

Rethinking Foreign Investment for Sustainable Development

Lessons from Latin America

Edited by

KEVIN P. GALLAGHER
DANIEL CHUDNOVSKY

Foreword by

JOSÉ ANTONIO OCAMPO



ANTHEM PRESS
LONDON · NEW YORK · DELHI

FOREWORD

This volume is a major contribution to a growing body of literature that questions the assumptions of market reforms undertaken in Latin America in recent decades, on the basis that market reforms did not deliver on their basic promise: rapid economic growth. Indeed, even when we take into account the recent period of exceptional conditions in international commodity and capital markets that has facilitated rapid growth in Latin America since 2004, the rate of GDP growth in the region has been 3.3 percent from 1990 to 2007 (and only 2.5 percent if the point of reference is 1980), far short of that achieved during the phase of import-substitution industrialization—or, as I prefer to call it, state-led industrialization—when Latin America grew at an average rate of 5.5 percent a year. Another set of criticisms relates, of course, to the disappointing social effects of market reforms. Again, a simple reflection of this fact is that only in 2005 did Latin America return to the poverty levels of 1980—i.e., the region experienced not a decade, but a quarter century lost in terms of poverty reduction.

The volume concentrates on one of the major aspects of the globalization and liberalization processes: the growing role played by multinational corporations (MNCs) and the opening up of the Latin American economies to foreign direct investment (FDI). Drawing on case studies from about half of the countries in the region, it explores the determinants of FDI, the role that it has played in advancing environmental sustainability, and some political economy issues associated with such investments. The editors are correct in claiming that the volume, for the first time, collects, synthesizes and analyzes in the English language the rich academic and policy discussions that have taken place in Latin America over the past two decades on these issues, and asks for a fundamental rethinking of the role of FDI in development.

I thus feel deeply honored to have been asked to write this forward. I am, furthermore, deeply moved by the fact that one of its editors and a dear friend, Daniel Chudnovsky, died shortly after this book was finished. I thus write this forward in his memory.

A Bit of History

The relations between FDI and development in Latin America have a long history, which has been the subject by heated economic and political debates. Latin America was very open to foreign investment since Independence, and all countries in the region actively promoted FDI in the nineteenth and early twentieth centuries, particularly in the exploitation of natural resources and the development of its infrastructure.

Later, largely as a result of the major slowdown of world economic growth and commodity prices in the interwar period, and the virtual collapse of the world economy in the 1930s and during the Second World War, development patterns became much more inward-oriented. Initially, such a reorientation was, therefore, more a result of external circumstances than of policy design. However, it turned gradually into an explicit development strategy, which was rationalized in the early postwar years by the United Nations Economic Commission for Latin America and the Caribbean (CEPAL, for its Spanish acronym).

Interestingly, although the state-led industrialization strategy that emerged took a mixed view on the opportunities that natural resource-based exports provided for development, such pessimism was initially *not* extended to foreign direct investment. Indeed, a policy of promoting investment by MNCs in new industrial activities became a central ingredient of state-led industrialization in Latin America. FDI was furthermore seen as a reliable source of private external financing in a world economy that offered, in the early postwar years, few opportunities of that sort. However, many countries in the region simultaneously took an increasingly hard line against the more traditional forms of foreign investment in natural resources and infrastructure, which were seen with skepticism in terms of development in the first instance, and the natural domain of the state in the case of infrastructure. The purchase by Perón of British investments in the Argentinean railroads was a landmark in this regard. Thus, during the early years of state-led industrialization, Latin America did not reject FDI, so long as it contributed to its industrialization.

The revalorization of the role of exports, particularly since the 1960s, was accompanied by a more mixed view of foreign direct investment. This was reflected in the limits placed on royalties and profit remittances, associated with the view that MNCs were getting excessive benefits from their investments in the region and the partial or full nationalization of foreign investment in natural resources and, in some case, other sectors. The nationalizations of the copper industry in Chile and of the oil industry in Venezuela in the early 1970s were some of the most important manifestations of this process, as the nationalization of the oil industry in Mexico in 1938

had been an earlier landmark.¹ But, contrary to the usual criticism that Latin American had underutilized the opportunities provided by FDI during its period of state-industrialization, the opposite is actually true, as reflected in the fact that in 1973–1981 Latin America received close to 70 per cent of all FDI flows to the developing world.²

Market Reforms and FDI

The liberalization process opened up the economies of the region to foreign direct investment, with very few exceptions. Foreign investment became intrinsically tied with the emerging patterns of integration into the world economy, which broadly followed two dominant patterns. A “Northern” regional pattern, shared by Mexico, several Central American and some Caribbean countries, is characterized by manufacturing exports with high content of imported inputs (in its extreme form, *maquila*), mainly geared towards the United States market. This pattern goes hand in hand with traditional agricultural exports and agricultural export diversification in Central America, as well as the growth of tourism in Mexico and the Caribbean. The “Southern” pattern, typical of South American countries, is characterized by a combination of extra-regional exports of commodities and natural-resource-intensive (and, in many cases, also capital-intensive) manufactures, and active intra-regional trade dominated by manufactures. In the case of Brazil, this has been mixed with some technology-intensive manufactures and services. There is also a third pattern of specialization, in Panama and several Caribbean economies, in which service exports (financial, tourism and transport services) predominate.

