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## The changing pattern of foreign direct investment in Latin America

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# Kieler Arbeitspapiere

# Kiel Working Papers

**Kiel Working Paper No. 736**

**The Changing Pattern of Foreign Direct Investment**

**in Latin America**

**by**

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The Changing Pattern of Foreign Direct Investment

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## ABSTRACT

Latin America has regained attractiveness for foreign direct investment. However, it is still uncertain whether the recent boom of capital inflows is sustainable, and which countries are well prepared to benefit from the current trend towards globalized production. Economic policies pursued by Latin American governments are shown to be of overriding importance for explaining why the region as a whole lost ground vis-à-vis Asian competitors for foreign direct investment, and why some Latin American economies were more successful than others in restoring their locational attractiveness.

JEL classification: F 21

## I. Introduction\*

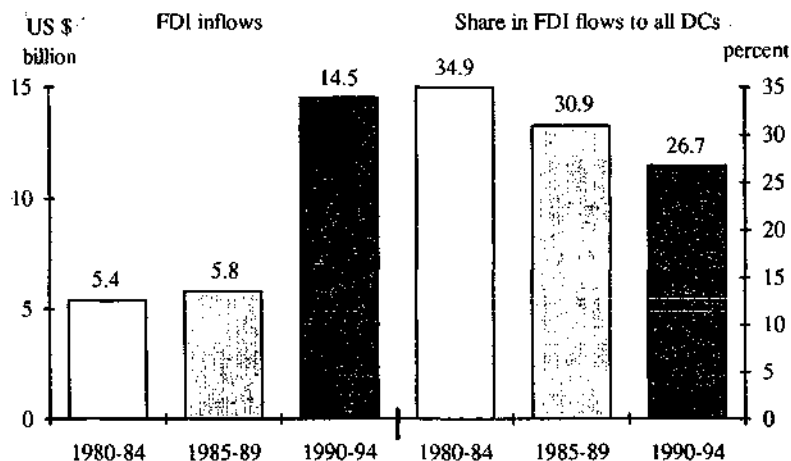
Latin America experienced a boom of foreign direct investment (FDI) in the early 1990s. FDI inflows nearly tripled as compared to the 1980s (Figure 1). Nonetheless, it is still uncertain whether Latin America has restored its attractiveness for foreign risk capital in a sustainable way, and which countries in this region are well prepared to participate successfully in the current trend towards globalized production. The prospects to succeed in this respect are closely related to economic policies pursued by Latin American governments.

We proceed in the following steps in order to substantiate these contentions. First, we argue that access to FDI is critically important for Latin America to become more integrated into the international division of labor. Second, we portray Latin America's position in the worldwide competition for FDI, and identify diverging trends between major economies within the region. Third, we analyze structural changes in the composition of FDI and overall capital inflows. Fourth, we draw the link between the significance and structure of capital inflows on the one hand and economic policies pursued by Latin American governments on the other hand. Finally, we derive some policy conclusions from the experience of those countries which were most successful in becoming involved in corporate globalization strategies.

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Figure 1 – FDI Flows to Latin America, 1980-1994 (annual averages)



Source: IMF [a].

## II. The Significance of Foreign Direct Investment in the Era of Globalization

The world economy has witnessed a surge in FDI flows during the last decade or so. Global flows in 1994 exceeded flows in 1980 by a factor of 4.3 [IMF a]. The fact that FDI did not only increase relative to world output, but also grew three to four times faster than international trade represents the clearest indication of the trend towards globalized production patterns [Nunnenkamp et al. 1994]. Globalization means an advancing division of labor at a worldwide scale. This process is driven by fiercer competition on international goods and capital markets. New competitors for foreign capital include the transition economies in Central and Eastern Europe, as well as Asian developing countries (DCs) which have opened up towards world capital markets. At the same time, the microelectronic revolution has resulted in declining information and transaction costs, which in turn have enhanced the international mobility of capital and the

transfer of technology. All this has rendered easier the fragmentation of production processes and the relocation of production to countries offering the relevant comparative cost advantages.

The ways in which various economies are integrated into corporate globalization strategies are adapted to country-specific factor endowments and specialization profiles [Gundlach and Nunnenkamp 1996]. Factor endowments typically prevailing in DCs have as a consequence that most of these countries play a marginal role in the *generation* of technological innovations; few DC companies have become part of technologically motivated business cooperation across national boundaries, e.g. through strategic alliances. It is the *application* of internationally available technologies which matters most for inducing catching-up processes in DCs. Besides international trade in capital goods and traditional forms of non-equity arrangements for technology transfers (e.g., licensing), FDI represents an important means to gain access to internationally available technologies. It follows that DCs with a relatively high attractiveness for FDI are most likely to benefit from globalization and to succeed in catching up with income levels in industrialized economies.

### **III. Latin America's Position in International Competition for FDI**

As a matter of fact, various DCs have become involved in the process of globalization. All DCs taken together attracted nearly a third of global FDI flows in 1991-1993. A DC share of 39 percent has been reported for 1994, which was close to twice the average figure in 1980-1990 [UNCTAD 1995a; 1995b]. If, as many observers argue, starting conditions were most favorable for relatively advanced DCs, Latin America should have been the first candidate to benefit from globalization. In 1980, the average per-capita income of this region exceeded that of Asian DCs nearly sixfold [UNCTAD a]. The share of agriculture in Latin America's GDP was below 10 percent at that time already (Asian DCs: 25 per-

cent). Manufacturing, which is the focus of corporate globalization strategies, accounted for nearly a quarter of GDP in Latin America; this share was comparable to industrialized countries such as France and the United States. Most importantly, Latin America had traditionally been a preferred host region for FDI; its share in FDI flows to all DCs was close to 70 percent in 1980 [IMF a].

Yet, in contrast to East and Southeast Asia, Latin America largely failed in the 1980s to grasp the opportunities involved in globalization. The region's share in worldwide manufacturing value added fell from 5.9 to 4.8 percent in 1983-1993, while the share of East and Southeast Asian DCs doubled from 2.8 to 5.6 percent (unpublished UNIDO database).<sup>1</sup> At the same time, the focus of foreign investors shifted from Latin America to Asia. The latter region received nearly 60 percent of FDI flows to all DCs in 1994. Latin America's share declined significantly (Figure 1). This decline was not restricted to the "lost decade" of the 1980s; it continued in the early 1990s, although absolute FDI inflows increased substantially.

