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FDI and Development: After the Washington Consensus

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Introduction

The impacts of Foreign Direct Investment (FDI) on the development objectives of host developing countries have been debated both in the academic as well as in the political arena in recent decades.

The dominant thoughts on the subject have been changing through time. In the first post-war years FDI was mostly perceived as a favourable element for developing countries insofar it was supposedly able to provide three factors which are often scarce in those countries: a) technology; b) capital; c) entrepreneurial capability. It comes as no surprise then to find that Transnational Corporations (TNCs), which are the carriers of the bulk of FDI flows at world level, played a dominant role in import substitution industrialization (ISI) episodes in many developing countries.

This pro-FDI view began to change in late 60's, when "anti-dependencist" arguments gained momentum, influencing the adoption of more restrictive policies towards FDI in many African, Asian and Latin American countries.

The pendulum swung once more with the emergence of globalization and the widespread adoption of pro-market reforms inspired in the "Washington Consensus". In the 90s not only FDI flows were deregulated in many countries, but open competitions or biddings for FDI were not unusual, even in developing countries. The rationale behind those competitions was that FDI was able to contribute with the reforms processes undertaken in those countries which were aimed at adapting their respective economies to the new reality of the globalized world.

Nowadays a certain consensus on the following argument has emerged: FDI, per se, is neither a panacea nor a poison for development. Its impacts depend on the nature of FDI inflows, the strategies and objectives pursued by TNCs when they invest in developing countries, the linkages they establish with domestic agents (firms, universities, etc.), the capabilities and assets of domestic firms, the macroeconomic, institutional and structural conditions and the public policies in force in host countries.

One of the issues that the recent literature on FDI and development has stressed is that not only the direct effects of FDI in host countries must be analyzed but also the indirect effects (spillovers) which mainly affect domestic firms. This is very relevant insofar domestic firms contribute with the bulk of employment in almost all countries.

In this article, after presenting some basic data on FDI and the role of TNCs in the world economy (including the trends towards the deployment of the so-called global value chains), a brief discussion on FDI impacts on host countries is made. Later on, the available evidence on the impact of FDI in Latin America is presented. The concluding section includes a reflection on FDI policies from a development point of view.

Some basic data

FDI flows at world level recorded a strong growth during the 1990s, peaking US\$ 1,400,000 million in 2000. After a deep fall between 2000 and 2003, FDI flows gained strength once more and reached a new record in 2007 (almost US\$ 1,900,000 million).

Taking into account these figures, it comes as no surprise to find that the weight of TNCs in the world economy has increased strongly in the past few years. In the early 1990's, it was estimated that there were approximately 37,000 TNCs with at least 170,000 foreign affiliates; in 2004, there were around 70,000 TNCs and 690,000 foreign affiliates, almost half of which were located in developing countries (UNCTAD, 2005).

We should not find surprising either that these companies concentrate a substantial part of the world trade. Since the early 1990's TNCs have accounted for 2/3 of global trade -and almost half of such trade is based on intra-company transactions, while the other half is to a large extent made with subcontractors- (UNCTAD, 2002).

TNCs play, additionally, a key role in the generation of new technologies. In 2002, almost all 700 companies with the most investment in R&D in the world – of which 80% are from just five countries: the US, Japan, England, Germany and France – were TNCs and represented 46% of all the global investment in R&D (UNCTAD, 2005)

Another key new factor is that the weight of the services sector increased from a fourth of the world's FDI stock in the early 1960's to less than half in the 1990's and to 60% in 2002 (UNCTAD, 2004). Such increase is due to different causes: i) the previous lag the sector showed in terms of transnationalization; ii) the growing weight of services in GDP in most countries; iii) the deregulation and privatization processes allowed foreign investors to gain access to previously limited sectors; and iv) the technological changes that made it easier to supply remote services (UNCTAD, 2004).

The driving forces behind the growth of FDI flows include: i) the proliferation of different ways of binational or multinational agreements, ranging from regional integration processes to investment treaties, which have liberalized investment conditions in many countries; ii) the adoption of market liberalization programmes in most developing countries; iii) the trend towards a growing globalization of competition in most industries; iv) the increasing fragmentation of production which has led to the creation of the so-called global value chains (GVC). The deployment of GVCs has been allowed by the advance of new information and communication technologies (ICTs), which help reduce the costs of the coordination, logistics and monitoring of operations carried out in a geographically decentralized way, and by the decrease in transportation costs.