The “Northern” specialization pattern attracted MNCs actively involved in internationally integrated production systems, whereas in South America, investment has concentrated in services and natural resources. In the terminology of this volume, whereas the first pattern attracted more “efficiency-seeking” investments, the latter was more biased towards “natural resource-seeking” and “market-seeking” foreign investments. FDI has included large shares of acquisitions of existing assets, first through privatization and then through private buyouts. A corollary of this process was the rapid increase in participation of foreign firms in production and sales, at the expense of public-sector firms in the first half of the 1990s, and of both public and private firms in the second half.³

The liberalization process was also accompanied by the transformation of large domestic firms into foreign investors, mostly to other countries in the region, but in the case of a few large firms, into global players. This involved,

interestingly, some firms that remained totally or partially state-owned. The Mexican and, with some lag, the Brazilian firms became the largest players in this game, but some Chilean and Colombian companies were also important in the regional arena.

A simple way to understand why this very active and, in a sense, successful process of export development and inward and outward investment did not generate rapid overall economic growth is that the multiplier effect and the technological externalities generated by these high-growth activities have been weak.⁴ Indeed, in many cases the new dynamic activities became mere “enclaves” of globalized production networks with few links with the rest of the countries where they were located.

Slow growth was therefore matched by poor productivity performance. Productivity did increase in dynamic firms and sectors. However, contrary to the expectations of reformers, positive productivity shocks did not spread. The growing number of “world-class” firms, many of them subsidiaries of MNCs, was therefore accompanied by the growth of low-productivity informal-sector activities, which accounted for seven out of every ten new jobs created in Latin American urban areas over the 1990s and most of them during the “lost half-decade” of 1998–2003. This pattern was only reversed during the boom that started in 2004. This growing dualism in productive structures also reflects the fact that restructuring was not neutral in terms of its impact on different economic agents, and had therefore deep distributive effects.

The Contributions of This Volume

On this background, the authors of this volume analyze whether the promise of reformers that opening to FDI would become a source of dynamic growth has been fulfilled. Beyond directly boosting exports and economic activity, the hope was that MNCs would bring knowledge spillovers that would build the skill and technological capacities of local firms, as well as the diffusion of the best environmental practices in the world. The real prize in FDI was, in this sense, the potential for “spillovers” in the form of human capital formation, demonstration and competition effects, backward and forward linkages and improved environmental standards.

The authors first analyze the determinants of FDI into the region during the liberalization period. Interestingly, they find that some of the most significant determinants of FDI flows to the region in recent decades—market size and economic growth and, therefore, market access—were similar to the determinants of those investments during the period of state-led industrialization. A second determinant was more specific to the recent phase

of development: export orientation. As pointed out previously, this factor affected not only the quantity but also the nature of investments into specific countries. Political and macroeconomic stability also played a role, as reflected in the latter case by the negative association between FDI and the level of inflation and/or the level of external debt of the receiving country.

Interestingly, however, the authors do not find strong evidence that trade and investment agreements have an independent effect on FDI flows in the region, putting into question the benefits of the boom of regional and bilateral trade and investment agreement (RBTIA) that has taken place in the region. At best, they argue, the impact of bilateral investment treaties (BITs) on FDI is small and secondary to the effects of other determinants, especially market size. They also find no evidence that Latin America's relatively weaker environmental regulations vis-à-vis those of industrial countries served as an independent determinant of FDI flows, indicating, in this sense, the region has not been a "pollution haven."

Most importantly, in my view, the authors find what they call "almost unanimous evidence that FDI resulted in very limited productivity spillovers for the region. Indeed, the boom of FDI in the 1990s coincided with a period in which domestic investment actually fell, suggesting, according to one of authors, that FDI could have actually "crowded out" domestic investment, by wiping out locally competing firms—a pattern that is in sharp contrast with the evidence for East Asia. The close analysis of microeconomic and sectoral data indicates, on the other hand, that foreign firms tend to have higher levels of productivity and higher wages, as well as positive effects on trade, but that they fall far short of generating "spillovers" and backward linkages and, as noted, may have even "crowded out" domestic investment. The use of tax incentives to attract FDI is another negative spillover. In terms of the hypothetical effect on macroeconomic stability, particularly of bringing capital flows that are less pro-cyclical, the evidence is also mixed; whereas FDI remained resilient to the recession that started in 1998, this was not true in the early 2000s and its performance over the past two decades has been, broadly speaking, pro-cyclical.

