Box 1
FOREIGN DIRECT INVESTMENT IN COLOMBIA: DEVELOPMENTS AND PROSPECTS

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Foreign direct investment (FDI) becomes a major source of long-term financing in economies with technological and capital constraints. Countries with limited savings capacity or underdeveloped financial markets do not have enough resources to expand their production frontier (Chenery and Srinivasan, 1989). In this sense, FDI channels foreign savings into the productive projects the country needs to develop its economy (FEDESARROLLO, 2007). This has potentially positive effects on economic growth, employment, gross capital formation and tax revenue, among other aspects. FDI also can lead to improvements in the production process through technology transfer (Haddad and Harrison, 1993), since multinational companies use skills, knowledge and procedures aimed at optimizing production, which can be transmitted to domestic companies.

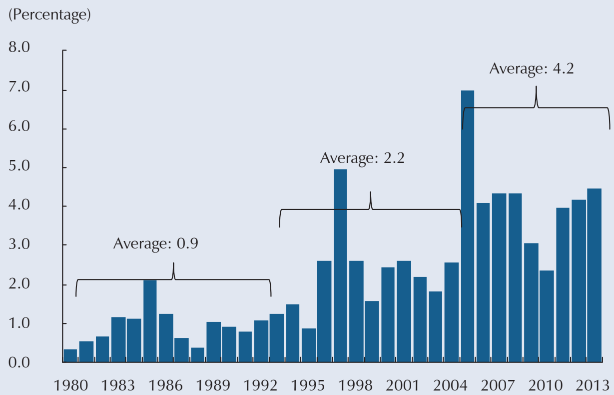
Considering how important this capital is to the Colombian economy, the developments in FDI as of the 1980s and the outlook for investments of this type are outlined in the following section.

1. Developments in Foreign Direct Investment in Colombia (1980-2013)

The regulatory framework for FDI was highly restrictive up until the late eighties, limiting the entry of this type of capital into the country. The legislation of the time banned foreign ownership in certain sectors of the economy and placed restrictions on remittance of earnings and access to domestic borrowing (Urrutia, 1996). This was reflected in relatively low levels of FDI: less than 1% of gross domestic product (GDP) in the 1980-1992 period (Graph B1.1, panels A and B).[1] It was concentrated on the extraction of natural resources and, to a lesser extent, on existing manufacturing industries (Graph B1.2).

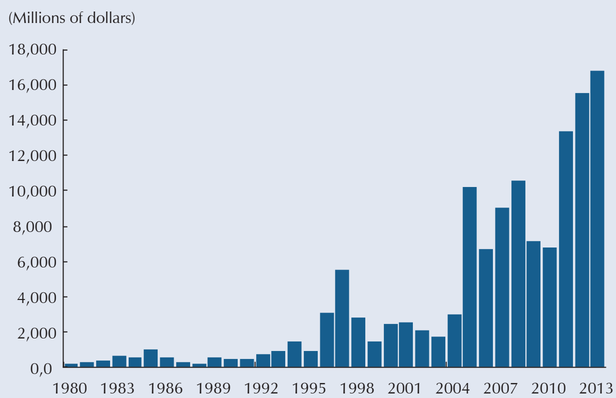
Graph B1.1

A. Foreign Direct Investment in Colombia (Percentage of GDP)



Sources: Banco de la República (Investment records, 1980-1993; Balance of payments, 1994-2013)

B. Foreign Direct Investment in Colombia



Sources: Banco de la República (Investment records, 1980-1993; Balance of payments, 1994-2013).

PBy the early nineties, a number of restrictions on FDI had been eliminated due to external financing needs in the context of a more open economy, relatively low terms of trade and restricted access to international borrowing. Significant changes to the international investment regime were made in this sense so as to allow equal treatment for nationals and foreigners, to give foreigners access to almost all economic activities, and to remove certain restrictions on the movement of capital. Sometime later, Proexport was created as the agency to promote FDI, and bilateral agreements were signed (Garavito et al., 2013). These positive changes in the

1 An estimate was done for the 1980-1992 period, based on the currency investment records of Banco de la República.

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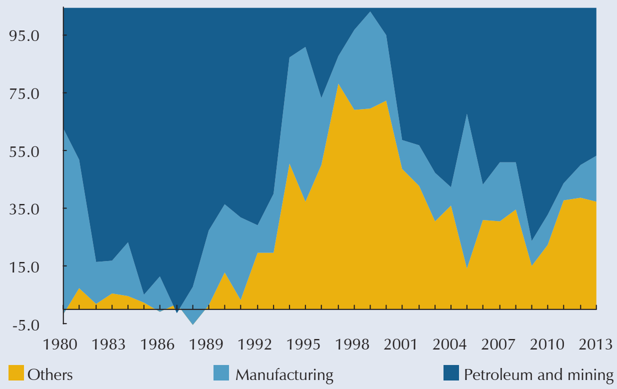
Graph B1.2
Distribution of Foreign Direct Investment in Colombia, by Sectors

(Percentage)



Source: Banco de la República

investment regime with respect to FDI were observed worldwide as a strategy for countries to attract this type of capital (UNCTAD, 2000).

