



The Global Financial Crisis and Foreign Direct Investment in Latin America

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Foreign Direct Investment into Latin America and the Caribbean increased sevenfold between 1993 and 2007. In the wake of the global financial crisis, this trend is bound to reverse. Rather than viewing the inevitable downturn in foreign investment as a major threat, the crisis should be seen as an opportunity to revamp Latin America's ability to capture more of the benefits of FDI when it returns. Despite the incredibly increasing amounts of FDI in the region over the past 15 years, there was a very limited contribution of the surges in FDI to the broader economy. A core part of necessary fiscal stimuli to combat the financial crisis should be to enhance the domestic capabilities of Latin American nations to absorb the benefits of foreign investment. That way the region will be able to reap the benefits of foreign investment when it recovers.

I. Prospects for FDI in LAC

Latin America and the Caribbean had just recovered from the last foreign direct investment (FDI) downturn that started in 1999. FDI reached an unprecedented level of \$106 billion in 2007. As recently as May of 2008, institutions such as CEPAL and BID said that FDI would be “ever increasing.” What a difference a few months makes. The world economy has experienced a financial crisis predicted to be the worst in over 100 years.

It was initially thought that Latin America and the Caribbean (LAC) might be “de-coupled” from the crisis. Since 2003 the region rode a commodities boom and piled up reserves. Since 2003 the region has experienced an average annual per capita GDP growth rate of 3.5 percent—a rate not seen since the 1960s and 1970s. What’s more, many nations in the region such as Chile, Peru, Mexico, and others had created “stabilization funds” to capture some of the benefits of boom years to spend during bust cycles. Now it is clear that the crisis, which was not of the region’s making this time, is at the LAC doorstep.

Much of the economic boom in LAC was fueled by commodities exports. Demand for exports has declined as prospects of a recession increase, causing a sharp decline in the prices of those exports. Global credit, which is crucial to exporters, has all but frozen. Banks in developing countries weren’t heavily involved in the mortgage business, but they did swap with and borrow money from banks in developed countries, creating a credit squeeze for the local economy as well. If that wasn’t enough, rising interest rates and credit tightening has strengthened the dollar, and currencies across LAC world are losing value—most notably Brazil and Mexico’s.

Table 1 shows the unprecedented rise in FDI flows in LAC since the early 1990s. FDI hit a peak in 1999 of \$87 billion, but then cascaded as the 1990s bubble burst and the world economy suffered from a mild recession in 2001. From 1999 to 2003, FDI decreased by 51 percent, resulting in the loss of many jobs and the wholesale relocation of

many firms to places like China. If FDI decreased by more than 50 percent after a relatively mild global downturn at the turn of the century, it is not irresponsible to predict a much more dramatic decline in LAC FDI for the short and medium-term in the wake of the global financial crisis.

Signs of decline are already here. According to the *Financial Times*, in Mexico, the government has stalled deadlines for bidding on a major port project that will give Mexico one of the biggest ports in the world. In Brazil, a \$2b cellulose plant has been put on hold by one of world’s largest paper and pulp producers¹.

II. Booms without Boons: Limited impact of FDI in LAC

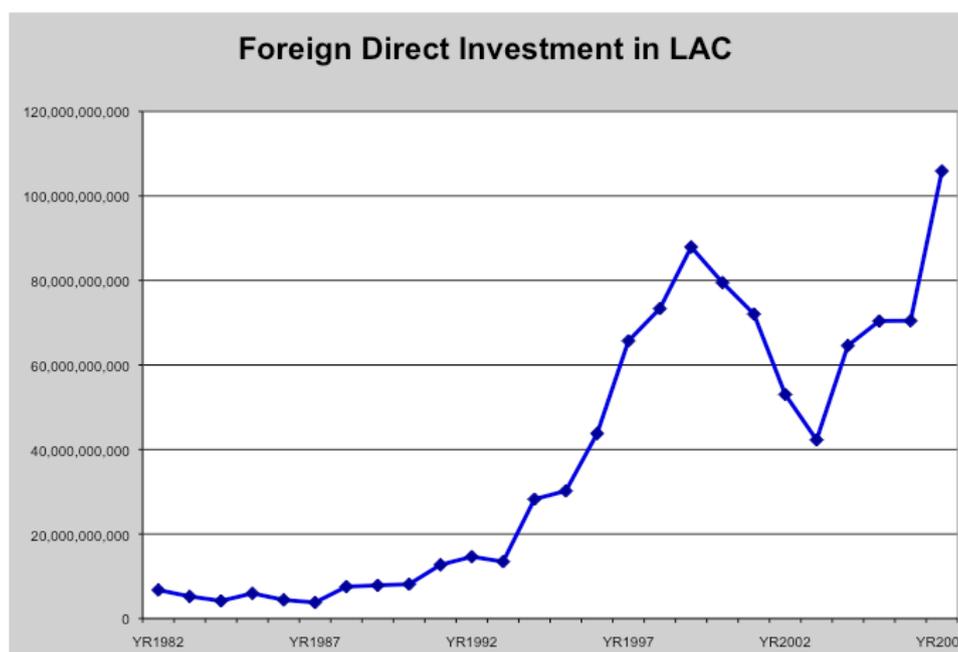
One relatively overlooked aspect of the 1993 to 1999 and the 2003 to 2007 FDI booms has been the fact that the overall impacts of such FDI surges has been extremely limited.

