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LATIN AMERICA IN A CHANGING GLOBAL ENVIRONMENT

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RESUMO

Este artigo discute as interações entre as tendências dos fluxos globais de comércio e investimento direto e as respostas nacionais de política econômica na América Latina. A análise é conduzida em dois níveis distintos, mas complementares. Em um primeiro nível discute-se o impacto provável da evolução do sistema mundial de comércio e dos fluxos globais de investimento direto sobre a região. Em um nível complementar, o artigo discute como estes condicionantes exógenos influenciarão a formulação das reformas de política comercial doméstica e, portanto, conformarão novos padrões de integração da América Latina na economia mundial.

ABSTRACT

This paper discusses the interactions between trends in global trade and FDI flows and national policy responses in Latin America. The analysis is conducted at two distinct but complementary levels. In a first level, the ways in which the likely evolution of the world trading system and of global FDI patterns are likely to affect the region are discussed. In a complementary level, the paper discusses how these exogenous conditionants will influence the design of domestic trade policy reform and thus shape new patterns of Latin America's integration into the world economy.

1. Introduction

There seems to exist today a wide consensus that, over the past decade, the interaction of structural factors - associated with the recent acceleration in the rythm and nature of technical and organizational change in the OECD - with a potentially unstable global macroeconomic environment increased the volatility of the determinants of international competitiveness. These changes decisively alter the strategic decisions of developed countries' governments and internationalised firms, altering both the institutional framework of the world trading system - giving birth to protectionism and greater trade regionalisation - and global patterns of FDI.

As far as Latin America is concerned, this increased environmental volatility in the world economy happens at a time in which, for virtually every country in the region, redesigning national policies with a view to achieve greater participation in global trade and FDI flows is placed very high in the domestic policy agenda. This coincidence is not fortuitous. The current global macroeconomic instability poses a major challenge to balance of payments adjustment in debtor countries which, to a large extent, animates this drive for policy reform. Indeed, although some reduction in the huge current account imbalances among OECD countries generated during the first half of the eighties has been achieved, there is still great potential

instability in world asset markets, and in no medium-term adjustment path towards a more stable equilibrium one is likely to see a significant improvement of the fundamental exogenous determinants of the balance of payments current account of the Latin American countries: OECD growh rates are likely to remain low and real interest rates likely to stay high by post-war standards. As the perspective of meagre financial inflows to Latin America is also almost certain, it is possible to conclude that the vast majority of the countries in the region will continue to face a potentially binding foreign exchange constraint if they return to average post-war growth rates without fundamental structural changes affecting their import and export propensities.

However, as the limitations of further trade adjustment through import compression are today widely recognised, these needed structural changes must contemplate more involvement in world trade and FDI flows. Thus, the ongoing transformations in the patterns of international trade in manufactures and the process of global industrial restructuring are seen as providing opportunities - and, indeed, a sense of urgency - for the overhaul of established defensive trade policies and the redesign of more open strategies of international integration one currently witness throughout Latin America.

This paper discusses the interactions between global trends in trade and FDI flows and national policy responses which

will shape Latin American patterns of integration in the foreseeable future. The analysis is conducted at two distinct but complementary levels. In a first level, the ways in which the likely evolution of the world trading system and of global FDI patterns are likely to affect Latin America are discussed. Thus, Section 2 assesses how protectionism and regionalization - especially the possible increase in regional integration around the EC and the US - may affect the region's export prospects, while Section 3 addresses the impact of globalization and the changing determinants of North-South FDI flows. In a complementary level, the paper discusses how these exogenous conditionants will influence the design of domestic trade policy reform and thus shape new patterns of integration into the international economy. This issue is addressed in Section 4, which argues that distinct but identifiable sub-regional patterns of integration are likely to emerge depending on the peculiarities of the current output structure and the present insertion of groups of Latin American countries in the world economy.

2. Regionalization in the North Atlantic and Latin American trade

The feasibility of a rise in the degree of openess of the Latin American economies with a view to explore the opportunities created by a rapidly growing volume of world trade in manufactures is obviously dependent on the ocurrence of a scenario in which not only competitiveness grows, but that access conditions in the relevant export markets improve. The experience of the more

industrialised countries of Latin America demonstrates that super-competitiveness in a narrow range of labour intensive products generate rates of import penetration which are not compatible with the politically feasible pace of structural adjustment in the large OECD markets, giving rise to protectionist measures generally aimed at single country or product. Thus, although the effects of protectionism can be minimised by domestic policy initiatives aimed at upgrading the export bill, in a medium term perspective market access conditions do matter for export performance.

Although it is difficult to predict the evolution of protectionist pressures in the leading developed countries, its growth as a generalised phenomena in the North Atlantic since the seventies is clearly associated to the small growth rates of domestic demand and exchange rate instability in Europe and the United States. During the second half of the eigthies, sustained OECD growth and the progressive realignment and relative stability of exchange rates gave a decisive contribution to reduce the widespread fears of growing protectionism. As far as Latin America is concerned, these trends could be consolidated if effective progress is eventually achieved in the Uruguay Round in areas of export interest to the region, such as tropical products, temperate agriculture and greater discipline and multilateral surveillance in the application of non-tariff barriers - especially VERs and anti-dumping actions - typically used against exports of manufactures from developing countries.

However the uneventful ending of the Brussels GATT ministerial meeting of December 1990, which was supposed to conclude the Uruguay Round, did not sustain high hopes of a bright outcome for the current multilateral trade negotiations and leaves open some crucial questions concerning the evolution of the institutional framework of the world trading system. The most likely scenario in the near term, as Lawrence (1991) argues, is a renewed impetus to regional integration around the large markets of the US, the EC and Japan. However, whether this will be a step towards greater liberalization will depend on whether the trading regions can be formed as "building blocs that are subsequently connected to form a more open integrated global unit."[1].