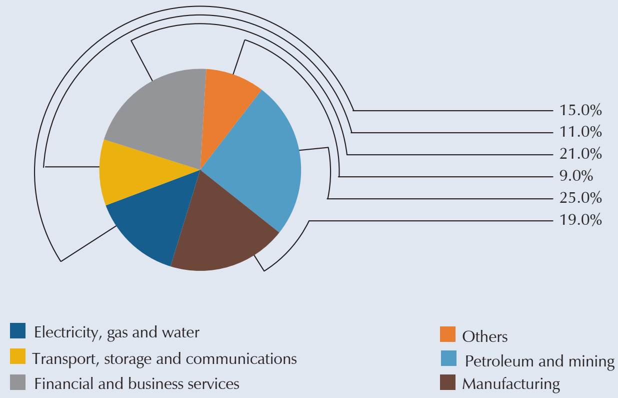
The more favorable environment for FDI, coupled with other structural changes in the economy (labor market flexibility, economic liberalization and the privatization policy) and a growing, captive domestic demand, was reflected in an increase in this type of capital and its sector diversification. In fact, during 1993-2004, FDI accounted for 2.3% of GDP on average, with some significant reductions, especially in the years close to the economic crisis in the late nineties (Graph B1.1, panels A and B).

These resources were channeled towards different productive activities (Graphs R1.2 and R1.3), mainly those focused on the domestic market (public utilities, financial services and telecommunications) and, to a lesser extent, the industrial sector (some of these firms used the country as an export platform for the region) and the exploitation of natural resources (coal and oil). The added share of FDI in the delivery of services followed international trends, in which this sector gained participation. The recent influx of FDI into this business is due partly to the fact that services are delivered locally, so investments must shift geographically.

Although FDI increased during those years as compared to the eighties, FDI flows could have been affected by various factors, including low international prices for oil and some minerals, the macroeconomic instability generated during the economic crisis in the late nineties, the deterioration in domestic security, the lack of infrastructure and the lag in education, among others (Garavito et al., 2013).

In the years thereafter (2004-2013), FDI gained force in Colombia as a result of stability in the regulatory environment, growth in the domestic market and increased profitability in the extraction of natural resources. In fact, during this period,

Graph B1.3
Distribution of FDI Flows, by Sector
(1993-2004 Cumulative)

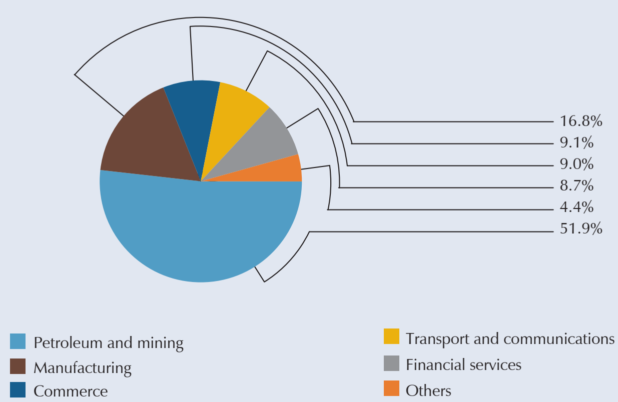


Source: Banco de la República.

FDI was above 4% of GDP and was concentrated mainly in the mining and petroleum sector, followed by manufacturing (Graph B1.4). The increase of FDI in mining and oil was associated with higher international prices for raw materials, tax benefits, better safety conditions, and, in the case of oil, a more favorable tax treatment for investors (Lopez et al., 2012).

As for the other sectors of the economy, one sees the consolidation of companies with FDI in Colombia, mainly to serve the domestic market and, to a lesser extent, the foreign market. Manufacturing firms are the most predominant in this segment, followed by transport and communications (Graph B1.4). For companies of this type, reinvestment of earnings has been an important financing tool. In fact, these resources have come to represent about 30% of their income from FDI (Graph B1.5). This has allowed for a number of things, such as financing companies during the financial crisis in 2008 amid a context of declining international liquidity.

Graph B1.4
Distribution of FDI Flows, by Sector
(2004-2013 Cumulative)



Source: Banco de la República.

