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## Latin America and EU widening to the East: possible effects on trade and investments

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# Kiel Working Papers

**Kiel Working Paper No. 828**

Latin America and EU Widening to the East

- Possible Effects on Trade and Investments -

by

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## **Abstract**

Pending EU widening to the East has revived concerns in Latin America that Europe may become more inward-looking. However, booming trade and foreign direct investment (FDI) relations between current EU members and Central and Eastern European countries (CEECs) are unlikely to harm Latin America. Trade patterns suggest that Latin America's exports to the EU are complementary to the exports of CEECs. Moreover, the recent surge of FDI flows to various host countries, including several Latin American economies, indicates that new investment opportunities in CEECs induce additional FDI, rather than causing diversion of FDI. This picture is unlikely to change significantly once some CEECs become members of the EU. The paper concludes that future economic relations between Latin America and the EU depend primarily on sustained economic policy reforms in Latin America and the EU's role in multilateral trade negotiations, rather than on EU widening per se.

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## I. INTRODUCTION

The widening of the EU to the East may involve a dilemma for Latin America. On the one hand, Latin America should be interested in a successful EU integration of Central and Eastern European countries (CEECs),<sup>1</sup> Latin American exporters could find new buoyant markets in CEECs, if economic transition and EU integration proceed smoothly. By contrast, if EU widening to the East were to fail, this would most likely result in economic and political destabilisation of CEECs. The adverse repercussions of such a failure may well spread beyond Western Europe. Non-EU members may become the victims of economic and political tension between the EU and CEECs. This is because the EU would be a less reliable partner with regard to its trade and investment relations to all non-members, including Latin America.

On the other hand, the pending widening of the EU has revived concerns that Europe may become more inward-looking. In many Latin American countries, the perception of being discriminated vis-à-vis domestic EU suppliers and privileged trading partners of the EU is deeply rooted. Adverse effects of discrimination are indeed to be expected if the prospective EU members among CEECs are direct competitors of Latin America in exporting to, and attracting foreign direct investment (FDI) from the EU.

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<sup>1</sup> For a similar line of reasoning, see Langhammer and Nunnenkamp (1993).

Concerns about trade and FDI diversion resulting from EU widening to the East are justified in principle. For various reasons, however, Latin America is rather unlikely to be affected by significant diversion effects. This proposition will be substantiated in the following, first by analysing recent trade patterns (Section II), and second by discussing the issue of competition for FDI from the EU (Section III). The evaluation takes into account that recent trends may change once some CEECs become full EU members. The conclusion is that economic relations between Latin America and the EU are most likely to prosper if EU integration proceeds smoothly *and* Latin America sustains economic policy reforms.

## **II. THE PATTERN OF EU IMPORTS: WHY TRADE PREFERENCES ARE NO SUFFICIENT EXPLANATION**

### **1. Booming East-West Trade: A Case of Trade Diversion?**

CEECs have benefited from an unprecedented shift in the EU's trade policy stance. In the socialist era, CEECs were seriously constrained in terms of market access to the EU. They faced high tariffs, quantitative restrictions and a wide range of contingent protection measures. At that time, CEECs ranked at the bottom of the pyramid of trade preferences granted by the EU to various groups of countries (Hiemenz et al. 1994: 18ff). The liberalisation of East-West trade began in 1988 (when the EU concluded a trade and cooperation agreement with

Hungary), but the major change came in 1991: The "Europe Agreements" promoted the former CSFR, Hungary and Poland to the top of the pyramid of trade preferences.

The shift from discriminatory to preferential treatment has certainly supported the boom of EU imports from CEECs. EU imports from a group of seven CEECs<sup>2</sup> increased fivefold from 1986 to 1995 (OECD, var. iss.). Though starting from a higher level, EU imports from Latin America just doubled during the same period. In 1995, imports from the seven CEECs exceeded imports from all Latin American economies. It is not unreasonable to assume that the trend of considerably faster growth of EU imports from CEECs will continue, considering that some of them will join the EU soon.

Yet, it is open to question whether booming EU imports from CEECs were (and will be) at the expense of other trading partners in general, and Latin America in particular. Likewise, it is debatable to which extent booming imports were due to preferential access of CEECs to EU markets. Historical trade patterns of the inter-war period as well as the simulation of "normal" trade patterns<sup>3</sup> suggest that CEECs would direct the largest share of their exports to Western Europe. It is for two reasons that exports of CEECs to the EU fell short

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<sup>2</sup> Albania, Bulgaria, Czech Republic, Hungary, Poland, Romania, and Slovak Republic.

<sup>3</sup> This is done by using gravity models which consider economic size and distance as the major determinants of the direction of trade; see, e.g., Piazolo (1996).



of the "normal" pattern until the early 1990s: Apart from the aforementioned trade restrictions of the EU, CEECs suffered from a deteriorating supply capacity under conditions of central planning. In other words, economic transformation of CEECs would most likely have resulted in rising exports to the EU even if preferential market access had not been granted by the EU.

This implies that the increase in EU imports from CEECs may reflect trade creation, rather than preference-induced trade diversion.<sup>4</sup> It is almost impossible to empirically assess the relative importance of trade creation and trade diversion. However, the subsequent evaluation suggests that the EU's trade policies towards CEECs are of minor importance in explaining Latin America's competitive position on EU goods markets.

