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Bernhard Fischer*

Latin America's Competitive Edge in Europe

The Hamburg Institute for Economic Research, the Institut für Iberoamerikakunde, Hamburg, and the Institute for European-Latin American Relations, Madrid, on the occasion of the 1993 Annual Assembly of the IDB/IIC Board of Governors in Hamburg, organized a seminar on "Latin America's Competitive Position on the Enlarged European Market". It was held under the auspices of the European Communities, Brussels, and the Inter-American Development Bank, Washington, D.C. The following article summarizes the discussion.

The seminar brought together experts from Latin America, South-East Asia, Central and Eastern Europe and industrial countries to discuss:

- the development of the Single European Market (SEM) and its impact on Latin America's export potential;
- the region's specific conditions of supply and market access in view of new sources of competition both within the EC and from non-EC countries or regional groups; and
- the implications of Latin America's changing supply conditions for future trade and investment flows between Europe and Latin America.

The discussions were based on a background paper prepared by Caroline Beetz and Willy Van Ryckeghem (Inter-American Development Bank) on "Trade and Investment Flows Between Europe and Latin America and the Caribbean". Their statistical analysis can be summarized by the following stylized facts:

Foreign direct investment (FDI) into Latin America and the Caribbean increased from a total of \$13 billion for the period 1983-86 to \$26 billion for the period 1987-90. Europe's participation in this total rose from \$3.5 billion for the first period to \$6.3 billion in the second. Four countries in the region – Argentina, Brazil, Chile and Mexico – accounted for almost 90 per cent of the total inflows from Europe in 1990.

European FDI is concentrated in the following sectors: automotives, chemicals, minerals, petrochemicals, electronics, aircraft and food products. Investment growth

has been most pronounced in Chile and Mexico in recent years but Brazil continues to attract the highest level of inflows from Europe. Argentina has also been an important recipient of European FDI – particularly in 1991 according to preliminary estimates.

The total value of merchandise imports into Latin America and the Caribbean rose from \$78 billion in 1987 to \$135 billion in 1991, with Europe representing 18 per cent of the latter total. Imports from Europe during this period grew at an average annual rate of 10 per cent, with an increase of 22 per cent in 1991 alone. The majority of these imports from Europe are intermediate inputs and capital goods used by both domestic producers and transnational corporations.

The Latin American and Caribbean countries exported a total of \$137 billion of merchandise in 1991 compared with \$90 billion in 1987. Exports to Europe grew at an average annual rate of 11 per cent during this period. Exports from Argentina, Brazil, Chile and Mexico represent 70 per cent of the region's total exports to Europe. Despite significant growth in manufactured exports from the region, primary commodities remain a primary source of export earnings.

Some of the results and major policy issues which emerged from the seminar are described below.

New Opportunities or New Threats?

Miguel Izam (Economic Commission for Latin America and the Caribbean) opened the seminar with a paper on "The Effects of the Single European Market on Latin America's Trade". Based on his observation of a "structural weakening" of the trade relations between Latin America and the EC he pointed out the highly

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differentiated potential effects of the Single European Market in the various countries that form Latin America. Izam's more general conclusion was that the repercussions of the SEM on Latin America's trade will, at least in the short and medium term, be negative. Among the worrisome threats of establishing homogeneous Community measures which would replace national restrictions were "grey-area measures" such as quotas, the acceptance of "basic import prices" and voluntary export constraints as well as new common provisions including standards for production, labelling and packaging, procedures for certification of quality and brand names, safety and consumer protection standards, and regulations concerning environmental protection and plant and animal health inspection. As a consequence, Latin America would have to respond to these challenges by diversifying its export structure, supported by more aggressive commercial policies, and by making the necessary investments to develop better competitiveness and better quality through the application of socially and environmentally sustainable models.

Ricardo M. Dominguez (Massachusetts Institute of Technology) in his comment told a so far successful story of an up-market niche organized by Latin American meat exporters to the EC. This niche was built upon the institutional constraints imposed by EC protectionism and by the strongly regulated international market. Taking into account the directives of the Single European Market, the changes in the Common Agricultural Policy and the negotiations in the Uruguay Round, Dominguez demonstrated how the transformation of new institutional constraints (upgrading of non-quantitative trade restrictions, relative freezing of import licences and reallocation of interlocutors and partners on the demand side) will threaten the existence of the niche. The only consolation for Latin American exporters would be that none of their competitors are fully capable of succeeding in the new labyrinth of regulations for meat products of the Single Market.