The regional pattern of FDI inflows obscures remarkable differences between individual Latin American economies.<sup>2</sup> Figure 2 shows that it was mainly Brazil which lost attractiveness as an investment location. Traditionally by far the most

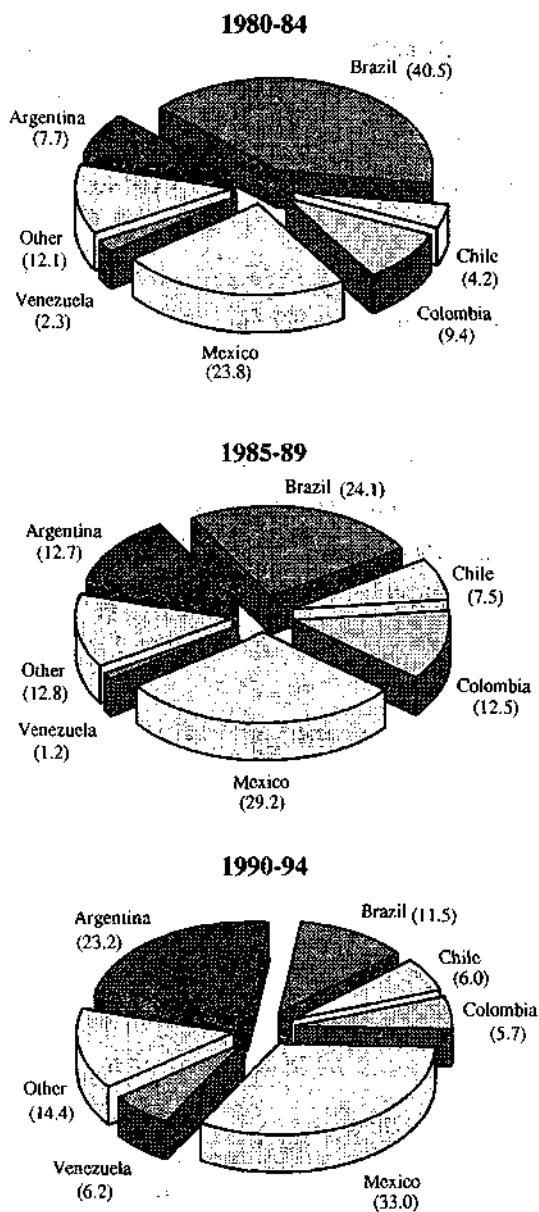
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<sup>1</sup> The discrepancy is even more obvious when calculating shares in manufacturing value added of all DCs. In 1983-1993, the share of Latin America dropped from 44.2 to 28.6 percent; East and Southeast Asian DCs recorded a rise from 21 to 33 percent.

<sup>2</sup> For a recent and comprehensive collection of data on FDI in Latin America, see IDB and IRELA [1996].



Figure 2 – FDI Flows to Major Latin American Countries, 1980-1994 (percent of total flows to the region)



important recipient of FDI inflows in the region, its share dwindled to about 12 percent in 1990-1994. Brazil was not only surpassed by Mexico, but recently also by Argentina. Argentina's share in Latin American FDI inflows tripled to more than 23 percent in 1990-1994, which was largely due to FDI in the context of privatization (see below). FDI shares of Chile, Colombia and Venezuela fluctuated over time. In the latter country, privatization of state-owned enterprises resulted in exceptionally high FDI inflows in 1991 [UNCTAD 1995c]. Colombia attracted up to one quarter of all Latin American FDI inflows in the mid-1980s, when flows to much of the debt-ridden region were at a low ebb. The country could not maintain this share when major debtor countries began to tackle their economic problems and regained competitiveness. Debt conversions accounted for much of the particularly high FDI flows to Chile in the late 1980s. Controlling for this distinct factor, Chile's attractiveness for FDI appears to be on a rising trend. In 1990-1994, average annual FDI inflows per capita of population amounted to US\$ 65; in per-capita terms, Chile ranked second (behind Argentina with US\$ 96) among the Latin American economies considered in Figure 2.

The comparison of per-capita FDI inflows between Latin American economies also reveals that the frequently noted concentration of FDI on a few major host countries [see, e.g., UNCTAD 1995c: 69] gives a misleading impression as to the participation of smaller economies in globalization. True, the six countries considered in Figure 2 persistently absorbed more than 85 percent of total FDI flows to Latin America. However, the high concentration of absolute flows is mainly due to a large country bias. In per-capita terms, various small countries proved more attractive for FDI than larger countries [see also IDB and IRELA 1996: 31]. Within a sample of 18 Latin American economies, the three smallest countries (in terms of population in 1992) were indeed among the best performers in attracting foreign investors:

- Per-capita FDI inflows of Trinidad and Tobago in 1990-1994 (US\$ 216) were more than twice the figure for Argentina.
- In the same period, Costa Rica received higher per-capita inflows than Mexico (US\$ 54). Similar to Chile, per-capita inflows increased nearly threefold in Costa Rica from an annual average of US\$ 22 in 1980-1984 to more than US\$ 60 in 1990-1994.
- Jamaica experienced a dramatic change from slightly negative FDI flows in 1980-1984 to per-capita inflows of US\$ 51 (annual average) in 1990-1994, thereby approaching the figure for Mexico.

On the other hand, the attractiveness of some relatively small countries remained fairly poor. For instance, per-capita FDI inflows in 1990-1994 were even below the depressed level of US\$ 11 for Brazil in Bolivia, El Salvador, Guatemala and Honduras. It is thus not surprising that a simple correlation between per-capita inflows and population size, calculated for the sample of 18 Latin American economies, turned out to be insignificant.<sup>3</sup>

#### **IV. Structural Features of FDI Inflows and Possible Implications**

FDI related to privatization of state-owned enterprises and the conversion of foreign debt into equity finance played a significant role in several Latin American economies.<sup>4</sup> In 1990-1991, FDI in the context of privatization accounted for about 30 percent of total FDI flows to Latin America. This share declined to 7 percent in 1993.