Nowadays, developing countries face the challenge of reaching a sustainable and favorable integration in goods and services global value chains. Integration in GVCs may help to diversify exports, penetrate new markets, generate employment and acquire information, knowledge and new technological capabilities, hence fostering competitiveness in developing countries. However, these benefits only accrue to those countries which manage to go beyond a “low labor-cost based” integration in GVCs.

FDI may be a way to help developing countries to integrate in GVCs. However, it is not always the case that firms from developing countries (be them domestic companies or TNCs affiliates) manage to climb the ladder towards higher value added stages in those chains. Another way towards the integration in GVCs is on the basis of “national champions”, but the conditions to create that kind of economic agents are stringent.

Below we discuss how Latin America has been managing the challenge of integration in GVCs. First, however, there is a need to analyze the different channels through which FDI may have an impact on economic development in host countries.

FDI and development: a brief framework

FDI’s contribution to the economic development of recipient countries depends essentially on the impact that the presence of transnational companies has on domestic economies.

TNCs affiliates enjoy “ownership advantages” thanks to their access to product and process technologies and to the organizational, production, business and environmental practices of their parent companies. Such affiliates —especially when they operate in developing countries— thus generally have advantages over their local competitors in terms of higher productivity and greater capacity for launching new products and productive processes on the market.

FDI can also be expected to influence trade flows in recipient countries because affiliates are part of corporate networks which, theoretically, facilitate the exchange of goods and services with other affiliates, with the parent company and even with third parties (suppliers and others). With their higher levels of productivity and easier access to foreign markets, it is reasonable to assume that affiliates will have a greater propensity to export than local companies. And because it is easier for them to purchase from foreign suppliers, including both inputs and finished goods and capital goods, they will also, presumably, be more likely to import than local companies.

In addition to its direct effects, FDI also has significant indirect effects (also called spillover) on domestic companies. In the area of productivity, for example, there may be positive spillovers for companies in the recipient countries, which may take various forms. For example: (i) Human capital may be improved when local companies and institutions gain access to operators, technicians and engineers trained by affiliates of transnational companies in production, marketing and/or innovation activities. (ii) The level of competition on the domestic market may increase when new transnational companies enter the market or existing affiliates become more competitive, prompting local companies that compete with the foreign firms to boost their productivity and/or enhance the quality of their products, either by making investments or by taking advantage of knowledge that trickles down from affiliates —i.e., through horizontal or intrasectoral spillovers. (iii) Local companies may benefit from the technologies and organizational practices of transnational companies, both as a result of the more stringent demands for quality, price and/or delivery time that affiliates generally place on their suppliers and as a result of the technical assistance that they may provide in order to ensure that those demands are met —i.e., vertical or intersectoral spillovers.

While affiliates would have incentives for avoiding horizontal spillovers, they might be inclined to promote vertical or intersectoral spillovers. This type of spillover will probably not have any adverse effect on the affiliates and indeed might well benefit them by making their customers and/or suppliers more productive and more efficient (Kugler, 2001). Affiliates can also generate positive spillovers in terms of access to external markets if their export activities reduce the cost of acquiring information on such markets or make it easier for local companies to learn to export, either through demonstration effects or through generation of greater competition.

However, spillovers will not always be positive. For example, productivity can be negatively impacted when local companies are forced to cut their production—thus lowering productivity in their establishments—in the face of a growing foreign presence in the market (Aitken and Harrison, 1999). Negative vertical spillovers can occur when, for example, local suppliers are displaced from the market as a result of affiliates' preference for foreign suppliers.

Empirical studies in recent years have attempted to assess the existence and magnitude of direct effects of FDI in recipient countries and determine whether those effects have been positive or negative. The methodology used in such studies has changed over time, with case studies of countries or industries in which transnational companies play a significant role increasingly giving way to econometric studies, as it is essential to employ procedures that make it possible to analyze both observable and non-observable characteristics of companies in order to isolate the importance of the foreign ownership variable in performance differences. This means analyzing the problem of endogeneity (Barba Navaretti and Venables, 2004). In this field, although most studies still find that TNCs have higher productivity and trade more than domestic firms, it is clearly the case that modern econometric studies find smaller differences between both groups *vis a vis* those that were based on less sophisticated techniques.

