Foreign Direct Investment Expected to Weaken This Year

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Despite the current global economic downturn, Foreign Direct Investment (FDI) in Latin American and the Caribbean (LAC) for 2008 is expected to surpass the 100 billion mark for the second consecutive year. ECLAC's preliminary estimates suggest that the region will receive around $105 billion in FDI, slightly below the $109 billion record level reached in 2007.

The resilience of FDI inflows into the region is remarkable although the regional totals hide distinct sub-regional realities. FDI inflows to South America are expected to increase around 7 percent, encouraged by high commodity prices that spurred natural-resource-based investment, especially in the mining, oil and gas industries. Strong economic growth in this sub-region also fostered foreign investment aimed at servicing local markets, especially in banking, financial services and telecommunications. Conversely, FDI inflows to Mexico and the Caribbean basin are expected to fall significantly, about 25 percent with respect to the previous year, in the aftermath of the US recession, the main destination market of the export-oriented FDI received by these countries.

The slowdown in the US economy has gradually reached developing economies, affecting efficiency, as well as natural-resource-seeking FDI. The single most important FDI determinant in the region—market-seeking FDI—is expected to decrease sharply in tandem with downward economic growth in LAC, from 4.6 percent in 2008 to a forecasted 1.9 percent in 2009. At the same time, commodity prices have fallen as of the third quarter of 2008, eroding previously strong corporate profits. This has not only affected the incentives to invest, but also the ability of firms to reinvest profits and finance their own expansions without the need of external financing. The financial crisis and the credit crunch are likely to add to the slowdown in FDI inflows as they significantly constrain the ability of firms to finance cross-border mergers and acquisitions, the most important form of FDI.

The factors mentioned above may affect FDI inflows to LAC in 2009 significantly. This scenario
provides, nevertheless, a good opportunity to recall that FDI is not an end but a means to economic growth and entails great potential as an engine of structural change. Thus, what matters for stimulating broad-based economic growth is not the amount of FDI, but rather the quality and its potential to generate spillovers and Hirschman-type linkages to enhance the recipient country’s productive and technological capabilities.

ECLAC has often advocated that FDI needs to be part of a more comprehensive development strategy, combined with targeted public policy initiatives that upgrade local capacity building in the domestic economies in order to better absorb the benefits and technological spillovers, as witnessed in many Asian markets. Even though there is still a gap between Asia and LAC, countries in the region have already taken some steps towards more active and focused FDI policies, especially under narrowing policy space due to more restrictive rules in bilateral and regional trade agreements.

The current international financial crisis will affect the region's real economy through several transmission channels, FDI being one of them, especially in 2009. However, the comprehensive reaction to the crisis should include, inter alia, the building or upgrading of domestic and productive capabilities which will help to reap the benefits of FDI and will simultaneously cushion the downturn effects of the current crisis. This configures a much broader and ingenious way of providing counter-cyclical response to the economy during downturns.

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