## **2. CEECs and Latin America: Competing Suppliers on EU Markets?**

Trade diversion to the detriment of Latin America would be most likely if substitution elasticities between (preferred) CEEC suppliers and (non-preferred) Latin American suppliers in EU markets were high. As substitution elasticities are difficult to measure, trade overlap indices are often considered as proxies (Langhammer 1994). Comparing the commodity structure of EU imports from

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<sup>4</sup> Piazzolo (1996: 25) concludes from a comparison of revealed comparative advantage of CEECs vis-à-vis the EU on the one hand, and vis-à-vis all trading partners on the other hand that "regional integration benefiting intra-group trade is unlikely to lead to substantial distortions".

CEECs and Latin America reveals a surprisingly low degree of overlapping. Most strikingly perhaps, manufactured goods accounted for 70 percent of total EU imports from CEECs in 1994, while the share of manufactures in EU imports from Latin America was just 20 percent (Table 1).

Table 1 — Commodity Structure of EU (12) Imports from CEECs and Latin America, 1989 and 1994 (percent)

|   | CEECs <sup>a</sup> |      | Latin America |      |
|---|--------------------|------|---------------|------|
|   | 1989               | 1994 | 1989          | 1994 |
| Manufactured goods <sup>b</sup> (total imports = 100) | 49.4               | 70.3 | 19.4          | 20.4 |
| Selected items (manufactured imports = 100):          |                    |      |               |      |
| – Chemicals <sup>c</sup>                              | 16.4               | 9.3  | 17.6          | 16.5 |
| – Machinery and transport equipment <sup>d</sup>      | 22.4               | 29.7 | 37.5          | 34.7 |
| – Textiles, clothing and leather <sup>e</sup>         | 30.4               | 30.0 | 24.3          | 23.3 |

<sup>a</sup>Without Community of Independent States. — <sup>b</sup>SITC categories 5-8 minus 67 and 68. — <sup>c</sup>SITC category 5. — <sup>d</sup>SITC category 7. — <sup>e</sup>SITC categories 61, 65, 84 and 85.

Source: OECD (var. iss.).

One may suspect that the significant increase in the share of manufactures in EU imports from CEECs since 1989 has hindered Latin America to reduce the strong bias in favour of non-manufactures (such as food products, crude materials and other commodities) in its exports to the EU. It is indeed striking that, in contrast to EU imports from Latin America, imports of the United States from this

region shifted considerably towards manufactures in the early 1990s.<sup>5</sup> However, several observations are in conflict with the above suspicion:

- The share of manufactures in Latin America's exports was about 50 percent lower in the EU market than in the US market even before CEECs were granted a privileged status by the EU (UN 1996).
- On the level of particular manufacturing industries, there is little evidence that shifts in the structure of EU imports from CEECs were related to shifts in the structure of EU imports from Latin America.<sup>6</sup> The shares of chemicals, machinery and transport equipment, and textiles, clothing and leather in manufactured EU imports from Latin America all declined slightly, irrespective of the direction of change in the share of these items in manufactured EU imports from CEECs (Table 1).
- Finally, for the bulk of manufactures, access to EU markets is largely unrestricted for Latin American suppliers. Put differently, preference margins favouring CEECs play a marginal role in large parts of manufacturing. This is

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<sup>5</sup> The share of manufactures in US imports from Latin America nearly doubled from 31 percent in 1990 to 60 percent in 1994 (UN 1996).

<sup>6</sup> Table 1 includes three prototype manufacturing industries: the chemical industry which is relatively physical capital intensive; machinery and transport equipment where production technologies tend to be relatively skill intensive; and textiles, clothing and leather the production of which is relatively (unskilled) labour intensive.

also because about 60 percent of Latin American exports of processed and semi-processed goods to the EU actually enter EU markets duty-free or with reduced duties under the Generalized System of Preferences (EUROSTAT 1995).

The latter argument suggests a closer look at trade overlaps in so-called sensitive areas. Notably for steel, textiles and agricultural products, EU imports have traditionally been quota-restricted. It is primarily in these areas that various CEECs were granted preferential treatment by the EU, which may have caused trade diversion. Yet, empirical analyses revealed rather small overlaps in the supply of CEECs and Latin America in quota-restricted EU markets (Langhammer 1994).

As concerns steel, trade overlaps in the late 1980s and early 1990s were basically due to competition between Brazil and the former USSR in special steel products. However, declining market shares of Brazil in this period cannot be explained by preference margins, but have to be attributed to price underbidding by successor states of the USSR. Trade diversion caused in this way diminished since 1992/93: The EU enforced "orderly marketing behaviour", imposed quantitative restrictions on steel imports from CIS republics, and subjected steel imports from the Czech and Slovak Republics to tariff quotas (WTO 1995: 59). Latin America *and* CEECs became subject to a "managed trade" strategy of the

EU, in order to protect both domestic steel producers and traditional trading partners against allegedly dumped steel imports. As a matter of fact, the share of iron and steel in total exports to the EU declined for both Latin America and CEECs.<sup>7</sup>

Likewise, Latin America does not appear to have suffered from considerable trade diversion with respect to textiles and clothing. True, Latin America's share in EU imports of textiles and clothing (SITC categories 65 and 84) from all non-OECD sources declined from 2.9 percent in 1989 to 1.7 percent in 1994, while the share of CEECs more than doubled to 16.2 percent (OECD, var. iss.).<sup>8</sup> However, the decline in Latin America's market share was even more pronounced in the 1980s,<sup>9</sup> i.e., before CEECs became the most favoured trading partner of the EU. Moreover, in 1989-1994, Latin America experienced a similar decline in

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<sup>7</sup> In 1989, iron and steel accounted for 7 percent of total EU imports from CEECs and 3.2 percent of total EU imports from Latin America; the respective shares declined to 5.5 and 1.4 percent in 1994 (OECD, var. iss.).