In principle there are no reason to believe that the move towards regionalisation is indicative of a possible weakening of the multilateral trade system, or that the multilateral system would break into three large protectionist blocs with strongly negative effects on access conditions facing Latin American exports to those markets. This is certainly true of the integration processes outside Europe. On the one hand, the most recent concrete development in United States drive towards the formation of free trade areas has specifically contemplated the

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1 R.Z. Lawrence (1991), p 26.

building of an Hemispheric free trade zone under the so-called Bush Initiative. Although it is difficult to believe - as argued below - that such ambitious aim will materialize in the near term, the free trade offer contained in the Bush Initiative raises the market access prospects of Latin American exports and is not incompatible to the continued adherence to the basic rules of the multilateral trade system. On the other hand, it is rather difficult to believe that the natural process of integration taking place in the Pacific basin - a result of rapid industrialization of the peripheric economies of the region and the wave of Japanese FDI in response to structural adjustment pressures created by rising wages and yen appreciation[2], and in which high rates of growth prevail - can have negative diversion effects on Latin American trade of the kind usually associated to the formation of a discriminatory bloc. In fact, the "threat" of the integrated Pacific basin stems from the productivity gains to be reaped by firms located in the area. This is something quite different from a protectionist threat, since it can be countervailed by compensating productivity increases in their trade partners.

Both the background and the consequences of European integration are somewhat different. The agreement on the Europe 92

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2 See Urata (1991).

White Paper by June 1985 and its ratification in July 1987 is a natural development of past trends towards the consolidation of what by any definition is already a trading bloc. The step now being taken by the EC-12 is to try and reduce - or, if possible abolish - existing non-tariff restrictions on intra-Community trade. This move is a strategic response to the perceived relative decline of intra-Community trade in manufactures vis à vis that with non-members since the seventies - or, in European jargon, the slowing down of the process of integration[3] - which has already gained a momentum of his own. Thus, not only one increasingly hear of prospects for the expansion of the EC-EFTA arrangements into a customs union as well as for closer economic ties between the EC and Eastern Europe, as there are fears - to be discussed in greater detail below - that structural adjustment costs of this last step towards European economic integration may lead to increased protection against third parties.

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[3] It is true that the evolution of the share of imports in apparent consumption of manufactures shows that, on the whole, integration has slowed down since the late seventies. The reasons for that, however, are not at all clear. This phenomenon could, as argued by Jacquemin and Sapir (1988), have been caused by greater impediments to intra-EC trade than those affecting EC trade with the rest of the world. Indeed, this argument supported the widely held notion that Europe was lagging behind the US and Japan in terms of competitiveness in new industries and that the negative effect of internal impediments to trade on optimal scales was to blame. However, Neven and Roller (1990, p 26) have shown that existing NTBs in the Community hamper more its trade with the rest of the world than intra-EC trade. This suggests that the cause of slower integration might lie in the increased competitive advantage of non-members.

Because of Latin America's much greater commercial integration with Europe and the United States than with the Pacific Rim countries, the relevant aspects of regionalization of world trade lie in developments in the North Atlantic, that is, the evolution of the Bush Initiative and the impacts of Europe-92. However, the issues arising from the formation or consolidation of these two blocs are quite different. Europe-92 is seen as potentially trade diverting - and, therefore, as a threat. On the other hand, the vision of a Western Hemisphere free trade area extending, as President Bush put it, from the port of Anchorage to Tierra del Fuego, can only evoke bright prospects as far as market access is concerned. However, by implicitly contemplating trade reciprocity among widely different countries in terms of size and factor endownments, it raises important issues relating to structural adjustment in member countries. The rest of this section deals separately with the issues arising in these two distint contexts. Section 2.1 evaluates the impact of EC-92 on Latin American exports. Section 2.2 assesses the likely outcome of the Bush Initiative.

2.1. Europe 92 and Latin American exports

The reduction of current non-tariff impediments to intra-Community trade may have three distinct effects on exports from non-members. The first is a pure static diversion effect, as the liberalization process increases the competitiveness of EC suppliers within the community. The ex-ante magnitude of the impact depends, basically, on the size of the existing barrier among the EC countries, the relevant price elasticities of demand and on the size of current trade flows.

The second stems from the rise in Community incomes occurring both from the once and for all effect of trade liberalization on the allocation of resources as well as from dynamic effects, especially those arising from faster productivity growth. The Cecchini Report[4] estimated the former as causing an increase in the range of 2.5% to 6.5% of the EC GDP, depending on hypotheses made about the extent of liberalization and underlying macroeconomic conditions. The accuracy of these estimates has been criticised by R. Baldwin[5], who claims that the Report may have severely underestimated the output growth effects of 92. Baldwin argues that the Report not only underestimated the static growth

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4 See M. Emerson et alii (1988).

5 See R. Baldwin (1989a) and R. Baldwin (1989b).

effects but, by ignoring the dynamic impacts of economy wide economies of scale, failed to take into account an effect which could permanently add between a quarter and one full percentage point to the EC's growth rate[6]. Even if the latter estimates are taken with a grain of salt, the fact is that the impact of EC-92 on the Community's GDP in the medium term can be substantial.

Finally, a third effect may arise from changes in the EC trade policy regime vis à vis the rest of the world - the structure of import protection as well as preferential arrangements with third suppliers - ocurring as accommodating side effects of EC-92.