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<sup>3</sup> This applies to both the early 1980s and early 1990s. By contrast, per-capita FDI inflows were correlated in a significantly positive way with per-capita income of recipient countries in both periods.

<sup>4</sup> The subsequent data are from UNCTAD [1995c]; on the role of privatization and debt conversion with regard to FDI in Latin America, see also IDB and IRELA [1996].

The significance of privatization and debt conversion in overall FDI differed remarkably between individual countries. Bolivia appears to represent an extreme case (although data on the composition of FDI inflows are highly fragmentary for this country): FDI inflows were completely due to privatization or debt conversion in those years for which a breakdown of FDI data is available; FDI flows not related to either privatization or debt conversion (i.e., "regular" FDI) turned out to be negative. Argentina comes closest to Bolivia; privatization and debt conversion accounted for nearly 80 percent of total FDI inflows in 1988-1993 (Figure 3). Privatization was of overriding importance in Peru. Likewise, "regular" FDI played a minor role in Venezuela. In sharp contrast, special factors were of marginal importance in Mexico, and particularly in Colombia.<sup>5</sup>

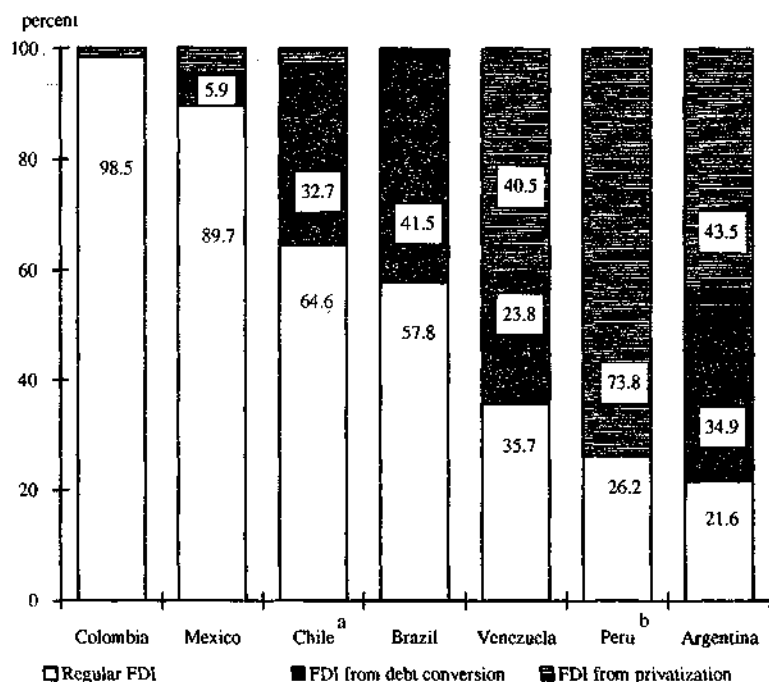
These differences may have important implications for the sectoral structure and sustainability of FDI. As concerns the sectoral structure of FDI, especially privatization may result in significant changes. Peru provides a case in point. FDI inflows of US\$ 2 billion related to the privatization of the Peruvian telecommunications sector in 1994 represented about 60 percent of total FDI inflows in 1988-1994 [UNCTAD 1995c]. Although individual projects have typically less weight than in this extreme Peruvian example, privatization of service activities figured prominently also in other Latin American economies.<sup>6</sup>

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<sup>5</sup> Brazil and Chile, which both reported significant FDI from debt conversion, rank in a medium position with regard to the share of "regular" FDI.

<sup>6</sup> For instance, significant FDI inflows resulted from the privatization of telecommunications in Mexico and Venezuela. In Argentina, foreign investors could participate on equal basis vis-à-vis national investors in the privatization of the railroad system, the national communications enterprise (ENTEL), radio and TV broadcasting companies, the national airline (Aerolíneas Argentinas), and other public services (e.g., gas, electricity, and postal services) [UNCTAD 1994].

Figure 3— Contribution of Privatization and Debt Conversion to Total FDI Flows to Selected Latin American Countries, 1988-1993



<sup>a</sup> 1989-1993. - <sup>b</sup> 1988-1994.

Source: UNCTAD [1995c].

As a matter of fact, the tertiary sector has absorbed a rising share of total FDI flows to major Latin American countries (Table 1).<sup>7</sup> This trend is also to be observed in countries such as Brazil where privatization did not play a major role.

<sup>7</sup> The assessment of the sectoral composition of FDI flows suffers from serious data constraints. Roughly comparable OECD statistics are available only for Argentina, Brazil and Mexico. Even for these three countries, the statistical information is not fully comparable because of differences in terms of coverage at the industry level, the classification of industries, and reporting periods. According to data provided by IDB and IRELA (1996), the service sectors have experienced the most dynamic growth in FDI inflows in many Latin American countries.

Table 1 – Sectoral Structure of FDI Flows to Argentina, Brazil and Mexico (percent of total FDI inflows)<sup>a</sup>

	Argentina	Brazil		Mexico	
	1990-92	1983-85	1990-92	1988-89	1992-93
Primary sector	6.9	3.2	-0.8	4.1	2.1
Secondary sector <sup>b</sup>	47.1	82.2	22.7	61.9	42.4
food, beverages and tobacco	2.0	n.a.	n.a.	7.3	11.2
textiles and clothing	0.3	n.a.	n.a.	1.2	0.9
chemicals	10.8	n.a.	n.a.	15.2	11.8
non-metallic products	2.0	n.a.	n.a.	2.7	1.0
metal products	0.2	9.3	-2.4	2.9	3.2
mechanical equipment	2.7	n.a.	n.a.	5.1	2.8
electrical equipment	3.8	n.a.	n.a.	3.7	1.9
motor vehicles	18.4	14.4	-13.1	19.1	7.2
Tertiary sector <sup>b</sup>	46.0	11.7	69.9	34.7	55.6
construction	1.0	n.a.	n.a.	0.6	0.5
trade	0.0	n.a.	n.a.	3.8	11.5
transport and storage	n.a.	n.a.	n.a.	0.0	0.1
finance, insurance and business services	21.5	n.a.	n.a.	15.0	32.5
communication	n.a.	n.a.	n.a.	8.3	3.2

<sup>a</sup> Annual averages. Percentage shares of sectors do sometimes not add up to 100 because of unallocated FDI inflows. – <sup>b</sup> Percentage shares of listed branches do not add up to sector totals because of missing data and neglected branches.

