create common markets. In the last two decades proliferation of both regional integration agreements and the growth of foreign direct investment flows have been observed and as a result a new framework has been created.

After a long period characterized by strong restrictions and controls imposed on foreign direct investment, a stage of complete liberalization was experienced, thus unleashing strong competition among countries that were attracting foreign capital to their regions. These FDI flows were reaching developed and developing countries. What is more, in the last years, the investment in question has become an external financing source in case of emerging markets including Latin America and the Caribbean in particular.

In this context, the article tries to analyze the evolution and role played by flows of foreign direct investment in the development of Latin America and the Caribbean in the period of 1990-2006. In order to carry out this analysis, the article is divided into five parts including the introduction. The second part includes different theories that explain foreign direct investment and economic development. The third part is dedicated to the evolution of foreign direct investment in Latin America observed in the period of 1990-1999. To analyze the evolution, the world investment reports published by the United Nation Conference on Trade and Development (UNCTAD) in the periods subject to analysis are discussed. It is important to mention that UNCTAD is the principal body of the United Nation General Assembly dealing with trade, investment, and development issues. The fourth part presents some index used as a tool to measure the effects of FDI flows upon the development of the Latin American countries. Finally, some conclusions are presented as a result of the analysis performed.

1. Foreign Direct Investment theories

Theoretically, there are different approaches that try to explain causes and destinations of foreign direct investment. At the moment of analyzing traditional international trade theories that are normally used to explain destinations of capital flows, it is found that they do not necessarily offer any base reference to study the behavior of foreign direct investment since such theories do not consider certain aspects including e.g. the very difference in productivity.

Different theories into FDI and FDI location have followed different alternative classifications. Firstly, location related theories that are used as a reference framework to carry out the analysis of different industrial location strategies in international markets were formulated. First contributions to these theories were made by German scientists Laundhart (1885) and Von Thünen (1826), with some minor differences related to international trade theories. Their goal was to maximize benefits due to cost reduction resulting from different flows.

On the other hand, it is found that the traditional theories to be considered in literature as one of the possible frameworks to study foreign direct investment and its determinants, explain movement of production factors (capital, labor, etc.) by means of trade in goods. This behavior is explained by the Hecksher-Ohlin theory. The theory provides for the trade pattern based on some relative supply of different nations' relative factors that explain international flows of capital from capital-abundant countries to labor-abundant countries. However, the theory is criticized since it considers indirect movements through the trade in goods.

In the same way, the Japanese theory or Kojima´s (1976) extends the Hecksher-Ohlin theory of the international trade to include a factor proportion understood as a determinant of commercial flows in intermediate goods. This theory assumes that FDI would be executed by enterprises that produce intermediate goods that require resources to be found in the capital-country that has a comparative advantage. Some extra activities that required resources in which the country in question has a comparative disadvantage are then added[1].

Helpman (1984) and Helpman and Krugman (1985) explain that the specific consideration of the existence of multinational enterprises allows for treating FDI as the movement of financial equity. However, capital-abundant countries that are to be found in production centres of highly capital-intensive inputs may locate production of relatively less capital-intensive goods in those labor-abundant countries through activities of foreign direct investment. In this way, the relative abundance of the labor factor in the receiver country would be, after all, the determinant variable for the attraction of FDI[2].

However, FDI has become an important external source of private financing for developing countries that are finally characterized by relative abundance of labor factor. This type of investment differs from other sources of private capital

1 J.R. Lucas: *Why Doesn't Capital Flow from Rich to Poor Countries?* AEA, "Papers and Proceedings" 1990, Vol. 80, No. 2.

2 P. Krugman: *Rethinking International Trade*. The MIT Press, Cambridge 1990.

because such other sources depend considerably on the long-term time perspectives in which investors have to obtain profits in productive activities controlled directly[3].

Lucas (1990), Krugman (1990), and Bajo and Sisvilla (1992 and 1994) explain the persistence in the considering FDI as the movement of physical capital with productive purposes, thus becoming one of the most recent contributions to the literature of the domain.

Ozawa (1992), while analyzing the impact of FDI activities on the process of economic development, analyses factors that can determine location of the FDI flows. The FDI inflows could contribute in the process of structural change, i.e. something that would facilitate the increase in income and transformation of the national demand. If there is more income in the receiver location, multinational subsidiaries that generate an incipient flow of FDI to countries with less income can be introduced. The receiver location becomes a source of FDI and it could continue attracting capital due to existence of a high level of human capital, better technology, and even some good political environment.

It is assumed that foreign direct investment is carried out by transnationals in foreign countries to control assets and to manage productive activities in the countries in question. A general theory of FDI must specify causes that determine the existence of multinational enterprises and factors that contribute to selection and preference of geographical zones, i.e. elements that are not always completely separated.

The Inter-American Development Bank (1999) states that although FDI represents investment in productive installations, its importance for developing countries is much higher. FDI allows some increase in resources available to investment and capital formation, but also becomes a vehicle for transferring technology, production, technical, and innovation capacity, institutional practices and management to different places. Moreover, FDI allows for accessing international networks of commercialization.

Developing countries seem to be most interested in attracting income via foreign direct investment since the problems of underdevelopment are related with poverty and its effects. The development theory suggested by Rostow provides a possible solution by promoting modernization in emerging countries[4].