A quantitative assessment of the impact of EC-92 on Latin American exports is beyond the scope of this paper. However, a glance at some basic features of the commodity composition of Latin American exports to the Community would suggest some plausible a priori conclusions. The data on the direction of trade displayed in Table 1 shows that the European market is an important outlet for Latin American exports, accounting for around

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6 The core of Baldwin's argument is that, in the presence of economies of scale, the rise in the capital-output ratio caused by liberalization not only has an once and for all impact on GDP, but the increase in investment caused by the higher rate of profit leads to a further, endogenous, rise in the productivity of capital. See R. Baldwin (1989a, pp 1-3).

a quarter of the total foreign sales of most countries in the region, except for the oil producers and the US trade satellites in the Caribbean.

Table 1
EC share of exports from selected Latin American countries: 1987-88 average.

Country	Share (in %)
Argentina	29.7
Bolivia	19.9
Brazil	27.1
Chile	34.7
Colombia	25.1
Dom.Republic	8.2
Ecuador	8.4
El Salvador	24.9
Guatemala	18.3
Haiti	10.5
Honduras	23.6
Jamaica	27.0
Mexico	10.5
Nicaragua	33.9
Panama	17.3
Paraguay	32.0
Peru	27.5
Suriname	34.3
Uruguay	27.4
Venezuela	11.3
Others	25.8

Source: IMF. Direction of Trade Statistics.

However, a look at the commodity composition of trade is more relevant to the present discussion. Table 2, below, shows the importance of EC as a market for Latin American exports for selected product categories. It can be seen that primary commodities still account for 88.9% of exports, and that non-oil

products - items 1 to 5 in the table - alone respond for not less than 68.4% of total shipments. As far as manufactures are concerned, although exports of relatively technologically sophisticated goods such as machinery and transport equipment have expanded in line with total manufactured exports since the 1970s, labour intensive goods such as textiles and clothing still account for a substantially larger share of exports. Thus, the bulk of Latin American exports to Europe are either non-competitive - such as tropical products or other food items not excluded from European markets by the operation of the Common Agricultural Policy, and oil - or manufactures likely to have very low elasticities of substitution in relation to domestic production.

Table 2
Commodity composition of Latin American exports to the EC and the world: 1985-86 average.

Product class	Value of exports (in US$ million)		EC share in total (in %)
	EC	World	
1. Food	8372	31181	26.9
2. Agric. raw mats.	677	2569	26.4
3. Crude minerals	1619	5056	32.0
4. Mineral fuels	3554	29977	11.9
5. Non-fer.metals	984	3460	28.5
6. Chemicals	574	4171	13.8
7. Iron and steel	380	3049	12.5
8. Manuf.goods	949	8201	11.6
8.1. Mach. and transp. equipment	784	9201	8.6
8.2. Text. & clothing	694	3447	20.1
9. Total exports	17964	97323	18.5

Source: UNCTAD. Handbook of Trade and Development Statistics.

These characteristics of the commodity composition of Latin American exports to the EC would suggest that - given the expected size of income changes stemming from 92 and the magnitude of the relevant substitution and income elasticities - Latin American countries are likely to benefit more from the raising EC incomes than lose from the trade diversion effects induced by it. Therefore, one can conclude that without accompanying changes in the Community's trade regime relative to third countries, the effects of greater European integration on Latin American exports are likely to be positive.

There are two problems with this optimistic argument, however. The first is that the static trade diversion effect of traditional theory assumes given, neoclassical, production functions, while the expected positive impact of greater European integration will come especially through induced technical efficiency and the attainment of economies of scale made possible by the larger common market. Indeed, this is the basic strategic motivation of EC-92 as repeatedly put forward by authoritative opinion in Europe. As Europe based firms become more efficient, they are bound to increase their shares not only of EC markets, but are likely also to displace overseas suppliers in third countries.

The second is the impact of a likely intra-EC relocation of production towards new sites to take advantage of the wide

variance of labour costs within EC-12. Greater efficiency here would stem mainly from classical comparative advantages; but they would also have the effect of decreasing the relative competitiveness of non-European suppliers. The problem here is not that these two effects raise the competitiveness of EC based firms in relation to those located in Latin America, as this can be countervailed by appropriate trade and industrial policies in the latter region. The danger is that they can affect EC's trade policy towards third parties.

It has been argued[7] that the existence of sizeable economies of scale to be reaped with the larger, integrated, market may justify strategic trade policies based on temporary protection. However, given the large relative size of the European market, the argument for strategic trade policy on these grounds may only be justifiable in very few sectors where potential competitors are Europe's developed industrial rivals, not the Latin American NICs.

The impact of intra-EC relocation of labour intensive production facilities is a different matter. As can be seen in Table 3, present differences in labour earnings within the Community are substantial.

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7 See R. Dornbusch (1989, p 353 ff).

Table 3
Hourly compensation in manufacturing in selected European countries, 1988.
Index. United States = 100.

Country	Compensation
West Germany	130
Italy	93
France	93
United Kingdom	76
Spain	63
Greece	34
Portugal	20

Source: United States Bureau of Labor Statistics, quoted in R. Dornbusch (1989, p 355).

Although these data are not corrected for productivity differentials they are large enough as to suggest that the use of best practice equipment and, in some sectors, the attainment of higher economies of scale in new plants geared to the European market are bound to result in differences in unit labour costs large enough to induce the migration of labour intensive industries towards Spain, Portugal or Greece. Indeed, the business periodicals are filled with stories of large investment decisions already taken on those grounds. However, if this spatial redistribution of efficient industrial plants within Europe occurs at a fast rate - and depending on macroeconomic conditions - it is likely to induce protectionist pressures in the high wage Northern European countries in precisely the sectors of great actual or

potential export interest to Latin America[8]. As suggested by Lawrence (1989), the demand for import protection may be reinforced in these circumstances by the present constraints on state aid, which reduces the scope for the use of subsidies in industrial restructuring schemes, as has been customary in Europe.