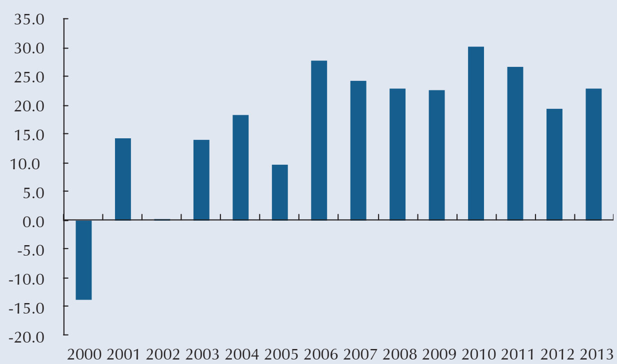
Although the country has been successful in attracting FDI to exploit natural resources and for activities focused chiefly on the domestic market, there is room for improvement in the influx of investment to create companies that export goods and services with more technological content, so as to enhance the positive impact of FDI on the rest of the economy and to increase the amount of such capital as a source of long-term outside funding. In this sense, several studies (Kalin, 2009 and FEDESARROLLO 2007) indicate the country must improve its transportation infrastructure, ensure the quality of higher education, increase spending on science and technology, improve the links between firms with FDI and domestic enterprises, and further simplify the tax system and the regulations to operate in Colombia.

2. The Outlook for FDI

As noted, the significant increase in FDI in recent years, particularly for sectors other than petroleum, is associated not only with the arrival of new capital into the country, but also with decisions to reinvest the earnings from foreign capital in Colombia. This trend is related to external factors that stimulated those decisions in a context of low interest rates in the advanced countries and the relative reduction in risk in emerging economies, especially with regard to the Latin American countries. Accordingly, it is important to point out that prospects for recovery in the advanced economies, mainly the US economy, can involve changes in the availability of FDI resources.

Graph B1.5
Reinvestment of Profits in Sectors Other than Mining and Petroleum

(Percentage of total income from FDI)



Source: Balance of payments, Banco de la República.

First, one would expect a less uncertain outlook and a recovery in the major advanced economies to imply an increase in the relative perception of risk in emerging markets, thereby reducing inflows of foreign capital into those economies. Furthermore, the best prospects for the developed countries would be accompanied, in the coming years, by a return to normal in their monetary policy stance, which would have implications for global liquidity and for expectations regarding investment returns. These factors also could affect the arrival of investment flows into the country.

Even so, a number of analysts agree that changes in the international environment could have different effects within the group of emerging economies, considering their exposure to international financial flows varies, as does the magnitude of their macroeconomic imbalances. In this sense, Colombia appears to be in a relatively favorable position to deal with the anticipated changes. This situation is confirmed not only by the moderate response witnessed in the country's indicators, but also by JP Morgan's recent announcement that it intends to increase the share of Colombian government debt in several of its investment portfolio indexes. These factors could be playing an important role in maintaining investor interest in the country.

One aspect that must be considered to ascertain the outlook for FDI is the existence or not of large investment projects. The country recently structured a number of projects that will be linked necessarily to the arrival of foreign capital. On the one hand, it is hoped the entire process to structure and develop the works in the government's plan for fourth-generation infrastructure will attract foreign investors to supplement domestic financing capacity and the technology necessary to carry out these projects.

Moreover, the start-up of 4G telecommunications technology will be associated with increased capitalization by companies in the sector, most of which are backed by foreign capital. These resources would be focused on developing the infrastructure required to deliver the new services. However, this does not mean investments in the oil sector would be neglected. In fact, it is estimated they will continue to represent an important source of foreign resources for the country, insofar as expectations for exploration and the development of new production areas are maintained. Added to this, the definition of parameters for unconventional hydrocarbon exploration will bring incentives.

Also important are the anticipated effects on FDI resulting from the free trade agreements (FTAs) that were signed recently by the country or are being processed and will take effect shortly. In this sense, an increase in FDI has been identified in the literature[2] on this subject as one of the most immediate outcomes of the implementation of FTAs between countries, given factors such as the possibility of accessing larger markets, leveraging advantages in terms of cost and productivity, and using economies of scale.

2 For example, these effects have been recognized widely by the WTO (1997) and in several empirical studies, such as those by Bae and Joon Jang (2013) and Worth (1998).

The experience of several countries in the region, such as Mexico, Chile and Peru, corroborates this notion. In the first case, the North American FTA (NAFTA, for its acronym in English) had a positive impact on FDI, which rose 15% annually, on average, during the first eight years of the treaty, with an increase of 150% in the first year alone. In Chile, the increase in these resources averaged 13% annually during the early years of its bilateral agreement with the United States, which meant two additional points of FDI as a percentage of GDP. In the case of Peru, one such treaty has gone hand in hand with more resources for investment, which rose 19% annually, on average, in the past two years.

All this supports the prediction that FDI flows to Colombia will remain at high levels, similar to those on record in recent years, despite the fact that changes in the international environment, namely, better investment conditions in the advanced countries, less global liquidity and reduced prospects for growth in the emerging economies, could slow foreign investment flows to the developing countries. In Colombia, circumstances as such as a better risk perception compared to other emerging markets, the infrastructure and telecommunications projects that have been announced, the momentum in the oil sector, and the signing of free trade agreements could more than outweigh the aforementioned effect.

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