If problems faced by these countries include the lack of productive investments, the solution will be to provide help in form of capital, technology, and experience. Loewendahl (2001) explains that although the institutional arrange-

[3] R. Díaz: *Las Teorías de la Localización de la Inversión Extranjera Directa: Una Aproximación*. “Revista Galega de Economía” 2003, Vol. 12, No. 1.

[4] G. Escribano: *Teorías del Desarrollo*. “Economíco” 2001.

ments vary from country to country, a common element for the promotion of successful investments is to be found in establishment of a specific entity or department especially dedicated to the issues in question[5].

Díaz (2003) states that despite the emergence of different perspectives there is no consensus on the location of foreign capital and its productive purposes. At a theoretical level, there is consensus on possible benefits of foreign investment. In UNCTAD, 2004 and 2005b it is possible to find information that even though there are multiple strategies and ways to attract FDI, countries with higher success in attracting and getting benefits from this type of investments include only those that have adopted more active and concentrated policies, which means the FDI itself does not solve problems of development and economic growth of countries, but it can become an important tool to be used while implementing any global development strategy in case of a particular country.

For the Economic Commission for Latin America and the Caribbean ECLAC (2005), the best way to take advantage of the benefits of FDI is to integrate investment attraction policies with development policies. Having these two policies integrated will allow a country to create the framework that attracts investors. Moreover, the above will also let the countries utilize all the potential benefits of FDI. The main objective for countries is to attract FDI that creates multiplication effects and to take advantage of all the benefits attributed to investors. It is also worth mentioning that the competition among countries wishing to attract FDI has been intensified and improved lately.

2. The evolution of Foreign Direct Investment in Latin America

Foreign Direct Investment, in the form of greenfield or cross-border mergers and acquisitions, has played a significant role in Latin America for the last two decades. This role could be presented in three major parts. The first part is characterized by a steep growth in foreign direct investment from 1990 to 1999. The second part witnesses a clear decline. Finally, the third part deals with phenomena observed since 2003 – the time when some irregular behavior has been observed.

5 P. Mallanpally, K. Sauvant: *La inversión Extranjera en los países en desarrollo. Revista Finanzas y Desarrollo*. "Banco Interamericano de Desarrollo" Marzo 1999.

2.1. A constant growth (1990-1999)

The beginning of the decade was characterized by the increase in foreign direct investment flows to Latin America and, in general, to all developing countries[6]. The nineties was a period of economic opening. Privatization of many state--owned enterprises as well as the adoption of some macroeconomic policies, the improvement in infrastructure, and the regional integration (e.g. MERCOSUR) explained fairly well the growth witnessed.

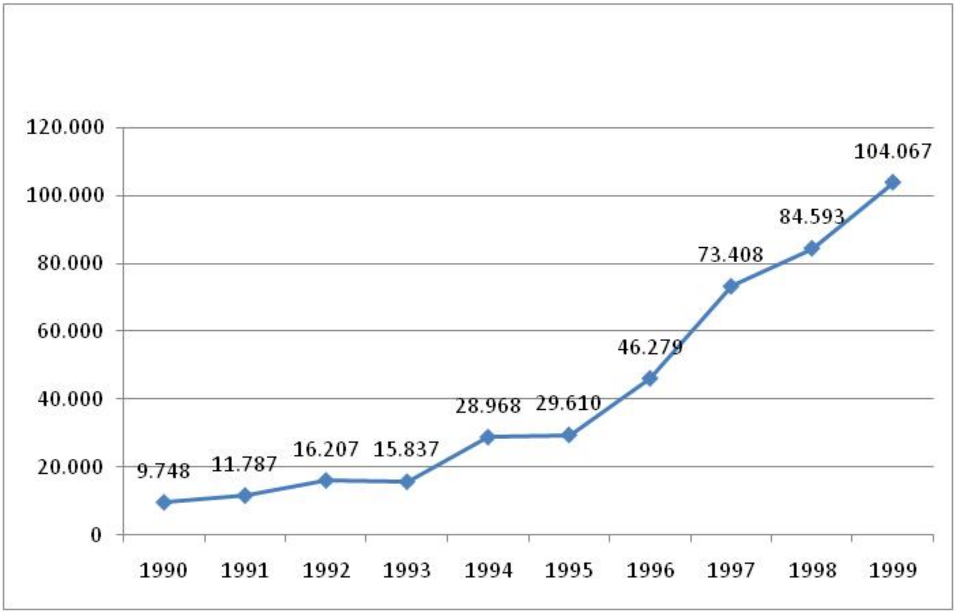

Figure 1. FDI inflows in Latin America 1990-1999

Although the growth was constant during the periods in question, it is important to highlight the fact that the Latin American countries are very susceptible to special circumstances that may change the flow of foreign direct investment in different periods. Political instability, economic crises, and insecurity (as in case of Colombia and other countries with guerrilla groups for example) have made Latin America an unpredictable field for some multinational enterprises.

The United States of America is the main investor in the region. According to UNCTAD, the outward flows from the USA were about $17 billion in the year

[6] According to UNCTAD, the volume of foreign direct investment flows to developing countries reached a total of $32 billion in 1990.