Armando Ortega (Permanent Mexican Representation to GATT), the second discussant, stressed that the prompt conclusion of the Uruguay Round must become a high priority, as a sign of determination to manage the world economy cooperatively and as a declaration of intent to continue more than 40 years of successful multilateral trade policy. He argued that the development of new European technical specifications and standards as well as the mutual recognition of testing and certification were likely to positively effect market access for third world countries in many product areas. Ortega in particular welcomed the EC's recent initiative for upholding the values of a multilateral trading system and

taking action, individually or collectively, for the protection of the environment thereby resisting protectionist voices hidden behind many environmental claims.

Pierre Buigues (Commission of the European Communities) presented a paper on "Recent Developments and Trends of European Integration", written jointly with J. Sheehy. He provided an overview of what has been achieved in removing physical, technical and fiscal barriers to trade as well as in eliminating controls affecting the free movement of people within the Community. Given the ambitiousness of the Internal Market programme progress was judged as having been substantial so far.

The forty industrial sectors where non-tariff barriers significantly impeded intra-Community trade represented 50% of the Community's value-added in industry and 40-55% of Community employment. These sectors included high-tech public procurement markets (such as computer, medical equipment and telecommunications industries), traditional public procurement sectors (e.g. pharmaceuticals industries), regulated markets (including shipbuilding and electrical engineering) and sectors with across-the-board moderate non-tariff barriers (basic consumer goods sectors). One of the structural consequences of completing the Single Market was effectively to facilitate trade in these sensitive sectors. A large majority of the 33 sectors experiencing large increases in their ratios of intra-EC exports to total exports was in this group.

The Community has been pursuing its own integration at the expense of greater integration with the world only to the extent that intra-EC barriers to trade have been progressively removed whilst barriers outside the EC to EC exports have remained relatively unchanged. On the other hand, Buigues argued that extra-EC countries have also benefited from the Internal Market programme as imports of those sectors traditionally most protected in the EC by non-tariff barriers have grown as fast from extra-EC countries as have intra-EC imports.

Martin Wolf (Financial Times) emphasized that due to the pervasive and complex nature of the EC it would be impossible to assess the impact of European integration in terms of the effects of changes in classic trade policy instruments on trade creation and trade diversion. Among the characteristics of the EC which help to explain how the Community behaves Wolf mentioned the following:

- internal negotiations tend to include long delays, log-rolling amongst interest groups, policy-making on the basis of the lowest common denominator and inflexibility towards the outside world;

- ☐ directionary administrative mechanisms are a central feature of the EC;
- ☐ as almost any industry is sensitive in at least one country the inevitable result of the log-rolling is that sensitivities are reflected in EC policy;
- ☐ trade policy is the central element in EC foreign relations, in particular with the USA and
- ☐ discrimination is a prime instrument for achieving integration and a convenient way of achieving foreign policy objectives.

Referring to Europe's present huge political, social and economic problems Wolf concluded that the more troubled the EC is the less able it will be to offer an interested ear to the problems of the rest of the world and that there is a permanent threat of inward-looking "*little Europeanism*".

New Sources of Competition

Magnus Blomström (Stockholm School of Economics and National Bureau of Economic Research) in his paper "New Sources of Competition within the European Economic Area" referred to the expansion of the SEM into the European Economic Area by an agreement between the EC and the EFTA countries (Austria, Finland, Iceland, Norway and Sweden). According to his analysis the effects of giving the "four freedoms" to the EFTA countries would most likely be minor, since EFTA has had a free trade agreement with the EC for a long time. Adding factor mobility in a free trade situation would not change very much. Blomström also discussed the potential effects on the future competitiveness of Europe. He stressed that Europe is currently far behind the United States and Japan with respect to high-tech production and highly dependent on (high-tech) imports from the USA and Japan, incorporated in trade in goods. But the USA and Japan are also dependent on Europe, but more as a destination for goods. Blomström therefore suggested that the Uruguay Round would have to come through with positive effects on all countries, including those in Latin America.

Hans-Eckart Scharrer (HWWA) in his comment discussed new sources of competition in Europe arising from institutional, locational, organisational, process and product innovations. He also pointed to the dangers that

- ☐ supply-side policy seems to be on the retreat in Europe;
- ☐ industrial policy is making a comeback, introducing (or reinforcing) the element of direct state intervention in competitive relationships among firms and
- ☐ there could in the face of rising factor costs, overcapacities and market changes be some temptation to

use exchange-rate policy deliberately as an instrument to obtain competitive advantages over partner countries ("beggar-thy-neighbour policy").