<sup>8</sup> Soaring EU imports of textiles and clothing from CEECs appear to be largely due to outward processing activities of EU companies in CEECs (Nunnenkamp et al. 1994: 76). By contrast, outward processing trade does not play a significant role in Latin America's exports to the EU. This implies that trade patterns in textiles and clothing are biased in favour of CEECs, considering that processed re-exports to the EU are inflated by imports of unprocessed inputs from the EU.

<sup>9</sup> In 1980, Latin America accounted for 5.8 percent of EU imports of textiles and clothing from all non-OECD sources (OECD, var. iss.).

its share in EU imports of all manufactures (from 7.1 to 4.5 percent; see Annex Table). This implies that preferential treatment of imports of textiles and clothing from CEECs does not provide a sufficient explanation of Latin America's poor performance. This is also because preferences granted to CEECs were less significant than suggested by the removal of quantitative restrictions: Similar to steel, preference-induced trade diversion in favour of imports of textiles and clothing from CEECs was contained by persistent trade monitoring by the EU. The remaining preferences will be further reduced once international trade in textiles and clothing becomes subject to WTO discipline, as was agreed upon in the Uruguay Round.

Arguably, the value of trade preferences granted to CEECs was particularly high for products covered by the Common Agricultural Policy (CAP). Nevertheless, the degree of trade diversion affecting Latin America does not appear to be as substantial as is widely believed (Langhammer 1994):<sup>10</sup> First, CAP products exported by CEECs in 1992 amounted to less than one third of

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<sup>10</sup> Koester (1996) analyses in detail the impact of the EU's agricultural policy towards CEECs on developing countries. He finds that "LDCs will certainly be somewhat negatively affected by the increase in preferential exports of the CEECs to the EU ... . Yet this effect is most likely to be .. marginal as LDCs sell a set of products which only compete indirectly through cross-price effects with products supplied from the CEECs" (Koester 1996: 174).

CAP products exported by Latin America.<sup>11</sup> Second, trade overlaps in food supply on EU markets by CEECs on the one hand and Latin America on the other hand were even smaller than for steel and textiles. Third, similar to textiles, preference margins in favour of CEECs will be reduced once the Uruguay Round agreements on agriculture are implemented completely.

### **3. Latin America's Position on EU Markets: Who Is to Be Blamed?**

Changes in the regional structure of EU imports from all non-OECD countries support the view that Latin America's relatively poor performance on EU markets cannot be attributed to closer institutional ties with, and trade preferences for CEECs. If discriminatory trade policies of the EU had been the major factor shaping changes in market shares, Asian suppliers should have been the first to suffer from trade diversion. This is because Asian countries, notably the newly industrialising economies in Asia, were a major target of discriminatory trade policy instruments applied by the EU (such as export restraint agreements and anti-dumping measures) (Hiemenz et al. 1994: 65-67).<sup>12</sup>

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<sup>11</sup> EU imports of food, beverages and tobacco suggest that Latin America has remained a more important supplier than CEECs. In 1994, CEECs (including the former USSR) exported about US\$ 3 billion of these items to the EU, compared to Latin American exports of US\$ 13.5 billion (UN 1996).

<sup>12</sup> Recent anti-dumping investigations concerned various Asian suppliers, including India, Indonesia, Malaysia and Thailand (WTO 1995).

Nonetheless, Asia further strengthened its dominant position among non-OECD suppliers of manufactured goods on EU markets in 1989-1994 (Figure 1; for details see Annex Table).<sup>13</sup> Asia gained market shares in capital and skill intensive industries such as chemicals and machinery and transport equipment, while its market share declined somewhat with respect to labour intensive EU imports of textiles, clothing and leather. In sharp contrast to Asia, Latin America's competitive position on EU markets deteriorated in 1989-1994. This applies to both total trade and trade in manufactures. Furthermore, Latin America's market share declined across various manufacturing industries (see Annex Table).

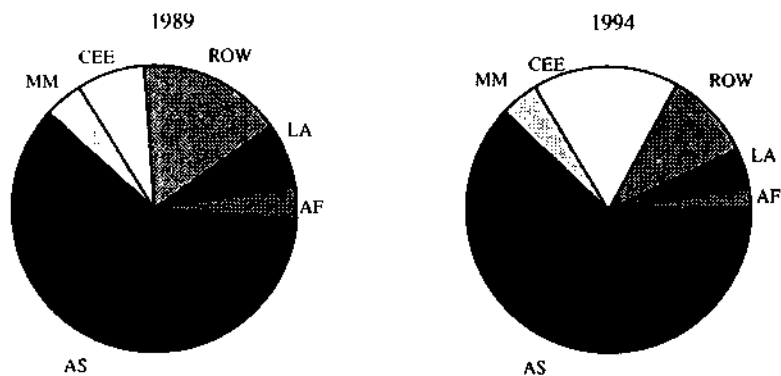
EU trade policies in general, and preferential treatment of CEECs in particular, cannot explain the contrasting performance of non-favoured trading partners in penetrating EU markets. Latin America lost market shares to other trading partners of the EU, irrespective of whether these trading partners had privileged access to EU markets (CEECs) or were subject to discriminatory treatment by the EU (Asian countries). It follows that the blame for Latin America's poor performance on EU markets has to be put on domestic supply constraints in the first place. Especially in manufacturing, the legacy of lasting import substitution policies may be responsible for such constraints. Import substitution policies

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<sup>13</sup> For a detailed analysis, see Agarwal, Langhammer, Lücke and Nunnenkamp (1995).