The same is true of spillovers. In the case of productivity spillovers, which were the first to attract the attention of the specialized literature, most of the pioneer studies found evidence of positive indirect effects, but they were based on cross-section data, which did not capture heterogeneity at the company level. Moreover, these studies did not take into account the effect of the sectoral composition of FDI, so even in the absence of spillovers there could be a positive correlation between presence of transnational companies and productivity of local companies, simply because transnationals tend to invest in high-productivity sectors. The most recent studies, most of which have employed panel data techniques, have tended to show a more heterogeneous reality, with many studies finding negative spillovers as well as others finding that spillovers are contingent on the strategies and objectives of TNCs and/or on the capabilities of domestic firms (Chudnovsky and López, 2007; Gorg and Greenaway, 2004).

Up to this point, we have been discussing mainly the microeconomic effects of FDI. Analogously, the aforementioned empirical studies have generally been based on firm-level data. However, many studies have also examined the relationship between FDI and growth (and investment), a topic which, obviously, must be treated at country level. In this area, too, the empiric evidence shows a positive to negative shift—from general optimism to general skepticism—as increasingly advanced econometric techniques have been used.

While some studies find that FDI is a causal factor in growth in developing countries, particularly when certain minimum thresholds for human capital and/or trade openness are met in the

recipient countries, other finds no evidence of a positive impact of FDI on growth or that the causal relationship goes in the other direction: growth leads to FDI. Other papers even find that FDI may have a negative impact on growth, for instance, when it arrives in the form of mergers and acquisitions (Chudnovsky and López, 2007).

To a large extent, the lack of a positive impact of FDI on growth is related to the fact that FDI does not seemingly have a positive impact on domestic investment in many cases. Agosin and Machado (2005) assess whether (FDI) in developing countries crowds in or crowds out domestic investment. Their analysis involves 12 countries in Africa, Asia and Latin America. The results indicate that, in all three developing regions, FDI has, at best, left domestic investment unchanged, and that there are several sub-periods for specific regions where FDI displaces domestic investment. In particular, there seems to be crowding out of domestic investment by FDI in Latin America.

All this evidence points towards the following conclusion: FDI positive impacts on host countries are far from being automatic. In the next section we have the opportunity to further illustrate this argument with the available evidence for Latin America.

The evidence for Latin America

Latin America and the Caribbean have lost weight in FDI inflows in recent decades, despite the fact that the volumes received by the region in the 1990s reached very high levels. In the 1970's, the region received 13% of total world FDI and 51% of that destined to developing countries, while in the 1990's such percentages dropped to 11% and 37%, respectively. In contrast, Asia increased its participation from 7% and 27% to 16% and 55% respectively (based on UNCTAD's data).

A substantial part of FDI that arrived in Latin America was as mergers and acquisitions. More than half of the inflows arrived to the region between 1996 and 2000 was due to change of hands – with remarkable records in Argentina (75%) and Brazil (67%) – (Chudnovsky and López, 2007). The respective figure for the average of developing countries was just above 30%.

Examining FDI distribution within the region we see that it has remained strongly concentrated in the larger economies –Brazil, Mexico, Argentina and Chile, in that order. These countries, as a whole, absorbed just about 2/3 of the FDI flows between 1990 and 2005, while the gross of the other 1/3 was destined primarily to the Caribbean's fiscal havens.

There are basically two patterns in the region in terms of the FDI received. On the one hand, in South American countries the exploitation of raw material and the access to the (national or regional) market seem to be the determining factors to the localization of FDI (resource and market seeking strategy), which basically turned to natural resources sectors, some industrial activities – mainly automobiles, chemicals and foodstuff – and services (for example public services, banks and trade).

On the other hand, Mexico, Central America and the Caribbean basin, by and large, received “efficiency seeking” FDI in sectors such as automobiles, textiles and clothing and electronics and motivated by the low labour costs (ECLAC, 2000). These investments are mainly established at labour-intensive stages in the TNCs’ production networks and they usually function similarly to “enclaves”, with low integration levels into the domestic economies.

