European Journal of Political Economy 34 (2014) 279–299

Contents lists available at ScienceDirect

European Journal of Political Economy

journal homepage: www.elsevier.com/locate/ejpe

Do changes in the rules of the game affect FDI flows in Latin America? A look at the macroeconomic, institutional and regional integration determinants of FDI

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ARTICLE INFO

Article history:
Received 1 June 2013
Received in revised form 1 February 2014
Accepted 4 February 2014
Available online 13 February 2014

JEL classification:
F: International Economics

Keywords:
FDI determinants
Institutions
Risk management
Latin America
Panel data analysis
Foreign direct investment

ABSTRACT

This paper aims to identify the main determinants of FDI in Latin America during the period 1990–2010. Evidence points to positive influences on FDI inflows of trade openness, maintaining low short-term debt levels and presenting a balance of payment deficit, government stability and low expropriation risk. Countries such as Argentina, Bolivia, Ecuador and Venezuela, in which the investment framework has become relatively less stable over the last decade, are finding it more difficult to attract foreign investors. From a risk-management perspective, both public solutions (such as sovereign guarantees) and private institutions have important roles to play in reducing the uncertainty involved in foreign investment decisions. Another result is that the DR CAFTA agreement does not seem to have played a significant role in the recent increase in investment directed towards Central America.

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1. Introduction

Over the past two decades, FDI inflows to Latin America have increased significantly, causing the regional stock of FDI in the region to currently be approximately 30% of GDP, similar to that of East Asia, compared with just 5% of GDP at the beginning of the 1980s (one-third of that observed in East Asia). However, not all Latin American countries have been equally successful in appealing to foreign investors (see Appendix A. Stylized facts on global and regional FDI flows). The aim of this paper is to identify the determinants of FDI flows to Latin America in the period from 1990 to 2010 to understand which factors may have led to success and which policy measures could be enhanced to sustain the appeal of this region to foreign investors at a moment when the overall region still exhibits notable economic dynamism.

Contrary to previous papers on FDI in Latin America, we choose not to include the "lost decade" years, focusing instead on a more recent period of study. This article also contributes to the existing literature by going beyond the macro cross-country exercise, bringing "risk management" issues into the discussion (e.g., the institutional risk perceived by foreign investors, closely related to the political economy of the country) and trying to describe options for policy makers. Political economy-related

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http://dx.doi.org/10.1016/j.ejpoleco.2014.02.001
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determinants are also important because the government's stability implies its ability to remain in office. However, governmental stability seems to be a necessary but not a sufficient condition because attracting FDI requires substantial institutional changes.

The main research questions addressed by this article are (i) to what extent better macroeconomic management has helped certain countries attract more FDI, (ii) what the role of improved and more transparent institutions has been and (iii) to what extent the DR CAFTA agreement may have contributed to the sharp increase in FDI inflows observed in Central America. It is worth mentioning that these hypotheses do not come from a single theoretical framework but rather represent a compilation of the dimensions that can be analyzed with macro-level data. It is also worth acknowledging that, due to data limitations for Latin American countries, we do not use a bilateral FDI flow matrix, and for this reason, a gravity-model approach is not adopted.

The results of the econometric analysis point to the previous stock of FDI, trade openness, low short-term debt levels, balance of payments deficits and governmental stability as the main (robust) determinants of foreign capital flowing to Latin America from 1990 to 2010. Contrary to expectations, the DR CAFTA agreement does not seem to have significantly enhanced FDI inflows to signing countries. There is also some evidence that foreign entrepreneurs show a greater propensity to invest in countries with sound legal frameworks and a low risk of expropriation. This evidence may also help explain why economies that have improved their institutions over the last decade (e.g., Chile, Costa Rica and Peru, which were clearly grouped by cluster analysis techniques) are currently receiving larger FDI flows. In contrast, Argentina, Ecuador and Venezuela have made more frequent changes to the rules of the game, and today, these countries are receiving foreign inflows well below their potential because investors perceive greater risk.

Other institutional variables considered here do not seem to be significant determinants of FDI. However, it is worth noting that under uncertainty (high exchange rate variability, institutional instability), potential investors may delay their entry into certain markets, or foreign subsidiaries already established in economies suffering from uncertainty may wait prior to making disinvestment decisions. These behaviors would lead to non-linearities in the relationship between FDI inflows and their determinants. We discuss the literature addressing hysteresis effects under the effects of uncertainty in more detail in Section 2.1 (see Dixit, 1989; Cross, 1994; Belke and Goecke, 2005; Belke et al., 2005).

The rest of this paper is structured as follows: Section 2 reviews existing literature on the determinants of FDI; Section 3 presents the empirical tests used in this work; Section 4 draws policy implications for policy makers in Latin America; Section 5 presents the conclusions.

2. The determinants of FDI: theory and evidence

There are large strands of literature that try to establish what the determinants of FDI are. In this section, we briefly summarize the main theoretical approaches used in an effort to identify the most influential variables for our analysis: (i) the neoclassical framework, (ii) Dunning's ownership, location and internalization advantage (OLI) framework, (iii) horizontal and vertical FDI models and (iv) risk diversification and institutional views.

2.1. Theoretical approaches to the determinants of FDI

(i) Neoclassical economic theory holds that under perfect factor mobility, capital would flow from relatively rich countries to relatively poor countries. The Law of Diminishing Returns to Capital implies that new investment should take place in countries with relatively low capital-to-labor ratios. Similarly, the H-O model (Ohlin, 1933) argues that a country will export the commodity that intensively uses its relatively abundant production factor.
This approach provides a preliminary intuition of the determinants of FDI, suggesting the importance of returns to capital and differences in factor endowments across economies. However, it is worth mentioning that these models do not perceive market imperfections and assume zero transaction costs. As observed by Lucas (1990), in reality, capital flows follow a “North–North” pattern rather than a “North–South” pattern. Despite increased international flows in recent years, international capital mobility is far from perfect. In reality, the existence of economies of scale, backward and forward linkages, systemic distortions and dissimilar regulations across countries are some of the reasons why neoclassical trade theory fails to predict the patterns of global capital movements.

(ii) From a microeconomic perspective, the OLI framework, initially formulated by Dunning (1973, 1980), examines the motivations of trans-national companies to invest abroad rather than simply exporting their products. Dunning distinguishes between three groups of advantages: *ownership* advantages refer to the existence of firm-specific assets and knowledge-based assets such as patents, differentiated management formulas, marketing organizations and others that provide multi-national companies with advantages over local companies in foreign markets. Second, *locational* advantages such as different factor endowments, benefits from positive externalities or the avoidance of transportation costs or trade barriers can be obtained by investing abroad (see Dunning, 2001). Finally, *internalization* advantages are derived from the theory of the firm in institutional economics (see Coase, 1960; Williamson, 1989); instead of exporting or licensing, a company can save transaction costs and minimize the risk of imitation or suffering reputational losses by locating directly in the target market. According to this framework, knowledge-intense industries are expected to represent a larger share of international companies and foreign-owned capital. A common criticism of the OLI paradigm is that although it helps to explain the distinguishing features of multinational companies, it fails to account for some FDI trends such as the predominant North–North pattern or the observed intra-industry investment (Buch et al, 2001).

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