If this indeed happens, it will strongly reinforce the basic motive for protection against developing countries in Europe since the 1970s. There can be no doubt that sharp trade policy reactions in Europe have been more often than not the outcome of too rapid labour or foreign exchange disequilibria caused by macroeconomic disturbances[9]. Fundamentally, however, the increase of EC's trade restraints against developing country is a response to the long term process of relocation of global efficient industrial capacity in labour intensive sectors to countries outside the EC.

This long term process of global structural change is irreversible. Although OECD countries still account for the bulk

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8 On this see M.J. Peck (1989, p 294). This, of course, will depend on how fast wages in the South converge towards the high levels prevailing in the North and on the extent to which the so-called "social dimension" of EC-92, which promises the harmonization of labour market arrangements, is actually implemented.

9 For a discussion of this point, see M. de P. Abreu & W. Fritsch (1989).

of change in import penetration in manufactures - as measured by the share of imports in domestic apparent consumption - in the EC, penetration by developing countries not only has increased at a faster rate in the aggregate but at many specific labour intensive sectors shows larger ratios than those of her developed trade partners[10]. This well established trend may even be reinforced by EC-92 if the lure of the larger market prompts developing countries to target the EC to overcome the front loaded learning costs involved in the entry of export markets as they usually did with the US[11]. It is true that the threat of continued indiscriminate use of VERs and anti-dumping actions in Europe may be much more of a problem for the Asian NICs - whose import penetration ratio in the EC-7 increased on average by 18.3% a year between 1970 and 1987 as against only 1.4% for Latin America and 3.6% for the world as a whole - but it certainly is a crucial issue for Latin America.

Another important multilateral trade policy issue for Latin America stemming from 92 is the possibility that the need to harmonise national trade regimes within the Community may affect protection agains third parties. This can happen in at least two ways. First, there may be changes in the trade preferences granted

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10 World Bank (1987, Table 8.8).

11 R.Z. Lawrence (1989, p 371).

outside the GSP, especially those to the ACP countries under the Lomé agreement, which will affect primary or semi-processed goods. To date, however, it is still not clear how Lomé preferences will be affected by 92. Second, and certainly more important for trade in manufactures, there are the fears that the harmonization of existing national quotas on some goods of non-European origin - the most important for latin America being steel, autos and, especially, textiles - may result in even more restricted access. This calls attention to the crucial importance of the Uruguay Round for the future evolution of Latin American exports of manufactures to Europe[12].

Summing up, the basic conclusion to be derived from the arguments put forward above is that a negative net impact of the direct effects of EC-92 on Latin American exports is unlikely. However, it may occur if accompanied by changes in trade protection against developing non-members induced by it. This, if the Uruguay Round succeeds in reversing the erosion of GATT discipline against the use of quantitative restraints started with the MFA, and appropriate macroeconomic policies generates an

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12 The discussion here touches only upon trade in manufactures. It goes without saying that liberalization of agricultural trade - a central issue in the Round - would have an enormous impact on temperate agricultural exports from Latin America, especially from the region's members of the Cairns Group.

environment of stable growth of world trade, integration between LA and Europe shall continue to increase.

2.2. Challenges and opportunities in a Western Hemisphere FTA

On 27 July 1990, the president of the United States made a speech at the White House launching what became to be known as the Bush Initiative. The central point of the Initiative in relation to trade matters is the proposal of a Hemispheric free trade area as a long term objective to be achieved through a series of bilateral agreements with individual Latin American countries or groups of countries already forming integrated trade areas in the region. In spite of its clear component of regional trade discrimination, the offer - as in other American initiatives of this kind in the recent past[13] -does not imply, however, the abandonment of multilateralism as the preferred option as explicitly stated by President Bush in his speech.

The motivation of the Initiative is manifold, comprising aspects of both a strategic and tactical nature. As an atrategic option, it has at least two chief objectives. The first is to

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13 For a discussion of the increasing importance of free trade areas in US trade policy, see J. Schott (ed.) (1989).

ressurect a sort of economic pan-americanism as a defensive response to the competitive threats foreseen in the unification of European markets and in the accelerated process of economic integration in the Pacific basin around Japan. The second, and perhaps more important as its immediate motivation, is the will to give an additional impetus to the ongoing process of trade liberalization in almost all countries south of the Rio Grande. This move would have the additional advantage of promoting the aggiornamento of hemispheric relations in the post-cold war world which requires the replacement of anti-communism by positive economic help - granted in terms of commercial advantages and larger bilateral investment flows - to the consolidation of the new democratic regimes in Latin America.

The chief shorter term motive of the Initiative is the intention of using the bilateral negotiating forum it creates to push trade liberalization beyond the traditional barriers affecting trade in goods, and into the realm of regulatory policies in the areas of the so-called "new themes" in the GATT Round, so dear to US economic diplomacy. According to the American proposal, the free trade agreements should contemplate the exchange of secure access to the US market for the progressive elimination of trade barriers and the establishment of clear rules to the protection of intellectual property rights and the

regulation of both direct investment flows and trade in services.[14]

The Bush Initiative poses a crucial strategic policy option relating to the extent and timing of integration to every single Latin American country. The central question is: should one seek a comprehensive commercial integration in a relatively short span of time, or simply create a priviledged locus for the debate of bilateral trade and FDI issues with a view to a progressive, slow, integration? The answer to this question requires the evaluation of the costs and benefits, to the smaller and more protectionist partner, involved in the formation of an FTA among countries of widely different size and levels of protection.