Notwithstanding the divergence in the degree and form of insertion of Latin America’s different regions into GVCs led by TNCs, it is seemingly the case that there are not big differences in terms of the impacts of FDI on the continent’s economies.

In the case of MERCOSUR, recent research (see Chudnovsky and López, 2007) show that the macroeconomic impacts from FDI have not been very significant, since its effects on GDP growth and investment have been neutral (and the same goes for employment creation). In contrast, the FDI microeconomic impacts seemed to have been stronger, although with heterogeneous signs.

There is evidence that foreign affiliates are more involved in international trade than domestic companies, in terms both of imports and of exports. However, there is no evidence of export spillovers for domestic firms. , except in Brazil, where spillovers do seem to have occurred, but they were very small in magnitude and were both positive and negative, generally benefiting the most productive local companies and hurting the least productive ones

At the same time, the participation of affiliates in the intra-firm trade of transnational companies shows some asymmetrical patterns. In Brazil, in particular, it has been shown that affiliates of transnational companies headquartered in developed countries tend to import mainly from their countries of origin—but they do not show the same tendency with regard to exports—and that such imports had a higher technology content than their imports from other regions.

Considering that most trade by affiliates of multinationals is intra-firma trade, and in the light of the findings of previous studies on the topic, it can be concluded that there is a sort of intra-firm international “division of labour” in a substantial proportion of the foreign companies with operations in the region. The technology content of affiliates’ exports is lower than that of their imports, and most such exports go to developing countries, mainly in Latin America. This means that advantage is not being taken of the possibilities that might be available to affiliates in the markets of origin of their respective parent companies. On the other hand, affiliates tend to purchase mainly from suppliers in their countries of origin, particularly in the case of goods with high technology content.

As for the productivity spillovers, the available evidence shows a heterogeneous picture. Only in the case of Brazil do there appear to be productivity spillovers from affiliates of transnational corporations to their domestic suppliers. The productivity of these Brazilian firms appears to have been enhanced by the foreign presence, which could be the result of conscious effort by the affiliates to help boost the efficiency of their suppliers.

In contrast, horizontal productivity spillovers —i.e., spillovers between companies competing in the same area of activity— seem to depend on certain characteristics of the local companies and of the markets in which they operate. For example, in Argentina it was the domestic companies with the greatest absorptive capacity that most benefited from the presence of transnational firms, whereas in Brazil the biggest beneficiaries were the domestic firms that had the largest productivity gap vis -à- vis the TNCs. While the finding in Argentina is presumably explained by the fact that greater absorptive capacity facilitates the transfer of knowledge from subsidiaries of transnational companies to local firms, the situation in Brazil appears to have more to do with the massive influx of market-seeking FDI, which displaced the local companies competing directly with foreign subsidiaries in the same markets.

In Brazil, there is also evidence of positive spillovers from the foreign presence on the R&D expenditures of local companies. Curiously, this was true even though subsidiaries in Brazil spend less on R&D than domestic companies. This does not, however, mean that they are less innovative. Indeed, in both Brazil and Argentina, transnational companies are more likely to introduce innovations into the market (and use more the patent system) than their domestic counterparts, a phenomenon explained by the fact that knowledge existing within transnational companies can be utilized at low cost by their subsidiaries.

While all this evidence is referred to FDI in the industrial sector, the same seemingly happens in other sectors. For instance, in Argentina's software and information technology services, which attracted significant FDI operations in recent years looking for skilled human resources, for exporting domestic firms to move from software factory or low value added services activities to more complex processes – such as business process outsourcing and knowledge process outsourcing— it seems to be essential, among other factors, to establish knowledge and training linkages with the TNCs that do actively participate in those areas. However, so far, this sort of linkages has been rather weak or non-existent (López and Ramos, 2008). The same scenario is also replied in a number of other knowledge intensive sectors and in other South American countries (López et al, 2009).

Going to the other region, in Mexico's case, meanwhile, FDI impacts, albeit positive in terms of exports, employment and wages (at least in certain regions of the country), have been weak in terms of production chains, human resources training and local technological development (Capdevielle, 2005; ECLAC, 2005; Dussel Peters, 2003).