Latin America vis-à-vis Other Competitors

Sree Kumar (Institute of Southeast Asian Studies) in his paper "Southeast Asian Export Strategies: The Lessons of Experience" stressed that export thrust is not solely a matter of trade policies and that export strategies have to be seen in the overall context of economic development rather than as a piecemeal exercise in itself. Among the instruments used by the main Southeast Asian export oriented economies for export promotion have been:

- ☐ mechanisms for providing exporters with access to imports at international prices,
- ☐ fiscal incentives such as tax rebates on profits earned by exports,
- ☐ measures to support short-term export finance,
- ☐ realistic exchange rates and free foreign exchange markets,
- ☐ the setting up of export processing zones and bonded warehouses,
- ☐ human resource development (in particular technical and vocational training), and
- ☐ the establishment of an institutional framework for information gathering, dissemination and marketing.

Kumar also provided evidence on strategies for market access and retention by pointing to more intensive dialogues with trading partners, active upgrading of production capabilities, improved quality control, joint ventures with European Multinational Corporations, increased market presence and diversification of markets and production.

In the first comment on Kumar's paper, Carlos Moneta (Sistema Económico Latinoamericano) noted that throughout the last three decades Latin America has been experiencing increasing marginalisation in world trade. During the 1980s and up to the present Latin America has been losing terrain in the Community markets whereas the newly industrialized Asian countries (South Korea, Hong Kong, Taiwan and Singapore) have increased their participation. Only Brazil, Mexico and Chile from the Latin American countries were able to maintain or improve their positions. Moneta provided as an explanation for this that Latin America's exports belong to less dynamic export products while the opposite is true for

exports from Southeast Asia. He therefore recommended the further exploitation of local comparative advantages by incorporating technical progress and by transferring resources to activities with greater dynamics. A factor that will contribute significantly in the future to an increased competitiveness of ASEAN vis-à-vis Latin America would be the rapid and in-depth process of intra-industrial integration taking place between Japan, the newly industrialized Asian countries and ASEAN.

Colin Bradford (OECD Development Centre), the second discussant, emphasized that environmental sustainability is crucial for long-run social and economic balance and that macroeconomic policies affecting prices and incentives can play a significant role in maximizing long-run returns. In particular technology and innovation would have important roles to play in the efficiency of resource use and the preservation of non-renewable resources. The democratic process in Latin America should be used as a means of reorienting society toward new opportunities and requirements and mobilizing national energies to generate greater economic dynamism.

In his paper "Latin America's Competitive Position vis-à-vis Central and Eastern Europe", András Inotai (Institute for World Economics, Budapest) stated that central and eastern European countries are in a better competitive position in the European market than most of the Latin American economies because

- their comparative advantages can mostly be identified in Western European market segments with higher than average growth prospects;
- the geographic proximity, accompanied by substantial EC interest in the stability of at least central Europe, adds to the cost advantages through lower transportation costs for bulky consumer goods and by facilitating daily personal contacts and just-in-time production and
- better market access is ensured by the association agreement and the prospects for full membership expand locational decisions of domestic and foreign investors.

The better starting position of central and eastern Europe would, however, not imply that Latin American economies would have no chance of entering the EC market:

- chemicals, material-intensive semi-finished goods and increasingly sophisticated machinery would have good selling prospects;
- the dismantling of still prevailing national quotas within the Community will enhance export possibilities also for Latin American economies and

- the success of GATT is expected to create a generally better environment for trade expansion.

Inotai concluded by stressing that even the most favourable trade policy and external environment would be unable to offer an adequate substitute for domestic reforms.

In his comment Rolf Langhammer (Kiel Institute of World Economics) referred to the central European economies (CEE) as an emerging region which will compete for access to EC markets in industries where domestic demand is far from buoyant. There would be no doubt that the three forerunners—Poland, Hungary and the Czech Republic—in particular enjoy a higher ranking in EC trade policy hierarchy than Latin America. But Langhammer also pointed to the evidence that preferential access conditions remain ineffective as long as supply conditions penalize exports. If foreign direct investment could be attracted some CEE could use their human capital potential and avoid direct competition in the labour and resource intensive products exported by Latin American countries. Such an "investment diversion" would be a blessing rather than a curse for Latin America since it would mean that the EC would not be exposed to negative cross-border externalities such as east-west migration which would be likely to give strong political priority to sustaining the CEE transformation process by discriminating more against Latin America in access-restricted sectors.