It is intuitive that for highly protected countries the costs of structural adjustment (such as transitional unemployment costs or losses due to rigidities in capital mobility) entailed by trade liberalization against a partner of the size of the United States are tantamount to those of a multilateral liberalization[15]. However, if the United States is not the most efficient supplier of the bulk of the country's imports, the static allocative

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14 Iniciativa para as Américas. Propostas econômicas do governo do Presidente George Bush para a América Latina (Sumário Atualizado das Medidas). USIS, Brasília, n.d..

15 For an ellaboration of the argument, see Fritsch (1989).

benefits stemming from bilateral liberalization are clearly smaller than those stemming from an equivalent multilateral liberalization. Furthermore, the greater the height of protection in the country, the greater the trade diversion effects on third parties caused by a bilateral liberalization against the United States and, thus, the greater the likelihood of opposition from other traditional OECD exporters competing with American products in Latin American markets.

The net benefits from forming a free trade area with the United States also crucially depend on the American trade regime, since the greater potential gains would result from the guarantee of market access with a preferential status relative to third partners facing the American MFN tariff. For a given product these gains would increase with (i) the height of the import barrier affecting it in the United States, (ii) the current volume of exports to the United States, and (iii) the price elasticity of demand for that product in the American market. This positive effects from discriminatory guarantee of market access would also increase the attractiveness of the FTA partner country as a location for export orientated FDI, especially by firms located in countries which already face severe trade barriers in the American market or fear its growth on a discriminatory basis in the future. One can, therefore, conclude a priori that forming a FTA with the United States which would abolish binding access restrictions affecting products of export interest of a country and

discriminate against exports from competing suppliers would bring certain benefits to that country.

Summing up the arguments of the preceding two paragraphs it is reasonable to conclude that the option for negotiations envisaging the immediate signature of a comprehensive FTA agreement will vary according to specific country features. As argued at greater lenght in Section 4, below, it will look as an optimal alternative for cases such as Mexico or some Caribbean countries, which trade chiefly with the United States, or Chile, which has already liberalized her import regime to an impressive extent and faces frequent access problems in the Unites States. However, for large and still protected countries with a geographically diversified pattern of trade, such as Brazil, the response to the American offer is likely to be much cooler, especially when the country has shown no intention of liberalizing extensively in the areas relating to "new themes".

Nevertheless, it is important to underline that the main attraction of the Bush Initiative is market access guarantee but that the extent to which this will be achieved is still very uncertain for at least two reasons. First, because the negotiating process in the Uruguay Round - which may introduce changes in the United States structure of protection - has not yet been completed, thus making impossible to evaluate the gains stemming from preferential treatment in a particular product. Second, and

perhaps more important, there is the issue of the credibility of the American offer of liberalization. Indeed, experimented Latin American trade negotiators are almost unanimously skeptical about the possibility of a radical change in American protectionism in areas of great export interest to the region, such as labour intensive manufactures or steel.

Finally, it is interesting to notice that the Initiative may also give a new impetus to the integration processes within Latin America. As bargaining power in bilateral negotiations carried out on the basis of reciprocity, as envisaged in the Initiative, depends on the size of domestic markets, incentives to carry them out by groups of Latin American countries will be high. The natural associations to be formed with that end would be the few existing regional integration fora. However, association with a view to carry out bilateral trade negotiations with the United States would require parallel efforts towards harmonization of protection among the countries concerned and this will force them to transform existing regional FTAs into effective economic - or at least customs - unions.

3. Global trends in North-South FDI flows and Latin America

Over the past ten to fifteen years, the coincidence of a wave of technological and managerial innovations with the growing environmental instability described above has produced marked changes in the determinants of strategic decisions of internationalised firms and, thus, in the dynamics of global FDI flows. The great recent changes in the spatial and sectoral distribution of global FDI flows within the developed world - of which the most remarkable feature is the rapid growth of Japanese investments in the auto and electronic industries of the larger North Atlantic economies - still basically follows the logic of the process of American and European post-war internationalisation: it is the response of Japanese firms holding a position of global industry leadership due to the possession of intangible assets in the shape of marks or technology to real or perceived protectionist moves in their strategic export markets.

However, the last few years witnessed important changes in the determinants of FDI flows towards the semi-industrialised periphery, with a clear reduction in the importance of the domestic market relative to the exploitation of specific locational advantages with a view to export. These changes in the determinants of North-South FDI result from the operation of two distinct causes. On the one hand, they reflect the ongoing process of "globalisation" of multinational firms, that is, the change in

the spatial configuration of their operations which replaces the traditional scheme of relatively autonomous national or sub-regional subsidiaries by a new configuration with a high degree of integration among productive operations carried out in several locations. This restructuring of global production networks is not likely to be reversed soon as it represents the competitive response of leading firms to pressures stemming from the greater environmental volatility mentioned above and the long term reduction of coordination costs made possible by advances in telematics[16].

On the other hand, they reflect direct investment decisions taken by non-internationalised exporting firms - which still operate from a single national base - to hedge their revenues against the impact of sharp exchange rate fluctuations on their international competitiveness or, as has been the case in Japan, rapidly rising labour costs. This has important implications for the analysis of trends in North-South FDI flows. If the still present expectations of further dollar depreciation in the medium term are maintained, this is likely to induce this kind of defensive FDI flows from Europe and Japan towards the dollar area, as indeed can already be observed. In the case of

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16 For an informed analysis of this process, see M. Porter (1986).

