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Smallish FDI, sluggish growth

Can MERCOSUR do better?

THE EVIDENCE

Since the 1990s, foreign direct investment (FDI) has been on the rise worldwide. By 2008, the world's FDI flows amounted to about $1.7 trillion (although they are expected to go below $1.2 trillion in 2009 during the economic downturn). Some key characteristics of this investment remain in place: Most of the investment goes to the developed world (almost 70%) with the balance going to developing countries, mainly the fast-growing economies of East Asia. In 2008, South America received less than 8% (or $91 billion) of the world's total, with Brazil ($45 billion), Chile ($16 billion), Colombia ($11 billion) and Argentina ($9 billion).[1] In relative terms, these inflows represented 12% and 15% of Argentina's and Brazil's gross fixed investment, respectively, but over 40% of Chile's. In terms of their respective economies, net FDI inflows represented less than 3% of their GDP.

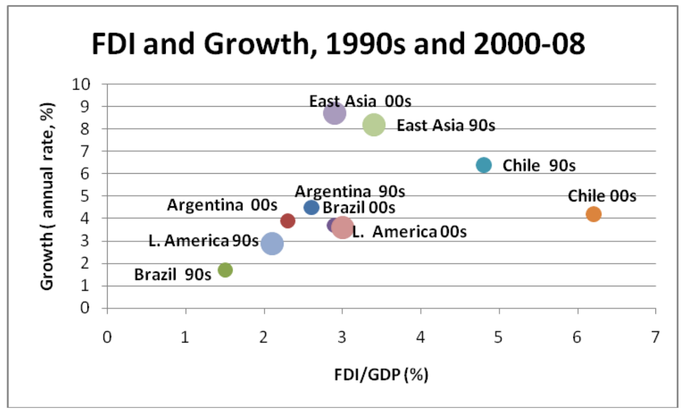
The work by the MERCOSUR network[2] has found evidence that FDI has had no significant overall impact on investment and growth. Other findings suggest that:

- Foreign-owned firms have advantages over local firms: they have higher productivity, are more likely to innovate and are more likely to engage in international trade.
- In some sectors such as retailing, local firms have suffered displacement by foreign firms, instead of benefiting from "horizontal spillovers" (understood as spillovers between firms operating in the same industry).
- However, researchers find evidence of positive "vertical spillovers" within the production chain so that local firms that supply foreign-owned firms have gained in productivity as foreign firms made efforts to increase supplier efficiency. Also, they find that local firms, especially in Brazil, have positive (but small) vertical spillovers as they have turned to export markets.

TOWARD INCLUSIVE GROWTH

Since the 1990s, growth in Argentina and Brazil has followed a path of ups and downs. Brazil's growth has kept a trend mostly below the growth path of all other emerging and developing economies. However, Argentina's growth has experienced substantive oscillations: very high growth rates in the early 1990s and mid-2000s, and negative rates in several instances over the period 1980-2003. Over the entire period 1980 up to now, neither Argentina nor Brazil had an average annual growth rate above 4.5%, a performance below the average of all emerging and developing economies (6.8%). These growth paths in the largest countries of the MERCOSUR have been accompanied by rising social and economic inequality within these economies. FDI has done little to change growth in either country and has contributed to increased inequality, at least in Argentina, as Lopez finds, as foreign firms pay higher salaries to skilled workers compared to domestic firms.

How much of this situation could be improved upon by foreign direct investment?



Source: World Development Indicators (2009)

KEY CHOICES

Active policies to increase FDI yield better results if multinationals are looking for efficiency improvements, rather than natural resources or large domestic markets. Conditions to attract FDI with high positive spillovers include access to skilled human resources, adequate physical infrastructure, and a stable regulatory framework and solid institutions, as also highlighted by the Economic Commission for Latin America and the Caribbean.[3] The MERCOSUR network researchers suggest key policy choices such as:

- Increase the capacity of small businesses to take advantage of spillovers from the presence of foreign-owned firms by building mechanisms for technology transfer with schemes for local suppliers to increase vertical spillovers; or
- Step up negotiations between governments and foreign firms to locate more of their corporate activities in other parts of MERCOSUR, besides Brazil, and to entrust these subsidiaries to develop global products for export or conduct more R&D locally through fiscal and other incentives; or
- Promote the integration of local firms into international value chains with outsourcing, partnerships and other modalities that have become commonplace in the rest of the world but that remain limited in Argentina and Brazil.

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[1] See UNCTAD. 2009. *World Investment Report 2009*, http://www.unctad.org/en/docs/wir2009_en.pdf.
[2] The note draws from the findings summarized in *10 Years of Economic Research in the MERCOSUR Network* (2008) as well as Chudnovsky and Lopez "FDI and development: the MERCOSUR experience", *CEPAL Review*, August 2007, pp. 7-23. IDRC has funded the Mercosur Economic Research Network (MercoNet) since 1999 (Project #105028 and others).
[3] See ECLAC. 2006. *Foreign Investment in Latin America and the Caribbean, 2005*, LC/G.2309-P, Santiago, Chile, UN Publications, No. E.06.II.G44.

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