Source: OECD [1994; 1995].

The available data actually reveal that service activities account for a larger FDI share in Latin America than in Asian DCs.<sup>8</sup> FDI in finance, insurance and business services appears to have played a particularly important role within the tertiary sector of Argentina and Mexico. FDI in these areas should help the recipient countries to gain locational attractiveness in the secondary sector as

<sup>8</sup> According to OECD [1994], the tertiary sector accounted for roughly one third of total FDI flows to South Korea and Taiwan in the late 1980s and early 1990s. In the case of Thailand, the FDI share of service activities (51 percent) was comparable with the figures for Argentina and Mexico. Similar to major Latin American countries, the significance of the tertiary sector in total FDI inflows increased over time in Taiwan and Thailand (but not in South Korea).

well, considering that globalized production and marketing strategies are supported by an adequate provision of business related services (including financing, transport and communication).

FDI in the secondary sector of major Latin American economies has traditionally been concentrated on relatively sophisticated manufacturing activities. Chemicals and motor vehicles figure most prominently in this respect. The structure of FDI at the industry level is more balanced in Asian DCs. In South Korea, for example, the manufacturing of mechanical and electrical equipment accounted for significant shares of total FDI inflows in addition to chemicals and motor vehicles [OECD 1994]. Especially the important contribution of electrical equipment to FDI flows to Asian DCs suggests that these countries became involved in globalization through exploiting their comparative advantages. Table 1 also reveals that Brazil's attractiveness for FDI is most seriously impaired in manufacturing. Industries which traditionally absorbed the bulk of FDI in the secondary sector suffered from considerable FDI outflows in the early 1990s. This refers particularly to the manufacturing of motor vehicles.

The next question concerns the sustainability of FDI inflows. One might argue that sustainability is at risk particularly for countries in which FDI due to special factors dominated "regular" FDI. Privatization and debt conversions may be regarded as distinct events with an immediate impact on FDI flows, which cannot be sustained once the potential for privatization and debt conversion is exhausted. It is indeed beyond serious doubt that exceptionally high peaks in overall FDI inflows may result from temporary factors. The broad-based privatization program of Argentina in the early 1990s and the aforementioned privatization of the Peruvian telecommunications sector in 1994 may provide cases in point.

However, FDI flows involved in privatization and debt conversion are not necessarily one-off events. In many cases, privatization contracts have specified

further capital commitments to be undertaken subsequent to the original purchase, sometimes stretching over years, and the change in ownership has often been associated with significant additional investment in the rationalization and modernization of privatized firms [UNCTAD 1995c: 75; IDB and IRELA 1996: 53]. Likewise, reinvested earnings of firms which foreign investors acquired through privatization and debt conversion may result in additional FDI flows far beyond the initial transaction. Furthermore, privatization and debt reduction programs may improve the climate for FDI in indirect ways. Especially privatization signals the government's seriousness on economic reform and reduces uncertainty about the sustainability of the reform process. Privatization is also instrumental to competition on a level playing field. It provides governments with better chances to impose hard budget constraints on enterprises, notably to stop the subsidization of inefficient state-owned firms. This would ease the fiscal situation and contribute to macroeconomic stability, which in turn provides better prospects to attract FDI. The hardening of budget constraints also removes distortions in the allocation of productive resources. As a result, new FDI may be induced in sectors which suffered from insufficient access to capital and labor markets in the past.

Especially the indirect effects of privatization and debt conversion on FDI flows are almost impossible to quantify. Tentative evidence for the seven Latin American economies considered in Figure 3 points to a rather ambiguous relation between the significance of special factors and longer-term FDI trends. The growth of "regular" FDI was lowest in Argentina and Brazil, although the significance of FDI from privatization differed remarkably between these two countries.<sup>9</sup> By contrast, the highest growth of "regular" FDI was recorded by

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<sup>9</sup> Growth of "regular" FDI is measured by the ratio of "regular" FDI inflows in 1993 to "regular" FDI inflows in 1988 (Chile: 1993 to 1989) [UNCTAD 1995c].



Chile, for which the significance of special factors was comparable with Brazil. Venezuela ranked second in terms of growth of "regular" FDI. At the same time, the share of FDI from privatization and debt conversion was fairly high in this country. One may thus conclude that all countries, irrespective of the significance of special factors, face a similar challenge when it comes to sustaining longer-term FDI growth.

Long-term FDI growth would also help to sustain overall capital inflows. FDI proved relatively stable in Latin America recently, especially as compared with the volatility of portfolio investment [Gundlach and Nunnenkamp 1996]. FDI typically involves a lasting commitment to the recipient economy, and therefore provides the best indicator on the integration of DCs into corporate globalization strategies. Other types of capital inflows are not directly linked to globalization. Portfolio equity flows, for example, may be transformed into productive investment; but they are frequently of a rather speculative nature, and are easily withdrawn if higher returns are offered elsewhere or risk perceptions change abruptly [see also UNCTAD 1995b].<sup>10</sup>

It follows that the composition of overall capital inflows may provide relevant insights on the sustainability of external financing and the prospects of becoming involved in globalization. Table 2 reveals that the structure of capital inflows differs significantly between Latin American economies:

- All countries reduced the significance of debt inflows, which clearly dominated external financing until the early 1980s. However, the reduction was modest for Brazil, whose reliance on debt inflows in 1993 was still fairly high by the standards of both Latin America and DCs in other regions. Though to a lesser

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<sup>10</sup> The susceptibility of portfolio investment to transient financial shocks was witnessed by the Mexican crisis of 1994/95. The previous boom was sharply interrupted in 1994, when portfolio equity flows to Latin America came down to 42 percent of the 1993-figure.