1998. Although the USA was a major investor, the role of the European Union grew during the decade with Spain contributing to the biggest flows into the region. In 1997, for example, one third of all the inflows coming from the EU originated in Spain[7].

As shown in Figure 2, most of the growth in FDI was boosted by Brazil, Mexico, and Argentina.

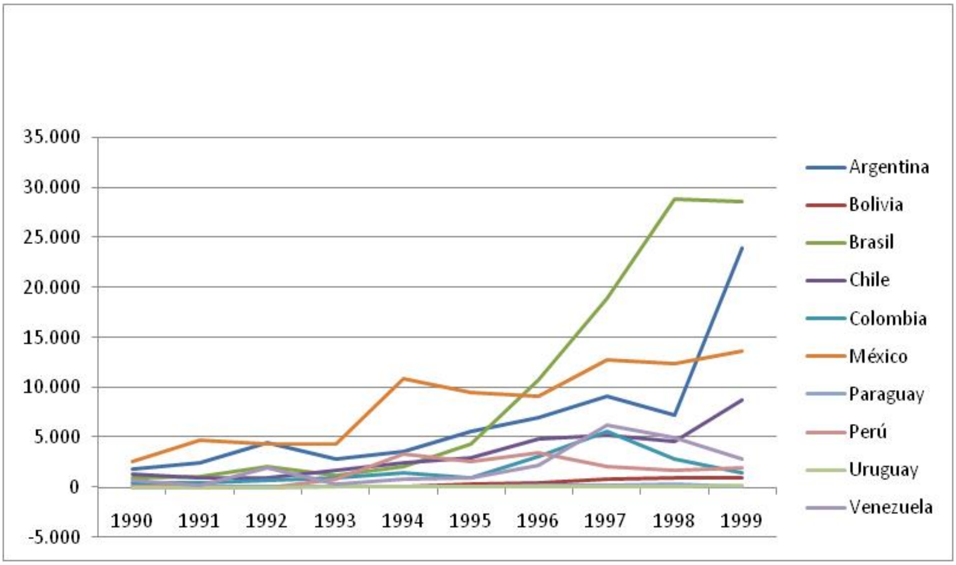

Figure 2. FDI inflows in Latin America

In 1996, a year in which Latin America and the Caribbean accounted for 30 percent of all developing country inflows, out of the total 46 billion registered as inflows, 10 billion came from Brazil and 8 billion from Mexico due to the reactivation of the privatization plan[8]. In case of Argentina, and in general of all the countries that belong to the Southern Common Market (MERCOSUR), the inflows of FDI showed a considerable increase promoted mainly by the manufacturing sector. In 1998, 70 percent of total inflows into Latin American countries were attracted by South American countries and half of all these inflows were received by the countries of the Southern Common Market[9].

[7] *La inversión Extranjera en América Latina y el Caribe*. Capítulo II: *Políticas Activas para Atraer*. CEPAL, "Inversión Extranjera Directa en América Latina y el Caribe" 2005.

[8] World Bank. World Investment Report 1997, p. 23

[9] World Bank. World Investment Report 1999, p. 61.

In case of Mexico, most of the FDI was directed at manufacturing industries supported by North American Free Trade Agreement (NAFTA). This agreement let Mexico maintain a constant growth in FDI inflows despite some particular moments of economic stagnation. All these examples demonstrate the influence of trade agreements including MERCOSUR and NAFTA on the promotion of foreign direct investment.

With reference to the outflows of FDI from Latin America, it is remarkable that most of the outflows are directed at the same region in this decade. According to UNCTAD, intra-regional investment reached around $8 billion in 1998[10]. Brazil and Mexico led the very process that showed a constant growth although there were some particular moments of financial turbulence experienced by Latin America in 1998. It is important to notice that there are also outflows from offshore financial centres that invest in some intermediate destinations and then invest their funds in other countries to be used by multinational corporations as destinations in the region. In 1998, FDI outflows from offshore financial centres were two-fifths of total FDI outflows in the region.

Finally, it would be important to mention two other phenomena observed in the decade in question. Firstly, although FDI entered the region in form of mergers and acquisitions promoted by a very intensive privatization plan and some other measures used to support the economic opening. Some export-orientation was taken into consideration due to the export propensity of some subsidiaries from USA. Some other aspects including macroeconomic reforms and reforms contributed to the promotion of exports in the region.

The other phenomenon refers to the fact that, as stated in the world investment report, 2000, the boom of FDI in Latin America "[…] has also been accompanied by large and rising current-account deficits, reviving concerns over a negative balance-of-payments impact. The immediate effects of trade liberalization on the balance of payments may well be negative because FDI tends to generate higher imports not only of capital and intermediate goods, but also of final consumer goods, if TNCs begin by establishing sales affiliates and distribution networks". Although it might be seen as negative, it is important to mention that FDI has also a stabilizing effect on the balance-of-payments since it can offset the possible deficits presented in the current accounts as it happens in 1998 when FDI accounted to offset a $56 billion deficit in the region's current account[11].

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[10] Ibid., p. 64.