Latin America's Economic Reforms

In his paper "Latin American Policy Reforms and their Effect Upon International Competitiveness" Patricio Meller (Corporación de Investigaciones Económicas para Latinoamérica) reviewed the results observed in the trade reforms, exchange rate policies, and the macro-stabilization programme and related them to export performance as an indicator of international competitiveness. One important conclusion from his analysis was that in Latin America in the 1980s macroeconomic stability was a key factor related to GDP and export growth. On the micro-level he observed that those Latin American countries with a relatively lower tariff protection structure showed higher manufacturing export growth rates while the relationship between exchange rate depreciation and expansion of exports was less conclusive. Meller doubted that regional integration automatically generates an export boom as long as supply conditions are insufficient. Better economic relationships among Latin American countries would require, above all, investment in infrastructure on international borders, deregulation of transportation by land, sea and air, as well as the elimination of administrative red tape.

Miguel A. Rodriguez (World Bank) in his comment stressed the need to study the situation in individual countries. For example, while Chile's reform efforts have resulted in thoroughly positive results the management of economic reforms in Brazil is still blocked by the difficult political situation. He was in particular concerned about the collapse of private savings in most Latin American countries and the hidden fiscal deficits in form of poor infrastructure. A key for further progress would be the liberalisation of capital markets and exchange rates.

Rosemary Thorp (Latin America Centre, St. Antony's College) in her comment argued that the supply side in Latin America would not only need the removal of counter-productive obstacles and the delivery of the stimulus of world prices but also a proactive policy in fields such as skills, technology, access to information, re-training and contract research as well as credit and infrastructure. Investment in the real and social sectors would be as crucial as capacity-building and institutional development to facilitate productivity growth in Latin America in the long term. Thorp also stressed the need to encounter a coherent political economy behind the reforms to ensure their sustainability.

Revival of Capital Flows

Fred Z. Jaspersen (Inter-American Development Bank) presented a paper, jointly written with Juan Carlos Ginarte, on "Capital Flows to Latin America 1982-92: Trends and Prospects". He emphasized that, based on a far-reaching shift in economic policy and a significant improvement in economic performance, several countries in Latin America have recently experienced a massive increase in capital inflows. By the end of 1992 net capital inflows into the region reached almost \$ 100 billion over the previous 30 months. The revival of capital inflows has been driven by a sharp increase in non-debt creating inflows – foreign direct and portfolio investment – and by renewed access to the international capital markets by enterprises in the larger countries. This has resulted, for the first time in a decade, in a shift from negative to positive net transfers to Latin America, allowing domestic savings to be converted fully into investment, reinforcing competitiveness in domestic markets by increased openness and contributing to rather than detracting from macro-economic stability.

While emphasizing that the dramatic change in capital flows has increased opportunities for accelerated growth and development, at least in the few countries which have been successful in accessing international capital

markets, Jaspersen also pointed to the challenges which these countries of the region face:

- ☐ additional savings may not contribute fully to growth and may simply finance a higher level of consumption;
- ☐ capital flows may be transitory and may increase the exposure of market borrower countries to external shocks stemming from macroeconomic imbalances in the industrial countries;
- ☐ such inflows can complicate the management of short-term macroeconomic policy and can make it more difficult to achieve long-term development objectives.

Carlo Secchi (Istituto di Studi Latino-Americani) complemented Jaspersen's paper with some further observations on the nature and sustainability of the present capital flows and on their interaction with the overall process of structural reform. He emphasized that the real challenge faced by Latin America is the turning of financial capital into productive investment. Otherwise the current inflows may end up by financing a speculative bubble or a consumption boom. Secchi further argued that a number of factors point towards a worsening of the current account including the limited capacity of domestic industries to compete against imports, the worsening of the terms of trade, the recession in the world markets, the uncertain destiny of the Uruguay Round and the appreciation of the US dollar.

Helmut Reisen (OECD Development Centre) in his comment was concerned with the question whether the heavy capital inflows in some Latin American countries over the past three years might endanger their future competitiveness. Low inflation as well as reliable and competitive levels of real exchange rates will be essential for long-run growth and would need stabilized intervention in order to keep monetary aggregates on target, inflationary expectations down and foreign exchange risk in check. Reisen considered the current rate of capital inflow temporary, rather than permanent, and put forward the following reasons:

- ☐ a large part of inflows have been in response to privatization in countries such as Chile and Mexico which is now by and large completed;
- ☐ part of the increased capital inflows consisted of previous flight capital which can only be repatriated once;
- ☐ the sharp drop in US short-term interest rates has been an important stimulus to relocate assets from North to South America and
- ☐ some countries – notably Mexico, Argentina and Peru – are heavily dependent on short-term capital inflows vulnerable to quick reversal in the event of change in investment sentiment.