In the case of the electronics industry, for example, according to official data, the level of national integration in the *maquila* sector is just 3% (Gallagher and Zarsky, 2004). The local innovative activity, in turn, is just about nil. Meanwhile, in a study for the automobile sector, it is pointed out that Mexico's export success was because it consolidated an export platform and not because it established an automobile manufacturing center, given the high foreign content in exported vehicles (Mortimore and Barron, 2005). Naturally, the weakness of the local linkages reduces the magnitude of potential spillovers.

Meanwhile, Bair and Dussel Peters (2006), when analyzing the clothing industry, state that, despite the optimistic expectations when entering NAFTA about the possibility of not only

increasing clothes exports to the US, but also of moving from assembling structures to “full-package manufacturing” ones, data show that not only did it not occur consistently in time, but also that it took place in only one textile district, but not in the rest of the country.

Something similar happens in Costa Rica with the advent of FDI in high-tech sectors (a paradigmatic case is Intel), since production in these sectors is carried out with hardly any local linkages, both in terms of suppliers¹ and customers as well as in terms of domestic technological development. FDI in those sectors does not seem to have generated externalities for local companies by means of human capital mobility either. Additionally, a dual export – and industrial – structure has been consolidated, since national companies are still specialized in primary and traditional goods (Ciarli and Giuliani, 2005).

The same situation is observed in Honduras’s textile industry, where while foreign affiliates are less exposed to pressures by customers than their local peers (which are often in the lower end of the value chain), while linkages between both groups of firms are virtually inexistent, hence limiting externalities for the local economy (Bair and Dussel Peters, 2006).

Latin America’s countries are also backward in terms of the internationalization of their domestic firms. Here the contrast with Asia lies not only in the magnitude of FDI outflows from each region but also in terms of the industries in which TNCs from each continent operate.

FDI from developing countries went from an annual average of US\$106 million between 1970-1974 to almost US\$ 9,500 million in 1985-1989, to reach later US\$ 76,400 million between 2000 and 2004. Latin America had less influence in this trend *vis a vis* Asian economies. While the weight of the latter region went from 3% of total FDI from developing countries between 1970 and 1974, to 67% between 2000 and 2004, Latin America’s participation dropped from 50% to 32% - percentage that is just 12% if the Caribbean major financial centers are excluded - (ECLAC, 2005).

Thus, it is not surprising that so far among the top 100 TNCs from developing countries, only 12 are from Latin America –“multilatinas” (8 from Mexico, 3 from Brazil and 1 from Venezuela). In addition to 11 South African companies and one Egyptian, the remaining 76 come from South and East Asia (UNCTAD, 2006).

In the case of “multilatinas”, investments tend to concentrate in basic industries –hydrocarbons, extractive mining, steel industry, cement, etc. -, food and beverages, and some services – engineering and telecommunications mostly. On the other hand, FDI from Asian companies is quite based on high-tech sectors (ECLAC, 2005)².

¹ Just 1.5% of the input used by Costa Rica’s high-tech industry is local in origin.

² Twenty-four out of the 76 main Asian TNCs operate in IT, electronics and telecommunication sectors, while this only occurs in 2 of the 12 “multilatinas” (UNCTAD, 2005).

Also, while Asian TNCs display efficiency or asset-seeking strategies, in the case of the “multilatinas” the search for natural resources or markets prevail, which may reduce potential positive externalities that might result from issuing economies.

Certainly, there are cases of Latin American companies reaching global excellence levels in their respective industries (for example Techint in Argentina, Cemex in México, Petrobrás in Brazil) and some even compete in activities subject to a fast technological change or in which competition by means of design and innovation is key - Embraer (Brazil) in the aeronautical sector (see Goldstein, 2002), Telmex and América Móviles (Mexico), in telecommunications, IMPSA (Argentina) in energy equipment. In general, they are exceptions in a not very dynamic context in terms of companies capable of going global.

Summing up, Latin America has played a significant role as a destination of FDI, but the impacts of this advantage have not been so powerful. In some cases, it was so because the FDI’s main objective was not to integrate foreign affiliates in GVCs, but basically exploit domestic and regional markets and take advantage of the human resources stock (South America). In others (Central America, the Caribbean, and Mexico) because while the integration into GVCs existed, it was primarily based on advantages related to labour costs, generating scarce local spillovers, and being subject to change of location threats towards areas with lower salaries (e.g. China) –see Kosacoff et al (2008).