[11] World Bank. World Investment Report 2000, p. 57

2.2. A continuous decline 1999-2003

This period was characterized by a constant decline in the foreign direct inflows in Latin America. As shown in Figure 3 the total inflows of FDI decreased from 104.067 in 1999 to 44.692 in the year 2003.

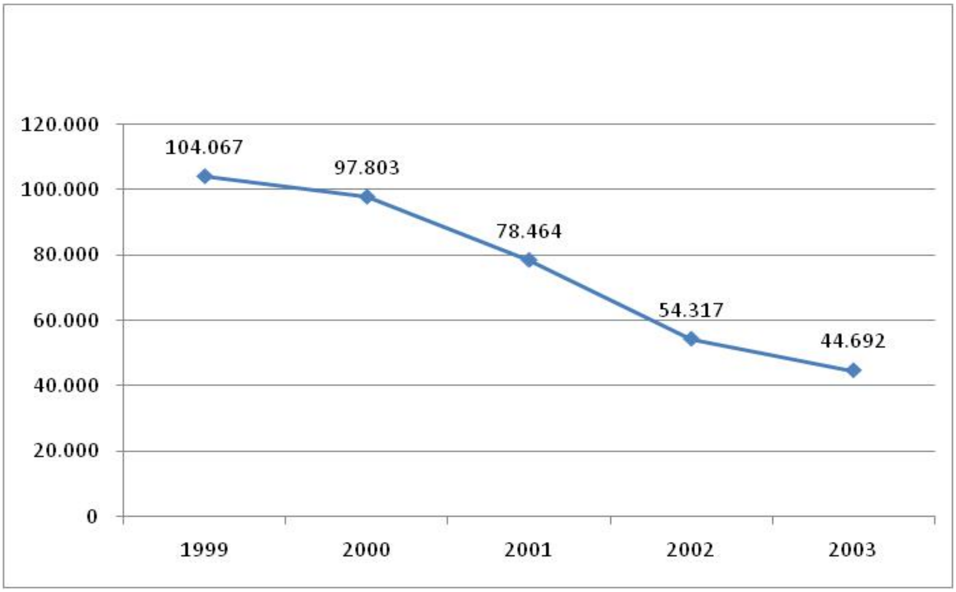


Figure 3. FDI inflows in Latin America 1999-2003

This behavior was explained by different reasons. The total investment of multinational corporations decreased due to a general deterioration of the economic conditions. The deceleration of the United States economy during the years 2001-2003 had a remarkable effect on FDI in Latin America since as it was expressed before, this country was one of the most important sources of FDI to Latin America.

According to UNCTAD, "Another factor was a steep drop in cross-border M&As in the region, both in number (from 581 in 2000 to 281 in 2003) and value, from a high of $64 billion in 1998 to $12 billion in 2003".

Another reason for the deceleration of FDI included normalization in the privatization process. The nineties was a decade characterized by a very aggressive privatization plan led by most of the Latin American countries. Countries including Brazil and Mexico experienced the largest privatizations of state owned enterprises, which made Latin America share almost 43% of the total FDI flows led to developing countries[12].

The region itself presented deterioration in GDP (0.7% in the period 2001--2001, UNCTAD). Many fiscal and monetary policies contributed to this poor performance of the region compared to a 6.6% reached by other developing economies such as Asia[13].

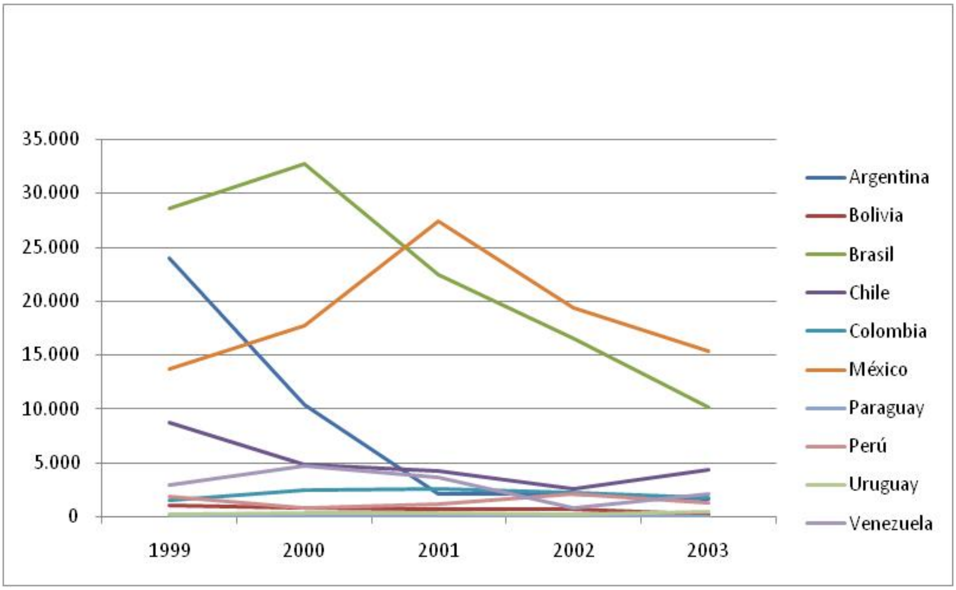


Figure 4. FDI inflows in Latin America 1999-2003

2.3. An irregular period 2003-2006

Latin America benefited from the recovery in the world economy after a period of stagnation. According to UNCTAD, some reasons including an increase in domestic demand due to the recovery in economy, favorable exchange rates, an increase in commodities demand, and reinvested earnings can explain the change observed in the FDI flows in the region.