Figure 1 — Regional Structure of EU (12) Imports of Manufactured Goods from Non-OECD Countries (percent)



- AF = Africa (excl. Algeria, Egypt, Libya, Morocco, Tunisia and Rep. of South Africa);  
 AS = Asia (excl. Middle East);  
 CEE = Central and Eastern Europe (excl. Community of Independent States);  
 LA = Latin America;  
 MM = Maghreb and Mashrek countries (excl. Lebanon);  
 ROW = Rest of non-OECD.

Source: See Annex Table.

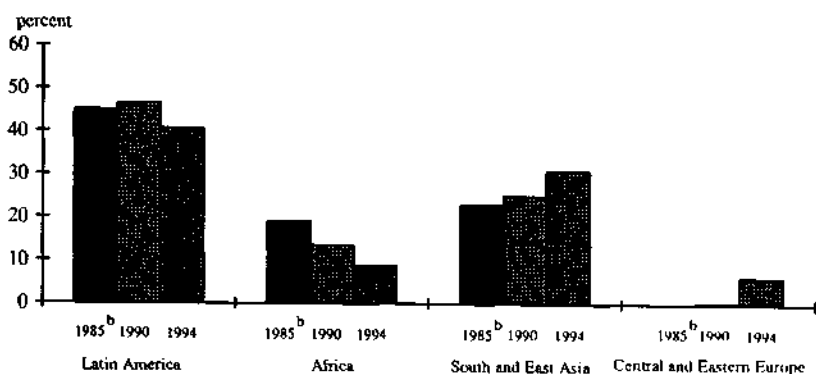
impaired the international competitiveness of Latin American manufacturers. The effectiveness of recent trade policy reforms in overcoming this problem may have been subject to considerable lags. The overriding role of domestic economic policy is also evident when it comes to explaining FDI patterns, to which we turn next.

### III. OUTWARD FDI BY THE EU: WHY A ZERO-SUM GAME IS UNLIKELY

#### 1. CEECs as New Competitors for FDI: A Threat to Latin America?

Latin America has traditionally been the dominant host region of FDI from the EU in the non-OECD area. About 45 percent of FDI stocks of the four major EU investor countries (France, Germany, the Netherlands and the United Kingdom) in all non-OECD countries were located in Latin America in 1985 and 1990 (Figure 2). About 60 percent of FDI flows from six EU countries<sup>14</sup> to the non-OECD area were channelled to Latin America in 1985-1987 (OECD 1996).

Figure 2 — Regional Distribution of FDI Stocks of Four EU Countries in Non-OECD Countries<sup>a</sup>, 1985-1994 (percent)



<sup>a</sup>France, Germany, the Netherlands and the United Kingdom; non-OECD includes Mexico. —

<sup>b</sup>1987 for France and the United Kingdom.

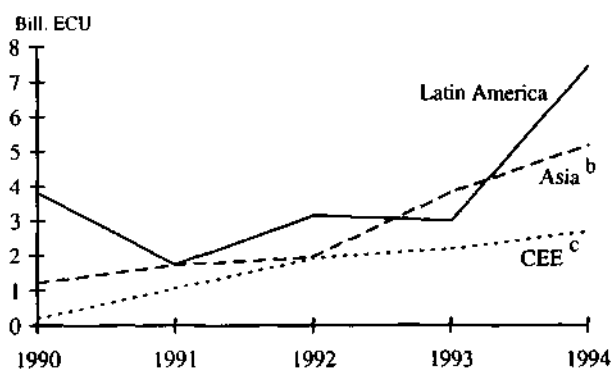
Source: OECD (1996).

<sup>14</sup> Flow data are also available for Denmark and Spain. OECD data for the remaining EU countries are either incomplete, inconsistent or completely lacking (OECD 1996).

CEECs were practically non-existent as competitors for FDI until the demise of socialism. In 1985-1987, six EU countries invested a meagre annual average of US\$ 20 million in Central and Eastern Europe, compared to US\$ 2.5 billion in Latin America (OECD 1996). Figure 2 shows that FDI stocks of the EU in this region were exceptionally low until recently.

However, CEECs experienced a boom of inward FDI since they started to transform themselves into market economies. FDI inflows from (six) EU countries soared thirteenfold to US\$ 2.7 billion in 1994 (Figure 3). By contrast, FDI flows from the EU to Latin America remained considerably below the inflows of 1990 in the three subsequent years, and increased substantially only in 1994.

Figure 3 — FDI Flows from Six EU Countries to Selected Regions<sup>a</sup>, 1990-1994



<sup>a</sup>Denmark, France, Germany, the Netherlands, Spain and the United Kingdom. — <sup>b</sup>Excluding Middle East. — <sup>c</sup>Central and Eastern Europe, including former USSR.

