Chapter 13
Integration and Foreign Investment in Latin America

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ABSTRACT

The processes of economic integration in Latin American economies have logic that goes beyond the simple interest of trade creation. The governments focus on the benefit produced by Foreign Direct Investment (FDI) as one of the most important reasons to formalize trade agreements. FDI differs in the way in which this investment relates with the local producer sector and the strategy trade policy followed by local governments. In this sense Latin American economies may receive horizontal or vertical FDI, and this chapter aims to examine the impact of strategic trade policies on the inflows of FDI into two Latin American regions: North Region and South Region. These investment flows come from three economic zones: Asia, America, and European Union. To this end, the gravity equation to compare the weight of variables such as distance, infrastructure, trade openness, and cultural affinity as independent variables and FDI as the dependent variable is estimated. The results obtained show that the strategy trade policy followed in the North Region in the form of trade liberalization, and the strategy trade policy followed in the South Region in the form of a relative closeness with the custom union plus the proposed trade agreements with other regions encouraged inflows of FDI in both regions during the analyzed period. While the gravity hypothesis holds on the South Region, in the North Region it does not hold. In the North Region, vertical FDI is received, and in the South Region it is horizontal FDI.

INTRODUCTION

Globalization, viewed as an economic rapprochement mainly through strengthening trade relations, is an inevitable and progressive process. This integration process has produced specific mechanisms and instruments to implement this initiative: trade agreements, customs unions, and economic unions are just some of the ways by which this integration takes place. As a result of international cooperation and competition, these instruments and mechanisms are specified according to the particular relationship among members in a particular agreement.

International economic integration is an institutional combination of separate national economies

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into larger economic blocs or communities. There exists a basic concern: Promotion of efficiency in resources use on a regional basis. The forms of economic integration present a progressive order starting from a preferential trading agreement, free trade area, custom union, common market and, finally, economic union. All of them with particular characteristics are supported by international trade theory.

In this sense, international trade seems to be the origin of this globalization process, so from David Ricardo to Paul Krugman there exists some theoretical consensus highlighting the role of international trade in the development of local and world economies. Under certain conditions, international trade will always benefit global economies and the world economy as a whole (Krugman, 1991). In theory, trade is usually beneficial for the countries involved. Trading harms one or more of the trading countries under very specific and particular conditions.

In Latin America, this integration process via international trade agreements is quite relevant and peculiar. The processes of economic integration in this region have logic and implications extending beyond the simple interest of trade creation. The governments place integration policies including trade, investment, infrastructure, and many more issues on the agenda. These integration policies seek to generate the conditions for a coherent and sustainable development supported mainly through implicit and explicit externalities as a result of cooperation and regional competition, and not necessarily through the establishment and / or strengthening of plain trade relations.

In this sense, there are processes of competition and cooperation between the partner countries where trade is not the unique motivation. Investment, regional political positioning, strategic development and employment are some of the main reasons why Latin American countries may engage in the formation of multiple agreements and conventions. Among these externalities this chapter will focus on the benefit produced by Foreign Direct Investment (FDI) as one of the most important reasons to formalize trade agreements. The emergence of FDI as a crucial source of development for many Latin American economies has produced many challenges inside these countries because this investment is not only an opportunity to boost the economy, but it is also the origin of disturbances in the domestic market[1]. The significant increase in FDI since the 1990s in developing countries has been accompanied with a strong tendency to open economies and the natural reduction and elimination of trade barriers. The flow of investment into these developing countries has taken the form of new investments, acquisitions, and cross-border mergers[2].

However, FDI differs in the way in which this investment relates to the local producer sector according to the nature of the FDI and the regional strategies followed by competing countries in the international trade competition arena. There is an evident relationship between the type of investment received and the trade policy strategy followed by Latin American economies. In this sense, Latin American economies may receive horizontal or vertical FDI and the impact of each of them on local welfare is different[3]. Even when there is unequivocal theoretical and empirical evidence that trade openness and the incoming FDI flow is large (Liargovas & Skandalis, 2012), in Latin American economies the integration process includes openness and restrictions to trade; cooperation at country level and competition at bloc level; and, a strategic behavior according to the international political environment. According to UNCTAD (2009), Latin American economies have been vigorous recipients of FDI and a very active region in terms of strategic integration policies.

This chapter divides the impact of strategic trade policies on the inflows of FDI into two regions including the North Region (Mexico, Guatemala, El Salvador, and Costa Rica), and the South Region (Brazil, Argentina, Uruguay, and Paraguay which are better known as the Southern Common Market or MERCOSUR). These invest-

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