Japan, the expected yen appreciation will only contribute to accelerate the process of loss of competitiveness and international migration of industries intensive in labour or imported raw materials.

The impact of those changes upon FDI flows towards Latin America - which sits firmly in the dollar area, has a relatively low level of wages and, in several countries, has built a reasonably sophisticated industrial infrastructure - should in principle be favourable. However, although for quite distinct reasons, these two kinds of export oriented direct investment flows - i. e., that associated to the globalization process and that associated to the relocation of exporting plants by firms located outside the dollar area - have a common feature: they are both extremely sensitive to the trade regime in the host country. This can be illustrated by comparing the export propensities (export to sales ratios) of American subsidiaries located in the Asian NICs - where plants were "born" extroverted - with those located in Latin America, shown in Table 4. The huge differences in export propensities before the 1970s reflect, to a large extent, differences in policy regimes affecting the trade orientation of foreign investments. In the same way, the narrowing of such differences in recent years reflect the reduction of the early anti-export bias in Latin America.

Table 4
Export propensities of US majority owned affiliates in the manufacturing sector of the host country (%)

Country	1966	1977	1982	1986
All countries	18,6	30,8	33,9	38,3
Developed	20,4	33,1	36,6	39,3
Developing	8,4	18,1	22,0	32,6
Latin America	6,2	9,7	11,9	20,1
Asian NICs*	--	81,2	76,2	76,0

* Hong-Kong, South Korea, Singapore and Taiwan.
Source: Adapted from Fritsch and Franco (1988b, Table 1).

These trends in the dynamics of global FDI flows suggest two main conclusions. The first is that the seizing of the opportunities opened to improve the export performance of Latin American countries is intimately linked to their policies towards FDI. By the end of the 20th century, even more than in the past, national strategies aimed at the growth and diversification of manufactured exports in technologically dependent economies such as those of Latin America cannot rely exclusively on national firms. The second is that, contrary to past trends, the attraction of foreign capital will increasingly depend on minimising the negative impact of the distortions created by the structure of protection on the efficiency of domestic plants.

In the light of the above discussion it is interesting to assess the impact of regionalisation on direct investment flows to Latin America. When compared with the influence of these general trends shaping the pattern of North-South FDI flows described

above, the impact of greater integration in the Western Hemisphere on inward direct investment flows to Latin America is likely to be small. As argued in Section 2.2, the growth of inward FDI flows generated by it will come from export oriented investments geared to the United States market, especially from Japan and most dynamic Asian NICs. However, these flows will only be sizeable if access to the American market is effectively granted on a stable basis to FTA members in manufactured product lines in which they hold clear competitive advantages, and this poses difficult domestic adjustment problems to the United States, as the negotiations of the Mexico-United States agreement demonstrate[17].

Assessing the likely impact of European integration on FDI flows is somewhat more complex as the discusssion raises two different issues. The first relates to the inducement given by EC-92 to direct investment decisions of Latin American firms in Europe, that is, its impact on outward FDI. The second bears on the extent to which the opening up of investment opportunities in Europe will affect the attractiveness of Latin America as a location, and thus divert FDI flows from it, that is, its impact on inward FDI flows to the region.

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17 See W.P. Nunes (1991).

The main determinants of outward FDI flows towards the EC induced by the prospects of 92 are expectations of (i) enhanced profitability as result of integration and (ii) of increased protection or other forms of discrimination against the supply of goods and services by firms located abroad. Given the very low degree of internationalization of Latin American firms, the first motive is not a fundamental determinant, as it is especially relevant to already established firms. The crucial determinant of direct investment by Latin American firms in the EC is the threat posed to exporters.

A survey of direct investment motives of a sample of Brazilian firms showed that reactions to 92 did not reflect a sectoral logic but are rather firm specific and depends on the importance already taken by foreign markets in its growth strategy.[18] According to this study, there are two basic patterns of behaviour. First, there are the firms which adopt a defensive strategy aimed at defending already established positions in the European market. Examples of such behaviour are the building of a blending unit for orange juice concentrate in Italy by a group of large exporters in association with local entrepreneurs, the joint venture established in Germany by Brazil's larger exporter of wood agglomerate or the plants being built by two leading national

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[18] See E.A.Guimarães (1990).

exporters of car parts. The second pattern of behaviour is more offensive, aiming at building a base on which to learn so as to expand the firm's European operations. This strategy has been typically used by firms in the clothing industry to which Europe is still a relatively unimportant market, absorbing less than 10% of Brazilian sales as opposed to over 80% in the US. In fact, the chief characteristic of vast majority or recent Brazilian direct investment in the EC is the resort to "new forms" of FDI as opposed to wholly owned subsidiaries. This reflects either the relative smalness or the lack of international experience of the new entrants to the European markets, a phenomenon also identified in the recent pattern of American direct investment in Europe.[19]

The other way in which 92 is supposed to affect global FDI is by reducing its flow to alternative locations. Indeed, a case can be made a priori that the process of integration, by increasing the ex-ante attractiveness of European locations, may divert FDI away from Latin America. However, the large extent of FDI penetration in Latin America suggests that future flows are more likely to be determined by domestic policies and the investment climate in the region which can indeed far outweight any negative diversion impact coming from the increased attractiveness of European locations after 92. Among domestic

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[19]On this see R.E. Lipsey (1990).

policy reforms, as argued above, trade liberalization is perhaps the most important one. However, given the large penetration of foreign business in Latin America, the crucial medium term determinant of FDI flows to the region is the sustained recovery of its normal rates of output and investment growth.