[12] World Bank. World Investment Report 2004, p. 60.
[13] Ibid., p. 62.

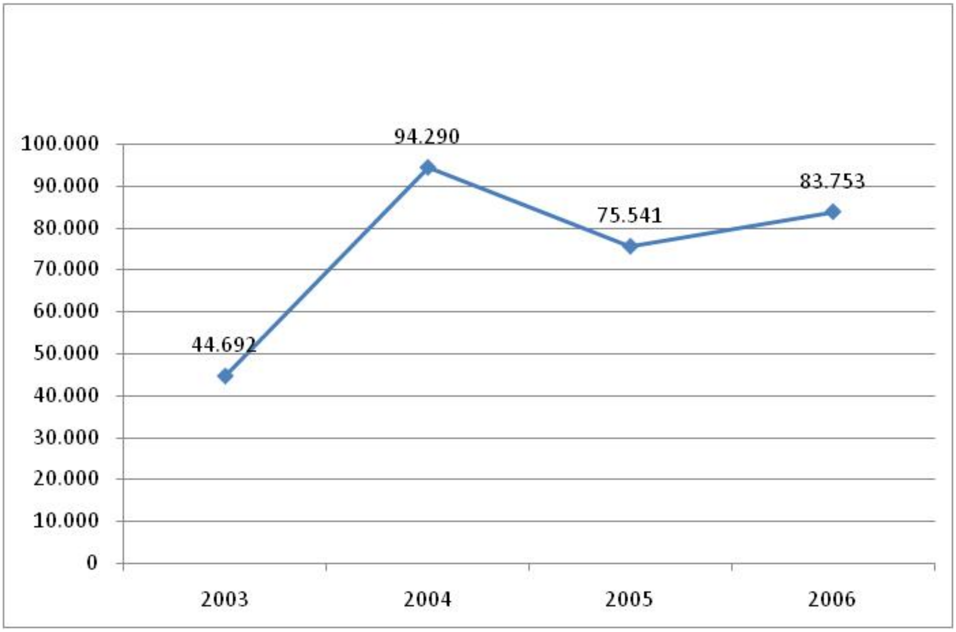


Figure 5. FDI inflows in Latin America 2003-2006

As shown in Figure 6, most of the countries present some increase in FDI flows in the years 2000 to 2003 with a slight decline in the years 2004 to 2005 (except Colombia). Some important aspects including the change in the entry mode (greenfields replaced cross-border mergers and acquisitions) and the reinvestment of earnings by multinational corporations explain the recovery experienced by the region.

It is also remarkable that some countries experienced negative flows of foreign direct investment. This behavior can be particularly explained by the fact that some Latin American countries went back to protectionist patterns against foreign direct investment. The case of Venezuela and Bolivia exemplifies the situation in question. Expropriations experienced in those countries by multinational corporations and some other policies contributed to some decrease in foreign direct flows as shown in Figure 6.

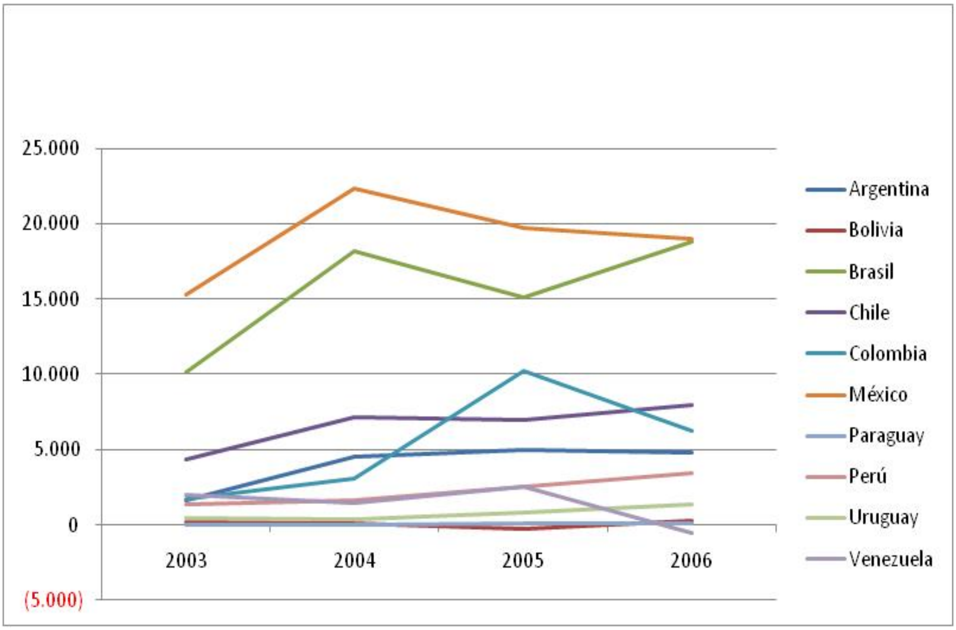


Figure 6. FDI inflows in Latin America 2003-2006

3. Foreign Direct Investment indexes: development measure approach

In order to complete the following section, some indexes that let us explain the effects of foreign direct investment on Latin American countries' development were taken into consideration. Three indexes were calculated. These three indexes can help us understand the effects of FDI on Latin American development. The data on FDI were obtained from the World Bank, UNCTAD, and ECLAC.

