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Does China have an impact on foreign direct investment to Latin America? ☆

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Abstract

We analyze empirically whether the emergence of China as a large recipient of FDI has affected the amount of FDI received by Latin American countries. Allowing for the structural break related to China's WTO accession, we found a significant negative impact of Chinese inward FDI on that of Mexico until 2001 and on that of Colombia after that date. The rest of Latin American countries do not seem to be affected by Chinese inward FDI. For the region as a whole, there is no significant Chinese effect on Latin America's FDI.

JEL classification: F21; F3
Keywords: China; Latin America; FDI

1. Introduction

The rapid emergence of China as an important player in the global economy is a remarkable issue with consequences for the rest of the world. An important aspect is foreign direct investment (FDI) since China has been attracting a growing share of FDI flows since 1990s. After receiving an average of $28 billion in the 1990s, China's annual FDI inflows have increased to $47 billion

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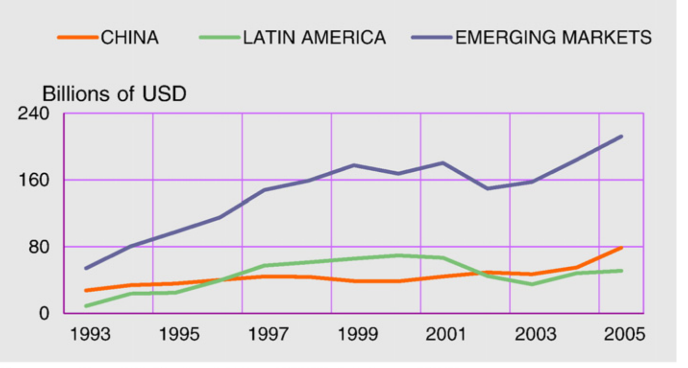

Sources: People's Bank of China, WEO database (IMF)

Fig. 1. Net FDI flows into emerging countries, Latin America and China.

on average since World Trade Organization (WTO) membership in 2001[1] (Fig. 1) and have continued to grow even faster, reaching $79 billion in 2005. In a relatively short period of time, China has accumulated the third largest stock of inward FDI after the US and the UK. Foreign firms are attracted by China's rapid economic growth, increasing demand for consumer goods, a relatively skilled and educated workforce for the wages paid, improved infrastructure and a more predictable business environment. Since the early 1980s, China has drawn significant investment from regional conglomerates in Hong Kong, Taiwan and Singapore, but also from the largest industrial economies, particularly Japan and the US.

In the same way as many countries fear China as a competitor in the export markets, there is a growing concern, especially in developing countries, that FDI may be diverted into China. FDI is very important for Latin America since it has been the major source of external financing in the last few years and has also helped modernize the region's economic structure. Nonetheless, FDI flows to Latin America started to fall in 2000 while FDI to China was accelerating (Fig. 1). Given its relevance for the future of the region, deepening our knowledge of the determinants of inward FDI seems clearly warranted. This is what this study does, focusing on the impact of China as an always more important recipient of FDI.

Whether external financing is diverted from Latin American countries into China will depend on a number of factors. A first one is the degree of integration of capital markets. If capital markets are not fully integrated across countries – or, more likely, regions – an increase in Chinese inward FDI will not necessarily imply a reduction in FDI to another country or region. The large regional FDI flows in Asia may fit into this description. In fact, Hong Kong, Taiwan and Singapore have been the main suppliers of FDI to China while practically irrelevant for other parts of the world, including Latin America.

A second aspect is the impact of Chinese inward FDI on worldwide FDI flows. If foreign direct investors reap large benefits from their presence in this country, or there are spillovers in other countries, more savings may be converted into FDI also in other areas of the world. This would imply that the supply of FDI flows is elastic to changing conditions. In the same vein, China's contribution to raising the rate of return of FDI could twist investors' preference towards FDI instead of other private capital flows (mainly portfolio or cross-border lending), particularly if their returns were hardly correlated with those of FDI.

[1] These figures are drawn from IMF International Financial Statistics.