Beginning in the early 1990s, nations in LAC began to liberalize their regimes for foreign investment. Pursued unilaterally or through regional and bilateral trade and/or investment agreements, a typical set of reforms included the elimination of performance requirements such as requirements to source from domestic firms or to export a certain percentage of production, restrictions on the ability to exclude certain sectors from FDI and to “screen” foreign investment for development goals, restrictions on the ability to require joint ventures or research and development facilities, and so forth. Moreover, such reforms alter the nature of settling disputes over foreign investment. Whereas trade agreements have traditionally relied on states to settle disputes among themselves in international fora, newer trade and investor agreements have “investor-state” dispute systems where foreign firms can directly sue a national or local government without host government oversight.

The promise, among others, of following these policies is that FDI by multinational corporations will flow to

1 *Financial Times* (2008) “Latin America Projects on Hold,” October 24

Table 1



Source: World Bank Development Indicators, 2008

developing countries and be a source of dynamic growth. Beyond boosting income and employment, the hope was that manufacturing FDI would bring knowledge spillovers that would build the skill and technological capacities of local firms, catalyzing broad-based economic growth; and environmental spillovers that would mitigate the domestic ecological impacts of industrial transformation.

These policies have raised concerns, in part because they have shown poor results. Economic growth in per capita terms in the region was slower than in the last decades of the import substitution period. Slow growth is in part explained by the fact that FDI failed to lead to more total investment into Latin American economies.

A comprehensive assessment of the impacts of FDI since the early 1990s recently concluded²:

- FDI was concentrated in a small handful of countries in the region. Brazil, Mexico, Argentina, Chile and Venezuela received more than 80 percent of all the FDI in the region;
- Foreign firms that located in Mexico and the Caribbean tended to serve as export platforms to the United States, whereas those that located in South America tend to sell to domestic markets and gain access to natural resources in that region.
- FDI was attracted by traditional determinants, not necessarily whether a nation had a regional or bilateral trade and/or investment treaty or if it can serve as a pollution haven for foreign firms;
- When FDI did come, foreign firms tended to have higher levels of productivity and higher wages and generally increase trade in the region; yet
- FDI fell far short of generating “spillovers” and backward linkages that help countries develop, and in many cases wiped out locally competing firms thereby “crowding out” domestic investment.
- The environmental performance of foreign firms was mixed, sometimes leading to upgrading of environmental performance, and in others

² Working Group on Development and the Environment In the Americas (2008), *Foreign Direct Investment and Sustainable Development: Lessons from the Americas*, Tufts University, http://ase.tufts.edu/gdae/WorkingGroup_FDI.htm

performing the same or worse than domestic counterparts.

More specifically, In Brazil, Argentina, Mexico—three countries that have received the lion’s share of FDI in the region—and Costa Rica it found that: foreign firms have higher wages, productivity, and trade *vis a vis* domestic firms. However, linkages with national firms and the domestic economy in general are weak, especially in Mexico and Costa Rica. Although foreign firms may bring the technologies generated in their headquarters, they do not contribute to an increase in R&D expenditures in the host economies. Indeed, in many countries in the region, increasing FDI was not associated with increases in economic growth or employment.

Recent econometric work comparing the impacts of FDI on total investment in Latin America and East Asia found that whereas in East Asia FDI “crowded in” domestic investment, in LAC FDI tended to “crowd out” domestic investment, meaning foreign firms often displaced domestic firms and investment rather than linking with the broader economy. This is quite clear in Table 2, where total investment (GFCF or gross fixed capital formation) as a percent of GDP in LAC has not been able to reach its pre-reform levels, despite increases in FDI. In Asia, a region that did not liberalize its investment region in a manner similar to LAC the opposite happens, increases in FDI increase domestic investment. The crowding out of domestic investment, and the overall lack of investment in general, is in part why the region has experienced such relatively low growth levels during the reform period.³

III. New Directions for FDI and Economic Development

A comprehensive response to the financial crisis that includes building the capacity of the domestic economy to absorb the benefits of FDI will not only lessen the blow of the crisis in the present but prepare LAC to be better poised to receive FDI when the next boom comes.