3.1. Per capita Foreign Index

Per capita Foreign Index presents a possible ration between FDI and the number of inhabitants per country. It is calculated as follows:

$$\text{FDI per capita} = FDI_i / P_i$$

where FDI_i is the foreign direct investment of country i and P_i is the total population of country i.

The results show that Argentina, Bolivia, Chile, Venezuela, Peru, and Paraguay experienced a considerable growth of FDI per capita in the nineties. Brazil seems to be the only country that during the first four years experienced stable behavior and from that moment until the year 2000 increased its investment levels per population. Uruguay presented very conservative behavior with respect to this index during this decade. Even though there was a growing tendency, its growth from one year to the other was significant.

With respect to Argentina, Bolivia, and Venezuela, these countries present a considerable decline in the very index. It is possible to see that from 1998--1999, the point in which they reached the highest participation in the FDI per capita index, the index begins presenting negatives rates. This can be interpreted as a loss of FDI flows in per capita terms. It seems that the lack of participation per capita of these types of investments represents long periods of productive stagnation. This is also reflected in the lack of access to high technology and the difficulty to incorporate efficient productive processes that accelerate high quality employment and better life conditions for population.

As it is seen, FDI is important not only as a financing source for a country. What is even more important, FDI can bring better quality life for population.

Finally, there are cases of Colombia and Mexico. Colombia shows a growing, but irregular tendency of the index. Mexico presents a constant growth of the index. This behavior could be interpreted by the fact that in case Mexico, it is easy to maintain a significant environment to attract foreign direct investment while Colombia has some difficulty maintaining the same levels year after year.

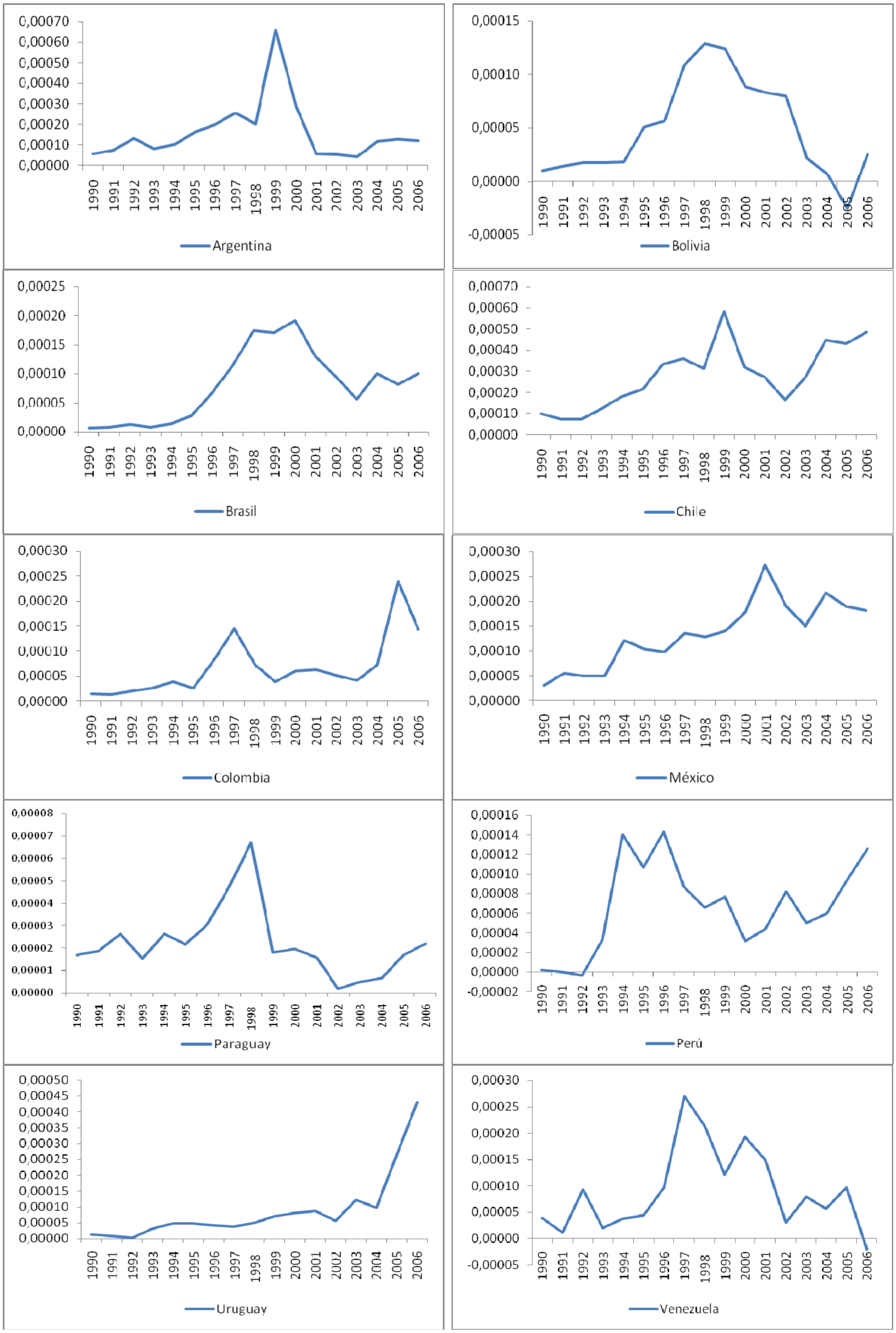
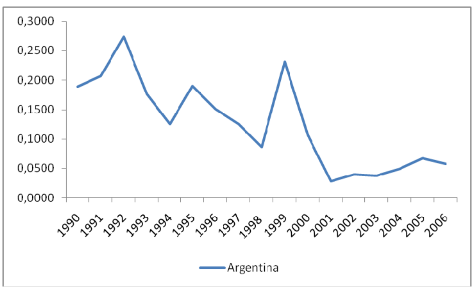