Source: OECD (1996).

Especially the prospective EU members among CEECs can be expected to become even more attractive hosts of FDI in the future. Previous steps towards closer EU integration have promoted FDI in EU member countries in several instances. Spain, for example, emerged as a major host country of FDI after the country had joined the EU in 1986.<sup>15</sup> For the EU as a whole, the Internal Market programme provided a major stimulus to intra-regional FDI flows (Agarwal, Hiemenz and Nunnenkamp 1995).<sup>16</sup>

All this seems to suggest that Latin America has much to lose as a host of FDI. Similar to trade, however, the region's attractiveness for FDI has little to do with EU integration and the emergence of prospective EU members as new competitors for FDI. This proposition is supported by a closer inspection of recent FDI patterns in the next section. Moreover, the subsequent discussion of investors' motivations underlying different types of FDI reveals that FDI diversion is likely to remain small in the future.<sup>17</sup>

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<sup>15</sup> FDI flows from all sources to Spain soared from ECU 2.6 billion in 1985/86 to ECU 5.6 billion in 1987/88 and ECU 11.8 billion in 1989/90 (annual averages). The increase was particularly pronounced for FDI flows from other EU members to Spain, which increased more than sixfold to ECU 7.3 billion in 1989/90 (OECD 1996).

<sup>16</sup> The intra-EU share of total FDI outflows of EU countries doubled from 31 percent in 1985-1987 to 63 percent in 1990-1992.

<sup>17</sup> In contrast to trade diversion, the notion of FDI diversion lacks analytical foundation. We use this term as a catchword indicating possible effects of fiercer competition for FDI on traditional recipients of FDI.

## 2. FDI in Latin America: How to Explain Impaired Attractiveness?

Various empirical observations are in conflict with the idea that Latin America has been affected significantly by FDI diversion resulting from EU integration and closer ties between the EU and CEECs. First, if FDI diversion had been a major factor, all non-OECD hosts should have suffered from improved attractiveness of CEECs. In particular, developing Asia should not have fared better as a host region of FDI than Latin America. Yet, the most dramatic shifts in the regional distribution of FDI in all non-OECD countries occurred exactly between these two regions (Gundlach and Nunnenkamp 1996: Figure 1): East Asia's share in global FDI flows has nearly quadrupled since 1980, whereas Latin America reported significantly declining shares. This pattern also holds for outward FDI by the EU. Although EU investors have traditionally been underrepresented in Asia, the shift from Latin America to Asia is evident from Figures 2 and 3.<sup>18</sup>

Second, Latin America's loss in attractiveness for FDI occurred mainly in the 1980s, i.e., before FDI diversion in favour of CEECs could have played any role. The region's share in global FDI flows collapsed from 12.6 percent in 1979-1982 to less than 4 percent in 1990 (IMF, var. iss.). Even more strikingly, Latin

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<sup>18</sup> FDI flows from six EU countries to Asia amounted to less than one third of their FDI flows to Latin America in 1990. This ratio increased to almost 90 percent when comparing average annual FDI flows in 1993/94 (Figure 3). For a more detailed analysis, see EC and UNCTAD (1996).

America's share in global FDI flows recovered exactly when CEECs entered the scene as new competitors for FDI. Latin America's share remained persistently lower in 1991-1995 than in 1979-1982, but, on average, it doubled relative to 1990.

Third, the recent increase of overall FDI flows to Latin America is mainly because of booming FDI from the United States (IADB and IRELA 1996: Table 11). Recently, however, also EU investors expanded their engagement in the region (Figure 3). The relatively modest increase of FDI flows from Europe<sup>19</sup> is unlikely to reflect FDI diversion, unless one would argue that this increase would have been more pronounced if CEECs had not attracted rising FDI from the EU (which cannot be proven). Rather, US FDI in Latin America generally appears to be more volatile than EU FDI in this region: The boom of FDI from the United States started from a depressed level in 1985-1989, whereas European FDI flows to Latin America were even somewhat higher in 1985-1989 than in 1980-1984.

Finally, the performance of Latin America in attracting FDI differed remarkably between individual host countries:<sup>20</sup>

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<sup>19</sup> According to data provided by IADB and IRELA (1996: Table 11), European FDI flows to Latin America throughout the period 1990-1994 were 65 percent higher than in the second half of the 1980s. In comparison, FDI from the United States increased sevenfold.

<sup>20</sup> For a detailed analysis and data sources, see Nunnenkamp (1997a).

- Traditionally by far the most important recipient of FDI inflows in the region, Brazil reported a steeply declining share in FDI flows from all sources to Latin America.
- Mexico and, recently, also Argentina surpassed Brazil in terms of total FDI inflows.
- Chile and Argentina proved to be most attractive with respect to average annual FDI inflows per capita in 1991-1995.

Brazil continued to be the most important recipient of FDI flows from the EU (Table 2). Nevertheless, FDI flows from the EU shifted remarkably towards other Latin American host countries. Similar to global FDI flows, Argentina and Mexico (in the 1990s) and Chile (since the early 1980s) were major beneficiaries of higher FDI flows from the EU.<sup>21</sup> These shifts seem to be closely related to economic policies pursued by the respective governments (Nunnenkamp 1997a). Note, for example, that Chile represents the frontrunner with respect to economic reforms in Latin America. The link between the timing of reforms and improved attractiveness for FDI is also evident for Argentina and Mexico. It follows that

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<sup>21</sup> The increasing share of the remaining part of Latin America suggests that EU investors strengthened their engagement also in various smaller economies within the region. Examples include: Jamaica, Peru, and Trinidad and Tobago (IADB and IRELA 1996: Statistical Annex, Table 23).