Table 2 – Structure of Capital Inflows, 1980-1994 (percent of total net resource inflows)

		FDI	Portfolio equity investment	Debt <sup>a</sup>	Grants <sup>b</sup>
Argentina	1980	19.2	0	80.8	0.1
	1993	34.8	19.9	45.1	0.2
Brazil	1980	28.9	0	70.9	0.2
	1993	6.5	44.6	48.5	0.5
Chile	1980	9.2	0	90.4	0.4
	1993	42.6	17.7	35.9	3.8
Colombia	1980	16.1	0	83.0	0.8
	1993	126.9	19.1	-57.6	11.6
Mexico	1980	24.0	0	75.9	0.2
	1993	22.0	64.2	13.7	0.1
Latin America	1980	20.5	0	77.4	2.2
	1994 <sup>c</sup>	43.6	24.1	26.5	5.8
East Asia and Pacific	1980	10.0	0	81.0	9.0
	1994 <sup>c</sup>	47.2	19.4	30.2	3.1
All DCs	1980	5.9	0	79.4	14.7
	1994 <sup>c</sup>	34.3	17.4	35.0	13.4

<sup>a</sup> Net flows of long-term debt, excluding IMF loans. – <sup>b</sup> Excluding technical cooperation grants. – <sup>c</sup> Projected.

Source: World Bank [1995a].

extent, the same applies to Argentina.<sup>11</sup>

- Yet, Brazil and Argentina differ in an important respect. In the former country, the shift was from debt to portfolio investment, whereas the contribution of FDI to total capital inflows declined tremendously. Argentina relied far less on portfolio investment and significantly more on FDI.

<sup>11</sup> It may be noted that the significance of FDI related to debt conversion had little impact on the degree to which the share of debt in external financing was reduced. As a matter of fact, the share of debt remained relatively high in Argentina and Brazil, although debt conversion figured most prominently in these two countries.

- Mexico's financing structure of 1993 proved to be unsustainable only one year later. The remarkable decline in the share of debt was completely offset by the boom of portfolio investment in the early 1990s. The reliance on the latter was exceptionally high by all standards. At the same time, the share of FDI in total external financing of Mexico remained substantially below that of other DCs, although nominal FDI flows to Mexico were 2.3 times higher in 1993 than in 1980 [World Bank 1995a].
- The structure of overall capital inflows suggests that the prospects to sustain external financing are most favorable in Chile and Colombia.<sup>12</sup> Both countries have drawn on portfolio equity flows to a limited extent. The shift was mainly from debt to FDI. Moreover, as shown before, this shift was primarily due to the increase of "regular" FDI, especially in Colombia. This may further help sustainability.

From the discussion so far it appears that, among major Latin American economies, Chile and Colombia were relatively successful in attracting foreign investors in a way which supports the sustainability of external financing as a whole. Moreover, the available evidence indicates that some smaller economies such as Costa Rica also performed fairly well. In sharp contrast, Brazil experienced a serious setback in participating in globalized production through close international investment relations. The recent position of Argentina and Mexico proved more ambiguous. As witnessed by the financial crisis of 1994/95, an inherently unstable structure of external financing had emerged in Mexico in the early 1990s. In the case of Argentina, it may be open to question whether FDI

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<sup>12</sup> Changes in the structure of external financing in Costa Rica have much in common with Colombia. In both countries, net flows of long-term debt turned significantly negative. As a result, FDI inflows exceeded total net resource inflows. Another similarity concerns the emergence of grants as a relevant source of external finance.

growth can be maintained in the longer run, when FDI related to debt conversion and privatization is fading away.

## V. The Role of Economic Policy

The different performance of Latin American economies in attracting FDI is largely determined by economic policies pursued by the governments of these countries. In order to substantiate this contention, three policy areas are addressed in the following:

- the regulatory regime governing FDI,
- transaction cost-related impediments to a closer integration into corporate globalization strategies, and
- major aspects of the overall policy environment.<sup>13</sup>

As concerns the FDI regime, recent survey results point to far-reaching liberalization of regulations in various Latin American economies [see also IDB and IRELA 1996: 27]. According to an assessment by the ERT [1993a; 1993b], the scope of remaining impediments to FDI (as of 1992) is low by international standards, for example, in Argentina, Mexico, and Colombia.<sup>14</sup> Among the Latin American countries analyzed by ERT, only Brazil is somewhat lagging behind. Even for Brazil, however, FDI restrictions are not considered excessive after considerable improvements in the late 1980s and early 1990s.

Major findings of the ERT survey are corroborated by an evaluation of various elements of the FDI regime in Latin America, as compared with Asian

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<sup>13</sup> A detailed evaluation of policies pursued in these areas is beyond the scope of this paper. We focus on issues which appear to be of considerable relevance in the context of FDI and globalization. This qualification refers particularly to the overall policy framework.

<sup>14</sup> Chile is not included in the ERT reports. Argentina and Mexico are given credit for extensive improvements in FDI conditions during 1987-1992.

competitors for FDI (Table 3). On average, the regulatory regime turns out to be more favorable to FDI in Latin America than in Asia. A notable exception concerns investment protection (column 6), which is considered insufficient especially in Brazil, Mexico and Venezuela. Brazil and Venezuela are relatively restrictive in other respects as well.<sup>15</sup>

As a result, the overall assessment is least favorable for these two Latin American countries (column 7). Even for them, however, the regulatory FDI regime does not constitute a considerable competitive disadvantage vis-à-vis major recipients of FDI in Asia. Argentina, Chile and Peru are at the top of the ranking in Latin America.<sup>16</sup> All in all, the FDI regime in Latin America appears to have converged at a lower regulatory level. The remaining differences are probably too small to account for the contrasting experience in attracting FDI.

Latin America compares less favorably with Asian DCs when it comes to transaction cost-related barriers to FDI. As mentioned in Section II, globalization has been supported by the general decline in transaction costs. It follows that countries in which transaction cost-related barriers to FDI continue to be relatively high are less likely to benefit from globalization. According to survey results summarized in Table 4, it is in several respects that Latin America suffers from competitive disadvantages in terms of transaction costs vis-à-vis the control

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<sup>15</sup> Compared with other locations in Latin America, it is regarded as difficult to acquire control in a domestic company (Brazil: column 1), to employ foreign skills (both countries; column 3), and to negotiate cross border ventures (both countries; column 5).

<sup>16</sup> Colombia and Mexico rank in a medium position. Colombia scores below the Latin American average with regard to the frequency of strategic alliances (column 4) and government interference with negotiations on cross border ventures (column 5). The result for Mexico is somewhat in conflict with the more favorable assessment by the ERT.