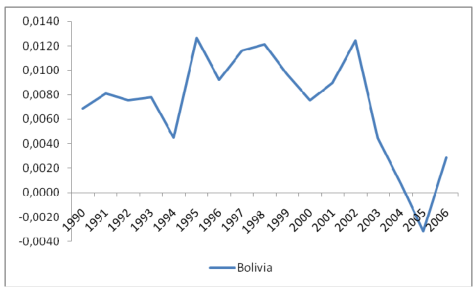
Figure 7. Foreign Direct Investment per capita

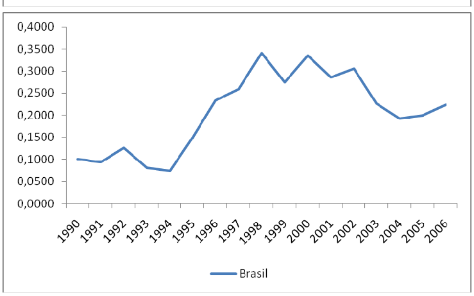
3.2. FDI participation of each country with respect to Latin America

In case of the FDI behavior of countries and their participation in Latin America, it is observed that Argentina, Bolivia, Paraguay, Peru, and Venezuela lost some weight during the time studied. It seems that the loss in the dynamism can be explained by emergence of protectionist mechanisms; contrary to what might be expected to create new development opportunities.

According to UNCTAD, in 2005 some countries experienced a remarkable evolution to a higher intervention from government in the economy as changes in governmental policies that affect directly foreign investors or some industries where FDI is very strong. Brazil and Uruguay experienced a growing tendency, while other countries such as Colombia, though stable in its participation, demonstrated some improvement between 2004 and 2005. These results presented might indicate an economic deceleration in Latin America. According to the theory presented above, the region was subject to the deceleration of development processes observed in each country.







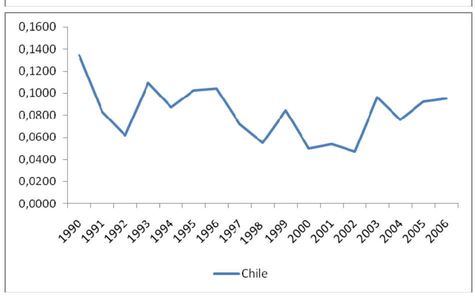


Figure 8. FDI participation of each country with respect to Latin America

3.3. FDI Income Index

Another way to analyze the evolution of FDI involves using the income index prepared by the United Nations Conference on Trade and Development (UNCTAD). This conference presents an index to compare regions with respect to the world. The proportion of the region as a destination of FDI worldwide flows is divided according to worldwide GDP. A value of 1 in this index means that the country attracts FDI in the exact proportion of its GDP.

In this case, a variation of the index was used to analyze each country of the region (Latin America). The analysis involves the proportion of the country as a destination of the Latin American FDI flows divided by its proportion in the Latin American GDP.

Hence, the index is calculated as follows:

Country Index i = (FDI Country/FDI LA) / (GDP Country/GDP LA)

where the relation FDI Country i is the foreign investment of the studied country with respect to FDI in Latin America that is foreign direct investment in Latin America divided by the relation GDP Country i, GDP of the studied country with respect to GDP in Latin America.

As it is seen, a value of 1 means that the country attracts FDI in an exact proportion of its GDP.

The value for most of the countries increased substantially. However, the results obtained show that in case of Argentina, Bolivia, Paraguay, and Venezuela FDI began losing its significant value with respect to GDP despite values higher than 1 at the beginning of the decade. Even in case of Bolivia and Venezuela some negative values represented foreign direct disinvestments. In case of Chile that during the studied period presented values bigger than 1, it can be stated that the received average of 1,46 times more FDI since the index presents an average value of 2,46. In case of Brazil that enjoys a growing tendency, the index reached a value bigger than 1 only in 1998 and 2000. During the studied period, the average was 0.66 showing that it was able to attract FDI in the same proportion of its GDP. Colombia also presented a significant advance in its FDI during the years 2005 and 2006, especially in 2005 when its FDI was 1.85 times its proportion of GDP.