FDI is not an ends but a means to economic

³ M. Agosin and R. Machado (2005) Foreign Investment in Developing Countries: Does it Crowd in Domestic Investment? *Oxford Development Studies* 33 (2):149-162

Table 2

FDI: Crowding Out Domestic Investment?

	<u>1960-1980</u>	<u>1980-2003</u>	<u>2003-2007</u>
East Asia and Pacific			
FDI/GDP	0.4	2.2	2.9
GFCF/GDP	24.6	30.3	35.8
GDP/CAP	3.5	6.4	8.6
Latin America and the Caribbean			
FDI/GDP	0.8	1.7	2.7
GFCF/GDP	21.9	19.3	19.1
GDP/CAP	2.9	0.4	3.5

Source: World Bank Development Indicators, 2008

development. The record since the 1990s proves that simply attracting FDI is not enough to generate economic growth in an environmentally sustainable manner. The unprecedented levels of FDI since the early 1990s, even in the nations that received the lion's share of FDI in the region—Brazil, Argentina, and Mexico—fell short of generating spillovers and sustained economic growth. FDI needs to be part of a comprehensive development strategy aimed at raising the standards of living of the nation's population with minimal damage to the environment.

Every economics textbook argues that government should take in more revenue and spend less during times of boom, and spend more while taking in less revenue during bust cycles. The good news is that for the first time many LAC nations are poised to do so. Many nations in the region impressively shrank both their fiscal and current account deficits during the boom period, while increasing their level of reserves. What's more, nations such as Chile, Peru, Mexico, and others created stabilization funds with the sole purpose of providing counter-cyclical support to the economy during downturns.⁴ That downturn has come.

New capital may also become available from abroad. The IMF has created a special liquidity fund for developing countries, a fund that does not require the draconian conditionalities of past IMF funding efforts. The US has made capital available to Brazil and Mexico as part of its bail-out efforts, and discussions still loom globally over the prospects of making significant amounts of liquidity available to the developing world and perhaps even fundamentally reforming the international financial institutions.

New capital, reserves, and stabilization funds can be used in the short term to fend off runs on LAC currencies. Just as important, new credit and capital can be coupled with coordinating governmental policies to build the productive capacities of promising and strategic domestic enterprises--and toward domestic consumers--to stimulate demand.

FDI policy needs to be paired with significant and targeted domestic policies that upgrade the capabilities of national firms and provide a benchmark of environmental protection. Upgrading the capacity of domestic companies, including small and medium sized forms, so they can take advantage of spillover possibilities rather than fall by the wayside, is essential. Increasing the stock of human resources in the region is also of paramount importance. Strengthening incentives and requirements for technology transfer and R&D operations for domestic firms for multinational corporations. Bargaining with foreign firms over the level of technological and logistical

4 J. Ocampo (2007) "The Macroeconomics of the Latin American Commodities Boom," CEPAL REVIEW 93, December.

sophistication in LAC subsidiaries, as well as the level of environmental policy will also be paramount.

A benchmark of environmental regulation should be established so that LAC nations can absorb the (positive and negative) environmental impacts of FDI in the future. Given that there is now widespread agreement that LAC is not a pollution haven that makes foreign firms move their because of weak environmental standards, raising such standards will not scare away future foreign investment.

Rushing to new international agreements solely with aims to attract FDI may be counterproductive. First, there is very limited evidence that such agreements have an independent affect on attracting investment to the regions⁵. Second, such agreements come at a cost. They often make it more difficult for LAC nations to deploy the appropriate policies needed to build the domestic capacity to benefit from FDI in the first place.

International agreements pertaining to investment, whether at the World Trade Organization (WTO) or at the level of regional or bilateral trade and/or investment treaties, need to leave developing nations the "policy space" to pursue the domestic policies necessary to foster sustainable development through FDI. New research has shown that many international arrangements, particular deals with the United States, are restricting the ability of developing nations to pursue some of the policy instruments that have been successful at channeling FDI for development in Asia and elsewhere.⁶

When acting collectively under the auspices of the WTO, LAC nations have largely succeeded in blocking proposals that would further restrict such policy space. However, slower movement in global trade talks has led to a proliferation of free trade agreements between developed and developing countries where developing countries have much less bargaining power and end up exchanging policy space for market access. Rather than looking outward for solutions, it is time for the region to tap its enormous inward potential in order to stand ready to reap more benefit when the global economy recovers from the current crisis.

5 R. Porzecanski and K. Gallagher (2007) "Economic Reform and Foreign Investment in Latin America: A Critical Assessment" *Progress in Development Studies* (2007)

6 R. Denae Thrasher and K. Gallagher (2008) *Twenty-First Century Trade Agreements: Implications for Long-run Development Policy*, Boston University: Frederick Pardee Center for the Study of the Longer Range Future (http://www.ase.tufts.edu/gdae/policy_research/KGPardeePolSpaceSep08.html).

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