Table 3 – Survey Results on the FDI Regime in Latin America<sup>a</sup>

	(1) Acquisition of control	(2) Equal treatment	(3) Employ- ment of foreigners	(4) Strategic alliances	(5) Cross border ventures	(6) Invest- ment protection	(7) Overall assess- ment
Argentina	9.6	8.6	9.2	7.2	9.4	6.5	8.4
Brazil	7.0	7.9	7.1	6.7	6.8	5.1	6.8
Chile	8.8	8.2	8.4	7.1	8.6	6.9	8.0
Colombia	7.9	7.6	8.2	5.7	7.1	6.1	7.1
Mexico	7.4	7.2	7.5	7.3	7.8	5.1	7.1
Peru	8.7	8.2	9.0	5.7	9.0	7.3	8.0
Venezuela	7.9	6.9	7.0	6.1	6.4	3.7	6.3
Latin America <sup>b</sup>	8.2	7.8	8.1	6.5	7.9	5.8	7.4
Asian DCs <sup>c</sup>	6.4	6.9	6.2	7.1	7.0	6.5	6.7

<sup>a</sup> Survey results are scaled from 0 (least favorable to FDI) to 10 (most favorable to FDI). The criteria listed are as follows:

- (1) Foreign investors may not acquire (0)/are free (10) to acquire control in a domestic company.
- (2) Foreigners are not treated (0)/are treated (10) equally to citizens in all respects.
- (3) Immigration laws prevent (0)/do not prevent (10) your company from employing foreign skills.
- (4) Strategic alliances are not common (0)/are common (10) between domestic and foreign firms.
- (5) Cross border ventures cannot be negotiated with foreign partners without government imposed restraint (0)/can be negotiated freely (10).
- (6) Investment protection schemes are not (0)/are available for most foreign partner countries (10).
- (7) Average assessment according to criteria (1)-(6).

<sup>b</sup> Average for seven Latin American economies. — <sup>c</sup> Average for China, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, and Thailand.

Source: World Economic Forum [1995].

group of Asian DCs.<sup>17</sup> Most notably, Latin America appears to be lagging behind Asian standards as concerns the development of technological infrastructure (row 11). This may represent a serious bottleneck to a closer integration into corporate globalization strategies, considering that the transfer and application of

<sup>17</sup> Latin America enjoys a significant competitive edge over Asian DCs in just one area, namely access of foreign companies to local capital markets. This reduces financial transaction costs for FDI projects that rely on local co-financing to a considerable extent.

Table 4 – Transaction Cost-Related Barriers to FDI in Latin America<sup>a</sup>

	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela	Latin America <sup>b</sup>	Asian DCs <sup>a</sup>
(1) Cultural barriers	8.0	8.2	7.8	7.4	6.7	7.8	7.6	7.6	7.2
(2) Country image	6.2	3.5	6.7	2.7	3.5	4.1	5.6	4.6	5.1
(3) State control	7.4	4.0	5.0	6.2	5.6	6.2	2.3	5.2	5.5
(4) Transparency	4.7	4.5	5.2	3.8	2.1	4.7	1.6	3.8	5.1
(5) Bureaucracy	4.1	2.7	3.9	4.6	2.0	3.3	1.8	3.2	4.0
(6) Corruption	3.1	3.1	6.9	2.4	2.0	4.1	1.9	3.4	4.1
(7) Lobbying	4.6	3.9	5.6	3.8	4.9	5.8	3.1	4.5	4.8
(8) Local capital markets	9.1	7.0	8.2	7.8	6.3	8.4	7.2	7.7	6.5
(9) Distribution system	4.5	5.0	7.0	4.0	4.4	4.7	4.2	4.8	5.4
(10) Telecommunications	5.6	5.3	9.0	4.9	5.0	5.5	4.5	5.7	6.3
(11) Technological infrastructure	3.8	4.2	5.9	2.3	2.8	3.7	3.3	3.7	5.0
(12) Overall assessment	5.6	4.7	6.5	4.5	4.1	5.3	3.9	4.9	5.4

<sup>a</sup> Survey results are scaled from 0 (least favorable to FDI) to 10 (most favorable to FDI). The criteria listed are as follows:

- (1) National culture is closed (0)/open (10) towards foreign cultures.
- (2) Image of your country abroad is distorted (0)/reflects reality accurately (10).
- (3) State control of enterprises distorts (0)/does not distort (10) fair competition in your country.
- (4) The government does not often communicate its intentions successfully (0)/is transparent towards citizens (10).
- (5) Bureaucracy hinders (0)/does not hinder (10) business development.
- (6) Improper practices (such as bribing or corruption) prevail (0)/do not prevail (10) in the public sphere.
- (7) Lobbying by special interest groups distorts (0)/does not distort (10) government decision making.
- (8) Local capital markets are not accessible to foreign companies (0)/are equally accessible to domestic and foreign companies (10).
- (9) Distribution systems are generally inefficient (0)/efficient (10).
- (10) Telecommunications infrastructure does not meet (0)/meets business requirements very well (10).
- (11) Technological infrastructure is developed slower (0)/faster (10) than in your competitor countries.
- (12) Average assessment according to criteria (1) - (11).

<sup>b</sup> Average for seven Latin American economies. — <sup>c</sup> Average for China, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, and Thailand.

Source: World Economic Forum [1995].

internationally available technologies depend on the availability of complementary factors of production in the recipient country.<sup>18</sup> A similarly large discrepancy between the two regions prevails with regard to transparency of public decision making (row 4). Lack of transparency, which is considered most serious in Mexico and Venezuela, obviously translates into higher information and transaction costs. The same applies to bureaucratic interference with business decisions (row 5) and the prevalence of corruption (row 6). Finally, higher transaction costs may result from less advanced distribution and telecommunications systems in Latin America (rows 9 and 10).<sup>19</sup>

Taken as a whole, Table 4 indicates that Chile has been most successful in reducing transaction costs, which helps to explain its favorable performance in attracting FDI. Likewise, FDI flows to Argentina have probably been encouraged by rather low transaction cost-related barriers to FDI. Nevertheless, the strikingly different pattern of FDI flows to Latin American economies can be attributed only partly to differences in transaction costs. For instance, transaction costs appear to be of similar significance in Brazil and Colombia, while these two countries recorded opposing trends in FDI inflows.<sup>20</sup>

The impact of FDI regulations and transaction cost-related variables was probably dominated by the overall policy environment prevailing in the host countries of FDI. Major factors shaping the competitive position of DCs in globalized production concern (i) macroeconomic stability, (ii) investment in physical and human capital, and (iii) openness towards world markets.<sup>21</sup>

<sup>18</sup> Technological infrastructure is considered deficient especially in Colombia, whereas Chile is more advanced in this respect than the group of Asian DCs.