Table 2 — Share of Four Major Economies in EU FDI Flows to Latin America,<sup>a</sup> 1980-1994 (percent)

|           | 1980-1984 | 1985-1989 | 1990-1994 |
|-----------|-----------|-----------|-----------|
| Argentina | 16.7      | 14.4      | 18.2      |
| Brazil    | 50.3      | 51.1      | 29.0      |
| Chile     | 5.8       | 9.2       | 8.9       |
| Mexico    | 12.1      | 8.9       | 14.9      |
| Other     | 15.1      | 16.4      | 29.0      |

<sup>a</sup>Annual average. FDI flows to offshore financial centres excluded.

Source: IADB and IRELA (1996: Table 23).

Brazil's particularly poor performance in attracting FDI is the consequence of seriously delayed reforms.<sup>22</sup>

To summarize, FDI diversion resulting from European integration appears to have been a minor factor in shaping recent FDI patterns. Both global and European FDI has been far from being a zero-sum game. Various Latin American economies have restored their attractiveness for FDI exactly when CEECs emerged as new competitors for FDI. Countries in both regions benefited from additional FDI at the same time, after they had implemented stabilisation and structural adjustment programmes. Recent shifts in the distribution of FDI across regions and among Latin American economies bear close resemblance to the timing and consistency of economic reforms.

<sup>22</sup> For a detailed analysis of the case of Brazil, see Nunnenkamp (1997b).



### 3. Motivations of EU Investors: Biased Against Latin America?

The next question is whether FDI diversion to the detriment of Latin America is more likely with closer EU integration in the future. An assessment of FDI in different sectors and the underlying motivations of foreign investors may offer some valuable insights in this respect.<sup>23</sup> This is because the potential of FDI diversion can reasonably be assumed to differ widely between various types of FDI (Agarwal 1994).

The underlying motives of FDI are basically the following three: (i) to draw on raw materials and natural resources available in the host country, (ii) to serve the domestic markets of host countries or regions, and (iii) to use overseas locations as platforms for global sourcing and marketing. The subsequent discussion will show that FDI diversion is hardly a relevant issue in the former two areas. FDI diversion may be a threat in the third area. However, it largely depends on Latin America herself whether it will actually occur.

As concerns resource-based FDI, Latin America is highly unlikely to suffer from FDI diversion in favour of prospective EU members among CEECs. With few exceptions, these countries do not offer promising investment opportunities in the mineral sector. Rather, most of them heavily depend on imports of minerals

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<sup>23</sup> For a comprehensive analysis of investors' motivations and possible FDI diversion effects, see Michalet (1997).

and other raw materials. From an endowment point of view, the situation is different in agriculture, where investment opportunities may exist. Yet, the available evidence suggests that the primary sector as a whole remained a negligible target of FDI in prospective EU member countries in the early 1990s (Agarwal 1994: Table 4). This is unlikely to change unless the restrictive CAP is reformed fundamentally.

In contrast to prospective EU members among CEECs, various successor states of the USSR do offer vast investment opportunities in the primary sector because of their favourable endowment of natural resources. This may induce a larger degree of FDI diversion if the EU strengthens its ties with these countries. Nevertheless, Latin America is unlikely to be affected significantly. First, for the time being, FDI conditions in successor states of the USSR remain clouded by economic and political uncertainty. Second, various Latin American host countries have little to lose. In Brazil and Mexico, for example, the primary sector as a whole accounted for about 2 percent of total FDI stocks in 1994 (IADB and IRELA 1996: Table 8). Third, FDI diversion may be a minor concern even in Latin American countries where the primary sector figures prominently in total FDI stocks.<sup>24</sup> Resource-based FDI tends to be highly location-specific. This

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<sup>24</sup> Examples are: Bolivia (76 percent), Chile (59 percent), Colombia (61 percent), and Ecuador (51 percent). The degree to which EU investors are engaged in the primary sector of these countries cannot be identified from the available data.

means that FDI diversion is conceivable only among countries offering the same quality of a particular commodity.

FDI for serving the domestic markets of host countries (in UNCTAD's jargon, market seeking FDI) seems to account for the bulk of FDI in Latin America (Nunnenkamp 1997a). This is a plausible assumption, although the available data do not allow for a clear distinction between market seeking FDI and FDI undertaken in the context of global sourcing and marketing (efficiency seeking FDI):

- The service sector, where the production of non-tradables is clearly dominant, accounts for a significant share of total FDI in major Latin American host countries,<sup>25</sup>
- Enterprise surveys and regression analyses reveal that the size and growth of host country markets have been major stimuli to FDI in manufacturing. This applies especially to Latin America, where lasting import substitution strategies provided a disincentive to efficiency seeking FDI in the past. The low share of manufactured goods in Latin American exports to the EU (see Section II.2)

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<sup>25</sup> The share of the service sector in total FDI stocks in 1994 was around 40 percent in Argentina, Brazil and Mexico, while it was about 25 percent in Chile (IADB and IRELA 1996: Table 8). Moreover, recent FDI flows to various Latin American countries were heavily concentrated in services, which was largely because of privatisation programmes (Nunnenkamp 1997a).

underscores that EU FDI in manufacturing has primarily been market seeking in this region.