The chapters on FDI and the environment, although somewhat mixed in their conclusions, are, overall, positive in their evaluation of foreign investment. It is found that MNCs play a positive role in transferring clean technology, particularly environmental management systems to countries in the region, and in diffusing some good practices through the supply chain, including labeling schemes. Nonetheless, this seems strongly associated with the environmental standards set by consumer movements in the industrial world—and thus stronger in the case of exports to Europe. On the less positive side, the authors find that the transferred technologies and management practices fell short of

best practice in several cases, and find no evidence that foreign firms are more apt to be in compliance with domestic environmental laws than domestic firms.

The volume ends with two chapters that focus on the changing political economy of FDI and natural resources in the region. The first, associated with the resurgence of the role of the public sector in the hydrocarbon sector in three left-leaning Andean countries, find that MNCs have generally decided to negotiate with new governments instead of making use of the rights to protection and arbitration they acquired during the liberalization phase through bilateral investment treaties. The second, dealing with the conflict between Argentina and Uruguay derived from the installation of large paper-pulp-producing plants in the banks of the frontier river, indicates that the conflict reflects less the true environmental nature of the problem than the weakness of the regional institutions for economic cooperation.

On the basis of this analysis, Gallagher, Chudnovsky and other authors of this volume draw three broad lessons, which I find very appealing. The first is that FDI has the potential to increase exports and competitiveness of firms while also generating technological and other spillovers, but in the absence of appropriate policies, it can also lock a nation into low-value-added assembly manufacturing, create “enclaves” where foreign firms operate on high-productivity islands devoid of spillovers, and even crowd out domestic investment. As a result, the capture of spillovers requires a proactive, coherent government industry policy that upgrades the capabilities of national firms and provides benchmarks for environmental protection. Finally, since the room to maneuver that international agreements provide to do so has been increasingly constrained by international agreements of global (WTO), regional or bilateral character, the authors claim that those agreements should provide developing nations the “policy space” for active domestic policies necessary to foster development, including policies aimed at increasing the benefits from FDI.

A Broader Reading of These Results

This leads me to some considerations on the role of FDI in the process of global convergence or divergence of levels of development, which was analyzed in the United Nations report that I had the opportunity to coordinate, together with other colleagues.⁵ The report argued that the specific strategies that countries follow to integrate their economies into the global markets for goods and services, and to attract foreign investment, largely determine the extent of the benefits those countries derive from enhanced trade and investment flows. Particularly important in this regard is whether production for the world market and by MNCs creates sufficient

linkages with other domestic sectors and firms, so that these activities allow for a dynamic transformation of the economy. In this context, FDI, when properly managed and incorporated into a strategy aiming at the continuous upgrading of the country's technological capacities, can bring lasting benefits, but success in capturing certain investments (such as assembly tasks) may not lead to rapid or sustained growth if these activities have limited value added. They are also likely to be footloose.

A key determinant of whether or not such FDI will reduce global income inequalities is the establishment of the dynamic investment-export nexus that emerged in the success stories in East Asia and led to a steady diversification of production away from those activities requiring only natural resources and unskilled labour. A good deal depends, as Gallagher and Chudnovsky argue in this volume, on whether FDI brings increased technological and organizational spillovers to developing countries and crowds in local private investment. To date, the evidence does not support the claim that such a nexus exists in most parts of the developing world. Indeed, in many cases, very dynamic investment has been associated with very limited increases in domestic incomes and value added, not least because FDI cross-border linkages are many times strengthened at the expense of domestic ones. One of the reflections of this fact is that FDI and domestic capital formation have been moving in different directions in the 1990s; as FDI flows increased, domestic investment rates declined or stagnated in many parts of the developing world. This is consistent with the evidence that “crowding out” of domestic investment by FDI is more prevalent in the developing world than “crowding in,” and is part of the broader conclusion that, on balance, the empirical evidence of positive spillover effects of FDI is inconclusive. This volume presents strong evidence that these results are valid for Latin America.

The report therefore concludes, as this volume does, that in order to profit from FDI, countries need to have the necessary absorptive capacity among domestic firms and institutions. Countries where an inflow of FDI has been paralleled by significant investments in building domestic capabilities (for example, Singapore and Ireland) have been the most successful in leveraging inward FDI. Conversely, when FDI is attracted in response to major tax incentives, or as a result of trade policy distortions (such as textile and clothing quotas), without a simultaneous buildup of local capabilities and without the creation of linkages between foreign affiliates and local firms, there is limited scope for long-term benefits from FDI. In this sense, *domestic* market integration—including creating the linkages between the activities of FDI with those of domestic firms—is at least as important as integration in international markets, and is indeed essential for the latter to succeed.

The successful post-war experiences of Eastern Asia and its integration into the global economy resulted from well-targeted trade and sectoral policies that constantly and consistently promoted the building up of technological capabilities. The space for these interventions is not absent but has been significantly reduced in recent decades. Therefore, policy space should not be reduced further and perhaps some of the current disciplines need to be reassessed in terms of their true value for development.

José Antonio Ocampo