<sup>19</sup> In both respects, Chile is again considered most competitive. Colombia and Venezuela represent the tailights of the ranking in Table 4.

<sup>20</sup> Moreover, Table 4 reveals higher transaction costs in Mexico than in Brazil, although Mexico performed much better than Brazil in attracting FDI.

<sup>21</sup> For a more detailed discussion, see Gundlach and Nunnenkamp [1996].



Comparative evidence for these factors, as portrayed in Table 5, reveals why Latin America as a whole has been less successful in attracting FDI than Asian DCs, and why some Latin American economies are well ahead of their neighbors in competing for FDI.<sup>22</sup>

Table 5 – Selected Indicators of the Overall Policy Environment

	Inflation <sup>a</sup>	Investment <sup>b</sup>		Schooling <sup>c</sup>	Openness <sup>d</sup>
		1985-89	1990-93		
Argentina	374.3	17.7	15.9	6.6	8.5
Brazil	423.4	22.5	20.6	3.5	6.0
Chile	20.1	19.7	23.7	6.3	8.8
Colombia	24.9	18.0	16.3	4.6	8.3
Costa Rica	22.1	19.4	21.3	5.4	n.a.
Mexico	57.9	19.1	19.8	4.1	7.4
Peru	316.1	18.2	15.3	5.7	8.8
Venezuela	23.9	19.8	18.1	5.4	4.7
Latin America <sup>e</sup>	157.8	19.3	18.9	5.2	7.5
Asian DCs <sup>f</sup>	6.8	25.0	30.3	5.6	6.7

<sup>a</sup> Annual average for 1980-1993 in percent. — <sup>b</sup> Annual average in percent of GDP. — <sup>c</sup> Average years of schooling of the working age population in 1985. — <sup>d</sup> Survey results scaled from 0 (national protectionism prevents foreign products and services from being imported) to 10 (national protectionism does not prevent foreign products and services from being imported). — <sup>e</sup> Average for the listed Latin American economies. — <sup>f</sup> Average for China (except investment and schooling), Hong Kong (except investment), India, Indonesia, Malaysia, Philippines, Singapore (except investment), South Korea, Taiwan (except inflation and investment), and Thailand.

Source: World Bank [1995b]; Glen and Sumlinski [1995]; Gundlach [1995, Table A1]; World Economic Forum [1995].

Macroeconomic stability, notably the absence of high and volatile rates of inflation, is the first indicator of a business environment which is conducive to

<sup>22</sup> An earlier assessment of economic policies in highly indebted Latin American countries revealed "a nearly perfect correspondence between the degree of reform-mindedness and the attractiveness ... for foreign capital" [Nunnenkamp 1993: 93; see also Nunnenkamp 1994].

becoming involved in corporate globalization strategies [see also Hiemenz, Nunnenkamp et al. 1991]. High inflation reduces the informational content of relative price changes, and results in higher investment risks and misallocation of resources. In sharp contrast to Asia, which is well reputed for macroeconomic stability, inflation was excessively high in various Latin American economies in the past. Only Chile, Colombia and Costa Rica have a longer tradition of preventing annual inflation rates from exceeding the 20 percent mark considerably.<sup>23</sup> It is probably not just by pure coincidence that exactly these countries were most successful in attracting FDI in a sustainable way. Mexico and Argentina regained attractiveness precisely when comprehensive stabilization programs were launched, whereas FDI dwindled in Brazil where excessive inflation was not tackled until recently [see also IDB and IRELA 1996: 31-32].

A similar pattern prevails with respect to investment in physical and human capital. This is not surprising: Investment can be expected to be higher in a stable macroeconomic environment, which tends to contain investment risk in the longer run. Gross fixed capital formation, in percent of GDP, has traditionally been high in low-inflation Asia. The investment ratio of many Asian DCs rose further in the early 1990s. Likewise, human capital formation (measured by average years of schooling) is more advanced in Asia than in Latin America.<sup>24</sup> Consequently, the former region had better prospects to participate in globalized production. A qualified workforce, and high and rising investment ratios improved the host

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<sup>23</sup> Inflation was much more volatile in Venezuela. For annual rates of inflation in the Latin American countries under consideration, see ECLAC [1995, Table A.3].

<sup>24</sup> The discrepancy between the two regions becomes more pronounced when human capital formation is measured by secondary school enrollment ratios in 1992. The World Bank [1995b] reports an average enrollment ratio of 47 percent for seven Latin American countries (no data available for Argentina), while the ratio was 55 percent for seven Asian DCs (no data available for Hong Kong, Singapore and Taiwan). Data on average years of schooling are drawn from Barro and Lee [1993], as reported in Gundlach [1995].

countries' endowment with complementary factors of production, and encouraged the diffusion and application of new technologies.

Compared with Asian DCs, "foreign investment has all too often substituted for, rather than supplemented, the development of a domestic investor base" in Latin America [The Economist 1995: 9]. Yet, the (physical and human) investment record varies significantly between individual countries:

- The share of gross fixed capital formation in GDP was declining in Brazil, but remained above the Latin American average. As concerns human capital formation, however, Brazil was clearly lagging behind other Latin American countries.
- Chile is again the top performer; rising physical capital formation resulted in the highest investment ratio within the region, and the country ranked next to Argentina in terms of human capital formation.<sup>25</sup>
- The indicators of physical and human capital formation also suggest that Costa Rica is relatively competitive in these respects. By contrast, the indicators are in striking contrast with Colombia's favorable performance in attracting FDI.
- The evidence for the remaining sample countries is more ambiguous. Argentina, Peru and Venezuela are above or very close to Asian standards in terms of average years of schooling, while all three countries are characterized by rather low and declining investment ratios.<sup>26</sup> Mexico's position is relatively favorable with regard to the investment ratio, but fairly weak with regard to schooling.