The sectoral distribution of FDI in several CEECs suggests that, similar to Latin America, market seeking FDI was dominant in the early 1990s (Agarwal 1994: 12). This is corroborated by recent survey results (OECD 1993; Michalet 1997). Most probably, this similarity between Latin America and CEECs greatly reduces the scope for FDI diversion. It is hardly conceivable that EU investors will give up important markets in Latin America, simply because of new market opportunities in CEECs. Rather, one can expect additional FDI if different regions offer favourable market prospects.<sup>26</sup> This view is supported by the recent boom of FDI in the service sector of various countries in Latin America, in Central and Eastern Europe and in other regions, after these countries had joined the worldwide trend towards privatisation and deregulation of services.

It follows that, as far as market seeking FDI is concerned, it depends on the economic prospects of Latin American countries, rather than on the future course of EU integration, whether the recent recovery of FDI flows to the region will be sustained. This is not to ignore that the prominence of market seeking FDI involves certain risks for Latin America. Indirectly, it may put Latin American

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<sup>26</sup> Additional FDI may be associated with relatively lower domestic investment in EU countries. In contrast to FDI diversion, one may call this "FDI creation" (in analogy to trade creation).

economies at a disadvantage in competing for the third type of FDI, i.e., efficiency seeking FDI.

In the era of globalisation, efficiency seeking FDI is considered to be the hallmark of the response of multinational corporations to the changing international environment (UNCTAD 1996: 97). The size of host country markets, as one of the most important traditional FDI determinants, is expected to decrease in relative importance. Under such conditions, Latin America may be handicapped vis-à-vis other regions.

Globalisation may shift the FDI balance further towards Asia. Various Asian countries are well-known for their world market orientation which puts them in a favourable position to compete for efficiency seeking FDI. By contrast, Latin American countries may still be suffering from insufficient international competitiveness of manufacturing industries that were established under conditions of import substitution. At the same time, the recent move towards trade liberalisation in Latin America tends to weaken the incentives of foreign investors to undertake market seeking FDI in this region in order to jump over protectionist fences.

It may also prove more difficult for Latin America than for CEECs to attract efficiency seeking FDI. The recent surge of market seeking FDI in CEECs occurred at a time when these host countries liberalised their foreign trade

regimes substantially. Hence, the existing FDI stock in CEECs is probably more in line with these countries' comparative advantage than in the case of Latin American countries. This could render it relatively easy for CEECs to switch from market seeking to efficiency seeking FDI. CEECs have two additional advantages in attracting efficiency seeking FDI. Geographical proximity favours CEECs in competing for this type of FDI from EU countries, as distance typically involves higher transaction costs. Furthermore, preferential access to EU markets provides an incentive to efficiency seeking FDI in CEECs.

It is in the area of efficiency seeking FDI where the largest potential of FDI diversion exists. One may argue that this poses a threat to Asian countries, rather than to Latin American countries, as world-market oriented host countries have more to lose than domestic-market oriented host countries. Under conditions of globalisation, however, overall FDI prospects seem to depend increasingly on locational attractiveness for efficiency seeking FDI. If so, Latin American economies have little choice but to prepare themselves for fiercer worldwide competition for efficiency seeking FDI.

Important steps have already been taken by various Latin American countries to reduce the risk of FDI diversion. Comprehensive reform programmes with regard to macroeconomic stabilisation and structural adjustment were instrumental to the recent recovery of FDI flows to Latin America (Nunnenkamp

1997a). The close link between reform-mindedness and FDI inflows supports the view that the future prospects of Latin America in attracting efficiency seeking FDI depend primarily on economic policies followed in this region, rather than on the deepening and widening of EU integration. Several studies suggest that host countries of FDI are most likely to participate successfully in globalised production if (i) macroeconomic stability is sustained, (ii) openness towards world markets is ensured, (iii) physical capital accumulation is encouraged, and (iv) human capital formation figures high on the government's policy agenda (Sachs and Warner 1995; Gundlach and Nunnenkamp 1996; Nunnenkamp 1996).

#### **IV. SUMMARY AND CONCLUSIONS**

Recent trade and FDI patterns suggest that EU widening to the East has limited effects on Latin America. As concerns trade, CEECs and Latin American countries have targeted different markets for their exports to the EU. Surprisingly small trade overlaps imply that trade diversion resulting from EU integration and negatively affecting Latin America is likely to be modest. This picture may change somewhat when several CEECs become full members of the EU. However, a dramatically different picture should not emerge in the future, considering that possible changes work in opposite directions so that their effects on trade diversion may cancel out each other:

- On the one hand, the potential of trade diversion will further decrease once the Uruguay Round agreements are fully implemented. Preference margins for CEECs will then be reduced, which contains trade diversion in "sensitive" areas such as textiles and clothing. Furthermore, trade overlaps may become even smaller in the future, if CEECs succeed in making better use of their relatively favourable endowment of human capital and skilled labour. With continued investment to replace the obsolete capital stock inherited from the socialist past, the comparative advantage of CEECs will shift towards skill intensive lines of production. Rising wages in CEECs during the process of economic transformation and EU integration will reinforce structural change towards more sophisticated manufacturing industries. The supply of CEECs on EU markets may then become increasingly complementary, rather than substitutive to Latin American supply.
- On the other hand, full EU membership of some CEECs may induce more trade diversion. Remaining trade barriers between these CEECs and current EU members will be removed. In addition, CEECs are required to reduce their (relatively high) protection against non-EU members to the (relatively low) level of external protection of the current EU. Taken together, the free trade area requirement and the customs union requirement may give rise to considerable structural adjustment needs in new EU member countries among



CEECs. Against this backdrop, these countries will probably address the EU to consider their higher demand for protection when it comes to trade negotiations with non-members. An extended EU may, thus, slow down the process of external trade liberalisation, especially during the period of structural adjustment in CEECs to import pressure from both current EU members and non-EU countries (Langhammer and Nunnenkamp 1993).

It is almost impossible to strike a balance between these opposing influences, let alone assessing the net impact on particular external trading partners of the EU such as Latin American economies. Even if trade diversion becomes more likely, new opportunities for trade will emerge simultaneously. For example, Latin America may be adversely affected if the EU becomes more reluctant to liberalise extra-EU trade. Nevertheless, Latin American suppliers will benefit from better access to still highly protected markets of CEECs, once the latter are members of the customs union. This may help increase the extremely low share of Central and Eastern Europe in total Latin American exports (1994: 0.3 percent, excluding former USSR; UN 1996).

Similar to trade, there are certain risks that Latin America will be affected by FDI diversion. For several reasons, however, such risks should not be overrated. Worldwide FDI flows have never been — and are most unlikely to become — a zero-sum game. The recent surge of FDI flows to various host countries and

regions, including many Latin American economies, indicates that new investment opportunities induce additional FDI, rather than leading to FDI diversion.

Furthermore, fears of FDI diversion tend to be greatly exaggerated unless it is taken into account that overall FDI is far from being a uniform phenomenon. Different motivations are underlying resource-based FDI, market seeking FDI and efficiency seeking FDI. The threat of FDI diversion is essentially restricted to efficiency seeking FDI. One may expect that this type of FDI is becoming increasingly important in the era of globalisation, whereas one of the most important traditional FDI determinants, namely the size of host country markets, may become less relevant. This would definitely involve a major challenge for Latin America, where the bulk of FDI has traditionally been market seeking.

It primarily depends on economic policies pursued by Latin American governments whether this challenge will be met. For Latin America to become more closely involved in globalised production, and thereby improve the prospects of attracting FDI, the following factors should be of priority concern: sustained macroeconomic stability, openness towards world markets, and accumulation of physical and human capital.

As it seems, many Latin American countries are in the process of restoring their international competitiveness and attractiveness for FDI. Sustained

economic policy reforms can be regarded as Latin America's contribution to prospering economic relations with the EU. The EU's most important contribution would be to ensure open markets for non-members, including Latin American countries, and to play a constructive role in maintaining a liberal multilateral trading system. EU widening to the East does involve some risk for external trade liberalisation, but the threat of more inward-looking policies of the EU may still increase if EU integration does not proceed smoothly.

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Annex Table — Regional Structure of EU (12) Imports from Non-OECD Countries,<sup>a</sup> 1989 and 1994 (percent)

|   |      | Total | Manufactured goods <sup>b</sup> | Chemicals <sup>c</sup> | Machinery and transport equipment <sup>d</sup> | Textiles, clothing and leather <sup>e</sup> |
|---|------|-------|---------------------------------|------------------------|--|---|
| Africa <sup>f</sup>                     | 1989 | 9.1   | 3.7                             | 5.3                    | 0.9  | 2.7   |
|   | 1994 | 6.6   | 2.3                             | 1.4                    | 0.6  | 2.2   |
| Asia <sup>g</sup>                       | 1989 | 30.4  | 60.6                            | 20.3                   | 68.9   | 63.1  |
|   | 1994 | 38.7  | 62.0                            | 28.0                   | 72.0   | 60.2  |
| Central and Eastern Europe <sup>h</sup> | 1989 | 6.6   | 8.0                             | 14.3                   | 6.0  | 7.4   |
|   | 1994 | 13.1  | 16.7                            | 20.9                   | 14.3   | 16.2  |
| Latin America                           | 1989 | 14.9  | 7.1                             | 13.6                   | 9.0  | 5.3   |
|   | 1994 | 12.2  | 4.5                             | 10.1                   | 4.6  | 3.4   |
| Maghreb and Mashrek <sup>i</sup>        | 1989 | 7.5   | 4.3                             | 8.0                    | 1.7  | 8.4   |
|   | 1994 | 6.9   | 4.4                             | 6.4                    | 1.7  | 10.2  |

<sup>a</sup>Including Mexico. — <sup>b</sup>SITC 5-8 minus 67 and 68. — <sup>c</sup>SITC 5. — <sup>d</sup>SITC 7. — <sup>e</sup>SITC 61, 65, 84 and 85. — <sup>f</sup>Excluding Algeria, Egypt, Libya, Morocco, Tunisia and Rep. of South Africa. — <sup>g</sup>Excluding Middle East. — <sup>h</sup>Excluding Community of Independent States. — <sup>i</sup>Excluding Lebanon.

Source: OECD (var. iss.).