4. Towards diverging sub-regional patterns of integration in Latin America

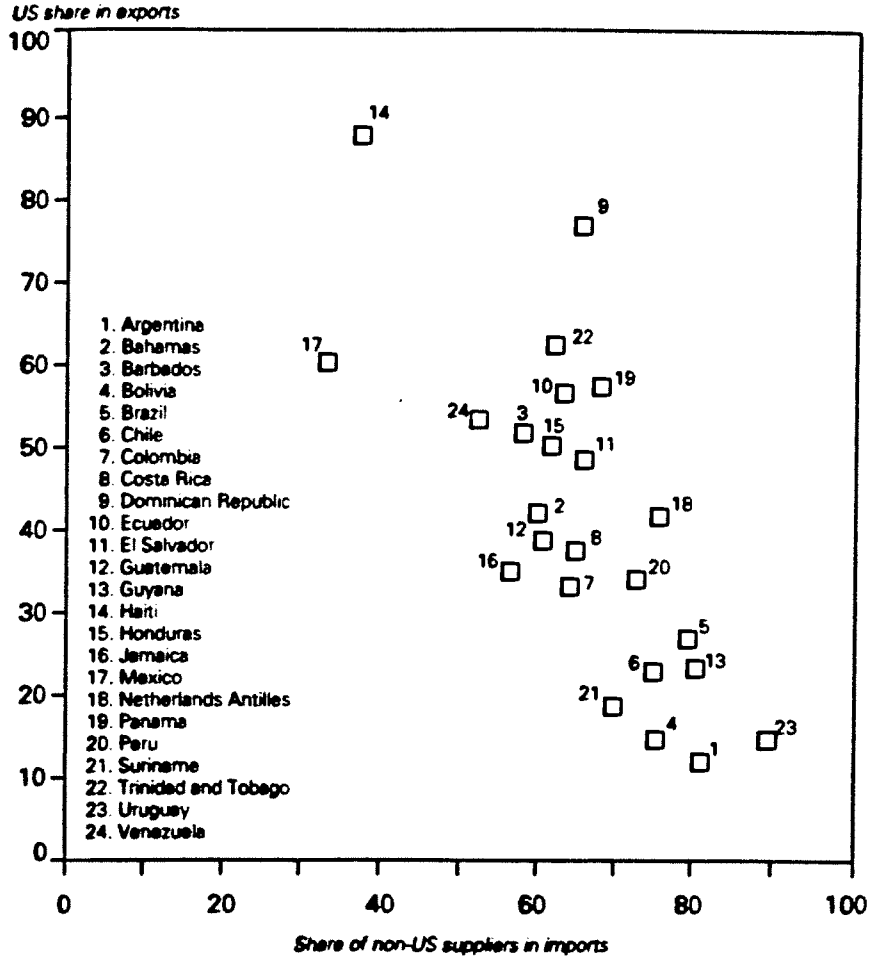
As mentioned in the Introduction to this paper, in nearly all Latin American countries there is today a clear perception that, given the poor prospects for foreign financial assistance and the return of voluntary lending, the solution of the current severe external adjustment problems requires rapid export growth and that, given global trends, trade liberalization is a necessary ingredient of trade expansion. However, the definition of new trade and industrial policy strategies in each country will reflect its perceived comparative advantages, which are bound to be decisively influenced by the peculiarities of its present output structure and of its insertion in the world economy.

It is important to note in this connection that during the past few decades certain structural differences among the economies in the region grew more marked and that today Latin American countries display a very heterogeneous insertion in the

international trading system. The heterogeneity of trade structures is twofold. First, there are the traditional differences in the direction of trade. As shown in Chart 1, the South American countries have - irrespective of their size and commodity composition of trade - a relatively much smaller dependence in relation to the US market than Mexico or many Caribbean economies.

CHART 1

US share in exports versus share of non-US suppliers in imports of 24 Western Hemisphere countries with exports to the United States greater than $100 million, 1985



Source: International Monetary Fund, *Direction of Trade Statistics*.

Second, there are the differences in the commodity composition of trade as the very uneven spread of industrialization, to a large extent conditioned by the size of domestic markets, gave birth to a few large and semi-industrialised economies in contrast to a large number of small primary producers. Indeed, the extent of import substitution industrialisation has advanced far more in countries with large domestic markets. Moreover, traditionally inward looking trade and industrial policies in these larger and relatively more self-sufficient countries has also given birth to more technologically sophisticated and fuller integrated industrial structures, which in turn affected the sectoral composition of their trade. This group of relatively large countries is a very small one, composed of Argentina, Brazil, Mexico and, if one excludes the larger South American oil exporters, perhaps by Colombia, Peru and Uruguay. However, trade heterogeneity is pervasive even among the big three, as Argentina's export interests lie chiefly on temperate agricultural products, Brazil is a large exporter of manufactures and Mexico is today predominantly an oil exporter.

An important consequence of this increasing heterogeneity of the trade and industrial structure among Latin American economies is that, although one witnesses a general tendency towards the adoption of more liberal trade and FDI regimes in the region, this move is likely to be accompanied by a non-negligible differentiation in the design of trade and industrial policies

across groups of countries. Thus, contrary to the more or less common style of policy generally followed up to the 1970s - which, except for a few and short lived trade liberalization experiments, was based on a combination of import repression and export incentives - and a more or less united front in multilateral trade negotiations, the present common drive towards trade expansion is likely to generate a diversified approach towards reform of domestic trade, industrial and foreign direct investment policies in different groups of countries and may give rise to even opposing stances in crucial issues in world trade policy.