Conclusions

FDI has not been a development panacea for host countries in Latin America. This conclusion may also be extended to other developing regions. However, FDI is a powerful economic force at the world level, and TNCs not only play a key role in trade and technological change, but also increasingly organize the world’s labour division by managing the deployment of GVCs in many different sectors and activities.

Moreover, while it is clear that FDI global inflows will surely decelerate as a consequence of the current crisis, the long run trends towards the deployment of global value chains governed by TNCs will probably still operate. Hence, the challenge for developing countries to find ways to have a better integration in GVCs will still remain. What are hence the options open to developing countries in terms of FDI and development policies?

At present, both in international financial institutions as well as in the academic arena, there is more agreement than in the past 20 years or so with the need of adopting specific policies aimed at dealing with market and coordination failures that may hinder development processes.

Hence, nowadays the challenge is not to find good arguments in favour of those policies based on economic theory and on many regions’ experiences, but of designing institutional arrangements able to have good diagnostics of the specific problems faced by countries to improve their

competitiveness levels in a changing world, adopting policy initiatives in the relevant areas and evaluate their effectiveness.

The foregoing suggests several areas in which policy measures might be applied in order to enhance the direct and indirect impacts of FDI in developing countries. For example, policies might be aimed at:

- Boosting the capacity and competences of local companies, in particular SMEs, to enable them to take better advantage of the spillovers effects from the foreign presence.
- Encouraging schemes for developing or improving suppliers which could lead to significant vertical spillovers to local companies.
- Strengthening incentives for R&D activities, for both TNCs and local companies.
- Initiating negotiations aimed at persuading TNCs to locate more of their corporate strategic activities in affiliates and to entrust those affiliates with greater responsibility, for example, with regard to the development of “global products” for worldwide export.
- Promoting various ways of integrating local companies into the value chains led by TNCs, including outsourcing, partnerships and other modalities.
- Adopting policies aimed at fostering the emergence of new high value-added and knowledge intensive activities and sectors.

From the list above it is quite clear that much of the policy action needed to ensure greater spillovers effects from FDI flows to developing countries is related to the level of business development in those countries. Certainly, this is a crucial issue that encompasses problems ranging from lack of access to financing—which basically affect capital and technology investment by local companies—to human capital deficiencies, limited absorptive capacity and generation of knowledge, and lags in adopting modern methods of business management.

A passive open door policy towards FDI may not be the best way to achieve the goal of enhancing FDI’s contribution to economic development. Developing countries must make use of the policy options still available within the current international disciplines setting to adopt initiatives aimed at dealing with the abovementioned issues (although it is also the case that those countries should keep struggling to widen those policy options in order to be able to adopt more pro-development policies).

This kind of “active” policies on FDI are likely to yield better results if the TNCs operating in developing countries are efficiency seekers (but without becoming cheap labour enclaves), rather than seeking only to exploit natural resources or domestic markets, as it was largely the case in the 1990s.

Accordingly, some thought needs to be given to how to create conditions that will attract a larger proportion of “quality” FDI to the developing world. Such conditions include access to skilled human resources, availability of adequate physical and logistic infrastructure, existence of a good science and technology base and a stable regulatory framework and solid institutions.

But developing countries they may also choose a restrictive stance towards FDI, trying to foster the emergence of “national champions”. This was largely the path followed by successful countries such as Korea and Taiwan. However this process may take time and requires an even more demanding set of conditions than trying to improve the positive impacts of FDI on host countries. While this does not mean that developing countries should not move towards that path, it only reminds us that it will be a long and hard process.

Summing up, although FDI may contribute to productivity increases and technological change in host countries, specific policies are needed to reap its potential benefits (e.g. linkages with domestic suppliers, inducing TNCs to undertake innovation activities, etc.). Furthermore, FDI per se does not contribute to change the trade specialization pattern of host countries (although it may help if proper policies are in place in that regard). Hence, FDI is not a substitute for the adoption of pro-development policies similar to those that in the past led to successful results in many developing and developed countries.

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