This index confirms the results obtained in the previous indexes. A remarkable transition of economies of countries like Venezuela, Bolivia, Paraguay, and Argentina to protectionist economies was observed.

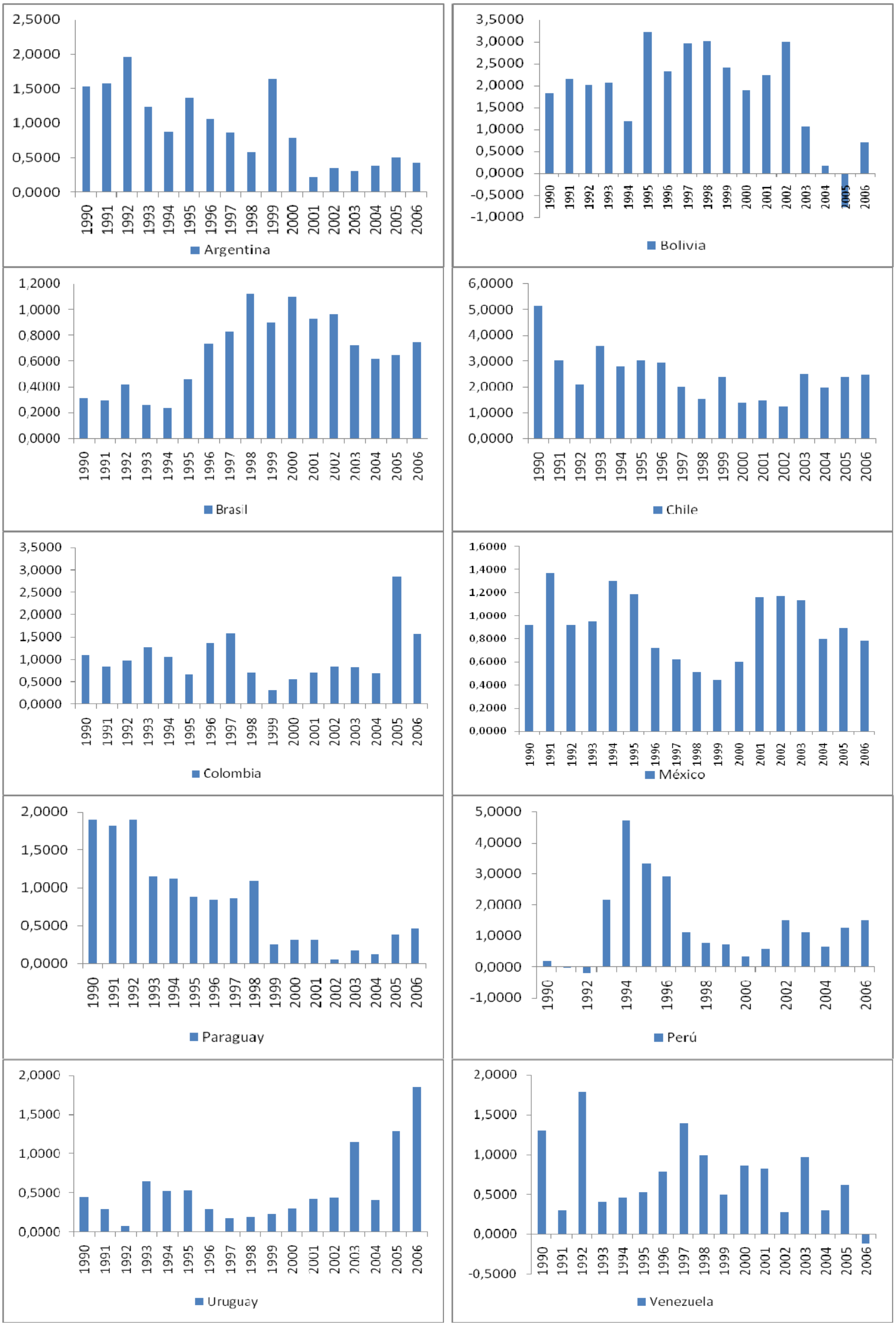


Figure 9. FDI Income Index

Conclusions

Worldwide, but in emerging economies of Latin America in particular, foreign direct investment has become an important source of external private financing. This can be explained since Latin American countries enjoy a relative abundance of labor factor and somehow facilitate the movement of capital of multinational corporations.

This type of investment is different from other sources of private capital since it depends greatly on the long-term time perspectives in which investors have to obtain profits in productive activities controlled directly.

Theories, like the one suggested by Ozawa (1992), analyze the impact of FDI activities in the economic process development. Foreign direct investments can contribute to a structural process of change, which facilitates the growth in income and the transformation of the national demand – especially in case of Latin American economies. This way, it is possible to facilitate some improvement in life quality indexes of the countries in question if the FDI flows tend to satisfy the needs of each country.

Indexes like Foreign Investment per Capita, FDI participation with respect to Latin America and Income Index of FDI show how economies of countries like Venezuela, Bolivia, and Argentina have lost participation of FDI. This is explained due to the transition they are experiencing to the establishment of protectionist economies. The results might indicate that the countries mentioned above can have lower medium-term development indexes than the current ones since the possible reduction of capital and technological transfer might indicate a lag in the region and worldwide.

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