The evolution of Latin American trade policies in recent years would seem to indicate that three distinct patterns of domestic trade reform - which one could label "orthodox", "integrated" and "selective" - are emerging in the region. The first is marked by the uniform and large reduction of existing trade barriers and restrictions on foreign capital. This is the strategy increasingly followed by the smaller countries in the region, possessing regionally diversified markets. It is justified as an attempt to explore static comparative advantages and, eventually, to generate dynamic efficiency gains by overcoming the limitations of a small domestic market through greater export orientation, replicating the successful experience of some small nations of Southeast Asia. A typical case in this category would be Chile.

The "integrated" strategy would be the path being followed by Mexico and some smaller Caribbean economies, extremely dependent on the American market for their exports. In addition to the characteristics of the orthodox strategy, it would have the peculiar feature of tight commercial integration and growing industrial complementarity with the US economy.

The third, or "selective", strategy is the one followed by the larger, semi-industrialised, economies of South America. They would still follow the general drive towards a radical reform of their very protectionist import regimes, involving in many countries the replacement of existing administrative import controls by tariffs. However, these reforms are to be accompanied by a large margin of sectoral selectivity in tariff heights, active industrial restructuring policies to reduce the costs of structural adjustment and, most likely, strategic industrial promotion in some areas, though with greater concern with productive efficiency than heretofore. The most representative country in this group is Brazil.

It goes without saying that the effective choice among these different strategies will depend on a complex interaction between the advantages governments perceive they can derive from their adoption in the context of debt or trade negotiations and the perceptions of the relevant domestic actors. What seems certain, however, is that the quest for trade expansion and the

opportunities open by the rapid transformation of the world industrial economy will make for a general drive towards liberalization, but that the present large heterogeneity of national economies is likely to produce a greater variety of approaches to trade and FDI policies than was the case in the past.

The growing differentiation among national economic structures may also give rise to sub-regional divergence in approaches to issues in world trade policy. Differences can already be seen in relation to specific issues in the current multilateral trade negotiations, and are also likely to arise concerning the importance attributed to preferential arrangements with the United States within the Bush Initiative.

As far as the main issues in multilateral trade policy are concerned, one has witnessed the ocurrence of both overlapping and conflicting interests among Latin American countries. Consider first market access problems related to the reform of Article XIX, which regulates the application of safeguards against rapid import penetration. The main dividing issue here - as was the case in the Tokyo Round - will be "selectivity", i.e. whether discrimination against particular (the "disrupting") suppliers will be allowed or whether the safeguard will be applied on an MFN basis. The position of large and small developing countries on this issue is traditionally different, as there are high rates of import

penetration from the former which usually triggers the introduction of the safeguard which, if the safeguard is non-discriminatory, also affects exports from the latter. Thus, small manufactured exporters tend in practice to favour selectivity and this division of opinions based on self interest is also likely to arise within Latin America. It is also interesting to note that selectivity in the application of safeguards will provide a legal cover for the use of discrimination in the application of VERs and, thus, increase the attractiveness of the "integrated" strategy for large countries such as Mexico.

The other divisive issue is agriculture. On the one hand, liberalization of world trade in temperate agricultural products is high on the agenda of the Latin American members of the Cairns Group of efficient agricultural producers and is by far the most important issue in the Round for specialized exporters such as Argentina and Uruguay. However, as the phasing out of the subsidies of the Community's Common Agricultural Policy will imply a rise in prices before a new equilibrium level of world supply is attained, agricultural liberalization is opposed by most, and especially the larger, developing net food importers. In Latin America, Mexico has taken a very clear stand in this direction.

Finally, as far as the so-called New Themes - Trade Related Investment Measures (TRIMs), Trade Related Aspects of Intelectual Property Rights (TRIPs) and Services - are concerned,

there seem to exist no contradictory interests among the Latin American countries. Since they are not substantial foreign investors, innovators or efficient producers of capital- or skill-intensive services they are all likely to take a cool view on these issues. However, the extent of support of the United States (or OECD) position on these issues may vary. Thus, small countries are likely to present little opposition to greater liberalization in trade in services or the enforcement of stricter intellectual property rules, as they are prospective substantial importers - not producers - of both sophisticated services and technology. One should also expect a supportive approach in the issue of TRIMs from those countries following a strategy of greater industrial integration with the United States under the Bush Initiative umbrella, because of the importance attributed by the American government to the elimination of some trade and industrial policy instruments affecting the trade flows of foreign companies.

As mentioned above, differences are also to be seen in the response to the proposal of free trade and industrial integration with the United States contained in the Bush Initiative. One could expect it to be much warmer not only in those countries which already opted by the "integrated" strategy, but also by those which have already liberalised trade to a large extent as a lower degree of protection implies lower structural adjustment costs. On the other hand, as argued in Section 2.2, for those still maintaining high degrees of protection and regionally diversified

trade flows, bilateral liberalization towards the the United States would certainly provoke a flurry of protests or even retaliation from their other leading suppliers and, in terms of static benefits from resource reallocation, is a second best alternative relative to multilateral liberalization.

Therefore, it is reasonable to presume that immediate negotiations aiming at a broad free trade agreements with the United States will be sought after by countries in the "integrated" group or by those "orthodox", like Chile. The reaction of the "selective" group to the recent United States government signals for greater hemispheric integration should be cooler that that of the rest. From their standpoint, the only potential benefits of the formation of a free trade zone stem from the attainment of preferential treatment in the American market relative to those suppliers facing the United States tariff. Thus, a positive response of these countries will decisively depend upon the credibility of the American offer to grant market access guarantees in products of their export interest, a point which will be put to the test in the early free trade agreements.

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