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<sup>25</sup> Secondary school enrollment in Chile (72 percent) was exceptionally high by Latin American standards.

<sup>26</sup> Human capital formation is considerably less advanced in Peru and Venezuela when measured by secondary school enrollment ratios [World Bank 1995b].

Finally, openness towards world markets may shape the prospects to attract FDI. On analytical grounds, the relation between the trade regime and FDI is not straightforward. On the one hand, FDI provides a means to jump over protectionist fences. On the other hand, the theory of optimal timing of FDI suggests that FDI follows trade and replaces exports, once foreign companies have reached a certain market share in potential investment locations. In several empirical studies, however, the correlation between trade and FDI turned out to be significantly positive.<sup>27</sup> This supports the view that both trade and FDI flows are driven by a common set of determinants.

The relevance of openness towards world markets is increasing under conditions of globalized production. DCs which restrict imports of capital goods and trade in intermediate and final goods are rather unlikely to become integrated into international sourcing and marketing networks. Conversely, DCs which avoided persistent discrimination against world market-oriented activities, such as various Asian economies, have emerged as preferred FDI locations; this, in turn, has contributed to sustained export growth [Agarwal et al. 1995].

As concerns Latin America, notable changes in the trade regime have taken place in many countries. According to recent survey results, Latin America is indeed considered more open, on average, than the control group of Asian DCs (Table 5). At the same time, the significance of protectionism continues to vary greatly within the region. Venezuela and Brazil are perceived to be most restrictive in this respect. By contrast, Argentina, Chile, Colombia and Peru are fairly open by international standards. Chile in fact ranked fifth within a sample of 48 industrialized and developing countries analyzed by the World Economic Forum [1995]. On the whole, the survey results on the significance of import protection

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<sup>27</sup> For a detailed evaluation, see Nunnenkamp et al. [1994: 82-88].

in Latin America are in line with the proposition that relatively open economies enjoy better prospects to regain attractiveness for FDI.

## VI. Summary and Conclusions

Latin America has made considerable progress in restoring its attractiveness for FDI. Nevertheless, the prospects to participate successfully in ongoing globalization remain clouded by uncertainty in several respects. First of all, some economies in the region have suffered from a serious setback in competing for FDI. Brazil exemplifies the costs in terms of forgone FDI that arise from persistent muddling-through, insufficient reform-mindedness, and lack of government credibility. For other economies, the sustainability of FDI growth is still at risk. This applies to countries such as Argentina, where the recent boom of FDI was mainly due to special factors such as privatization and debt conversion. Moreover, Mexico's financial crisis in 1994/95 testifies the susceptibility of capital inflows to changing risk perceptions of foreign investors. Such changes may occur abruptly once policy inconsistencies become obvious, for example, in the context of exchange rate-based stabilization programs.<sup>28</sup>

Domestic economic policy is of overriding importance for explaining why Latin America as a whole has lost ground vis-à-vis Asian competitors for FDI, and why some Latin American economies have been more successful than others in restoring their locational attractiveness. DCs are no longer free to pursue economic policies of their own liking in the era of globalized production. The dismal experience of Brazil strongly suggests that policy constraints are binding not only for small countries, but also for economies offering huge domestic markets:

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<sup>28</sup> For a detailed account of the risks and inconsistencies entailed in Mexico's exchange rate-based approach towards macroeconomic stabilization, see Langhammer and Schweickert [1995].

- Countries being reluctant to follow the worldwide trend towards liberalization of FDI regulations run the risk of being delinked from corporate globalization strategies.
- High transaction costs (e.g., resulting from government interference with business decisions, lack of transparency, and inadequate infrastructure) tend to discourage FDI inflows.
- Countries characterized by macroeconomic instability, low investment in physical and human capital, and a restrictive trade regime are most likely to fail in attracting FDI.

The general trend towards reform notwithstanding, significant differences persist as to the extent to which Latin American economies have fulfilled the prerequisites to becoming part of global sourcing and marketing networks. These differences are clearly reflected in country-specific FDI developments. Countries such as Chile which have made substantial progress in improving the policy environment for FDI were most successful in attracting FDI in a sustainable way. From this account, the current challenges and future risks concerning Latin America's integration into globalized production are more or less obvious.

Most importantly, governments bear major responsibility for creating and maintaining a policy environment that is conducive to FDI. Macroeconomic stability is primarily a matter of government budget discipline. The rate of investment depends on business taxation, government regulations and the efficiency of public infrastructure. The amount of compulsory formal education reflects the government's attitude towards the provision of public goods. Openness towards world markets requires governments to resist the demand for protection by special interest groups.

In other words, attractiveness for FDI critically depends on economic policies pursued at the national level. This is not to deny that the recent revival of regional

integration may provide an additional stimulus to FDI in Latin American economies being part of integration schemes. The envisaged formation of NAFTA encouraged FDI flows to Mexico at the beginning of the 1990s already. However, regional integration *per se* is unlikely to enhance the locational attractiveness of Latin American economies. The Mexican example rather suggests that domestic reforms are a prerequisite to successful regional integration. Hence, regional integration must not be regarded as a substitute for improved investment conditions at the national level.

Latecomers in economic policy reform might face an uphill struggle against competitors which are presently absorbing the bulk of FDI flowing to DCs. However, the relevant question is whether any promising alternative to macroeconomic stabilization, physical and human capital formation, and an open trade regime exists. The Brazilian example clearly suggests a negative answer. Furthermore, international competition for FDI is not a zero-sum game [Bergsman and Lall 1995]. Hence, if a country such as Brazil were to restore its attractiveness for foreign investors, *additional* FDI might be the result, rather than Brazil having to divert FDI from other locations.

Yet, FDI inflows must not be considered a substitute for domestic capital formation. While globalization tends to spur international capital mobility, there are few examples of large and sustained net capital inflows even among the most successful Asian DCs. Empirical evidence indeed suggests that countries are essentially constrained by their own domestic savings [see also Feldstein 1995]. Consequently, Latin American countries have to raise more domestic savings in order to ease constraints on physical and human capital formation, which in turn would help to fully exploit the potential for FDI.

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