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Can Latin America Learn from Developing Asia's Focused FDI Policies?

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Abstract: This paper argues that foreign direct investment (FDI) can make a very important contribution to development. The nature and level of benefits for developing countries and transition economies from FDI has become a much more controversial topic. While the accelerated growth of surging Asian economies, especially China, suggest that FDI in the right circumstances can be considered an important ingredient for economic advance, the debate over technological and other spillovers from FDI has shifted decisively against the existing presumptions regarding 'automatic' FDI benefits to the point of questioning their very existence based on East European and Latin American experiences. As a consequence, more and more developing countries and transition economies now make significant efforts to compete to attract 'quality' FDI at the same time that they also seek to ensure that they effectively benefit from the FDI they receive. To understand this phenomenon, this paper examines existing statistical information on FDI and the operations of transnational corporations (TNC) in the context of the *new global political economy* in which developing countries and transition economies are becoming much more assertive. In this new setting many developing countries and transition economies see themselves as needing general FDI less but wanting quality FDI more. For these reasons, developing countries and transition economies are increasingly prone to use active and focused policies to both attract quality or priority FDI and to ensure that the benefits from such coincide with their developmental priorities.

Keywords: Foreign direct investment, transnational corporations, industrial policy, development

JEL classifications: F21, F23, O14, O38

1. An Emerging New Global Political Economy

Since at least the beginning of the 21st Century developing countries and transition economies as a group have enjoyed improved macroeconomic growth and stability, have been very successful in increasing their export earnings due to higher international prices for their commodities and

increasingly more competitive manufactures, and have as a consequence accumulated considerable volumes of financial assets. As a consequence, they have gained negotiating power. This has to an important degree turned on its head the old world order in which the industrial economies deployed their wealth through FDI, loans and bonds investing into the faster-growing emerging markets, which in turn accumulated foreign exchange reserves that were invested in low-yielding, low-return US treasury bonds (Euromoney, 2006). Many developing countries, especially Asian newly industrializing countries and oil exporters, are no longer willing to accumulate such reserves rather they want to convert them into higher return assets, such as equities and risk assets. This changes the existing global political economy in at least two important ways.

First, it challenges the old world order in which developing countries and transition economies held huge quantities of US treasuries and euro government bonds which in turn permitted the industrialized countries to hold interest rates much lower while still meeting their inflation goals in the context of the declining prices of their imports from the major emerging economy exporters (*The Economist*, "Weapons of Mass Deflation", 2006b). As developing countries and transition economies accumulated massive foreign exchange reserves, many industrialized countries, especially the United States, were saving less and less, producing a global financial situation which was neither desirable or sustainable. However, at the same time, any rapid change on the part of developing countries and transition economies with regards to their existing financial holdings would be destabilizing for the global economy as it could provoke a sharp devaluation in the dollar and the US economy would not be able to continue to purchase the exports of the developing countries and transition economies at the existing level. The industrialized countries are only slowly coming to recognize the new global political economy and the new leverage of developing countries and transition economies, for example, by incorporating some of the world's larger new creditor countries into global economic institutions such as the G7 (the principal rich country economies), G8 (G-7 plus Russia) or International Monetary Fund (IMF, 2006). Evidently, industrialized countries will have to adapt faster and better to this shift in financial power and the reduction of their negotiating power.

Second, the financially less dependent developing countries and transition economies are becoming more assertive. That aspect is particularly evident in the behaviour of the larger ones, such as the so-called BRICs – Brazil, Russia, India and China – as they seek a greater say in world affairs and as they and other major developing countries and transition economies creditors begin to reorganize their financial assets. The former president of the World Bank has gone on record stating that the Western world of wealthy nations

must prepare itself for Chinese and Indian dominance as in 25 years the combined GDPs of those two countries will exceed those of the G7 wealthy nations (Yahoo! News, 2006). The developing countries and transition economies will still make more focused efforts to attract quality FDI from the industrialized countries, particularly what they consider priority FDI that brings tangible benefits, especially by contributing new technologies and organizational practices. These countries also simultaneously have increased their own outward FDI. The investors from these countries are more prone to purchase existing assets in other countries than to undertake new (greenfield) ones, thus, the expansion of developing countries and transition economies into the acquisition of real assets in the industrialized countries is becoming a point of friction, especially with regard to sovereign investment funds owned by governments. Developing countries and transition economies will have to learn to manage their improved negotiating power and international expansion in this area so as not to produce a backlash from the industrialized countries.

This emerging global political economy represents a relevant new context to analyze the recent tendencies of world FDI and TNC operations. After such analysis, the situation in Latin America will be contrasted with some of the new policy initiatives by Asian developing countries. Lessons will then be drawn.

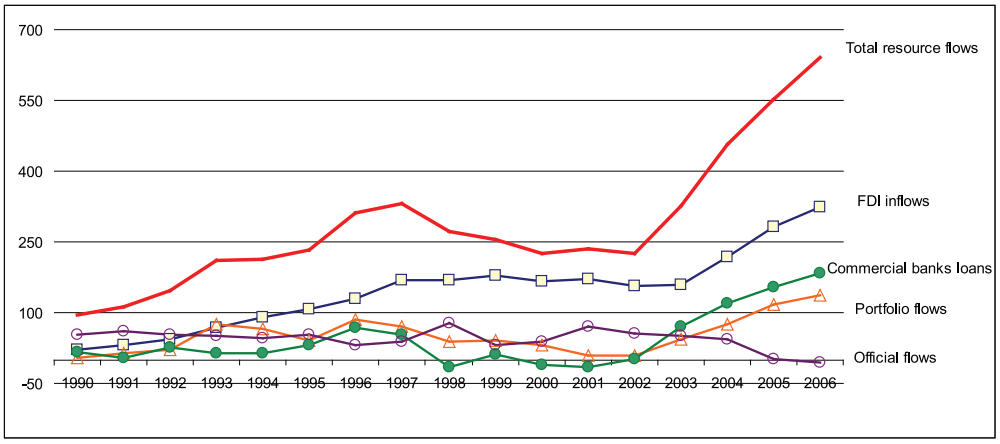
2. FDI Tendencies: Global and Latin America and the Caribbean

It must be mentioned before entering into the analysis of the FDI phenomenon itself that while global FDI inflows to developing countries and transition economies have rocketed from about 25 billion to about 380 billion dollars per year over 1990-2006, the share of FDI in total net resource flows has fallen from over 90 per cent during 1999-2002 to about 50 per cent in 2006 due to the fact that commercial bank loans and portfolio flows made dramatic recoveries (Figure 1). Thus, while FDI inflows continue to expand with force in developing countries, they are not the single dominant aspect of total resource flows that they were only a few years ago.

2.1 Statistical Information on FDI

Today, statistical information on FDI is plentiful and the gradual improvement in quality allows one to use it to better understand the complex nature of this phenomenon. Nevertheless, there are still problems that limit the use of that statistical information for analytical purposes (Box 1). The principal purpose of examining this statistical information is to define the volume, direction and nature of FDI flows.

Figure 1: Total resource flows[a] to developing countries[b], by type of flow, 1990-2006 (billions of dollars)



Notes: [a] Defined as net liability transactions or original maturity of greater than one year.

[b] The World Bank's classification of developing countries differs from that of UNCTAD in that it includes new EU member states from the Central and Eastern Europe and excludes high income countries such as the Republic of Korea and Singapore.

Source: UNCTAD, based on World Bank 2006.

2.1.1 FDI Inflows

Global FDI inflows became very significant as of the 1980s and experienced accelerated growth throughout the 1990s, reaching over US$1,400 billion in 2001, and then they collapsed to under US$600 billion in 2004 before experiencing a new upswing that reached over US$1,300 billion in 2006. Developed or industrialized countries accounted for and received the major part of the FDI inflows, especially during the information technology-related boom and bust cycle of the early 2000s, however, developing countries (including transition economies) have been receiving a far larger proportion at around 40 per cent of the total during the last few years of recovery of global FDI inflows.

In terms of the principal recipients, the European Union (15 countries) and the United States have traditionally dominated such inflows. During the last few years, while the EU15 have recovered their lead in FDI inflows at about 40 per cent of the total, the United States declined to the 10-15 per cent level and developing countries from Asia have increased to about 22 per cent and Latin America and the Caribbean is bordering the 10 per cent level. South-East Europe and the Community of Independent States have surged to the 3-4 per cent level and now receive more FDI inflows than all of Africa.

Box 1: The limitations of FDI statistics

The most internationally-comparable FDI statistics are those of the IMF and they are conceived from a balance of payments perspective. *The Balance of Payments Manual, Fifth Edition, 1993* of the IMF and the OECD *Benchmark Definition of Foreign Direct Investment, Third Edition, 1996* provide the relevant conceptual framework. The IMF and the Organization of Economic Cooperation and Development (OECD) have laboured for years to improve these statistics and they have made important advances, however, several important shortcomings still remain. Some of the principal problems that affect the kind of analysis found in this document are the following:

- While the Balance of Payments focus is useful for comparability, a number of important *accounting issues* arise. On the one hand, a huge FDI flow might really have little economic importance. When in 2005 Royal Dutch Shell of the Netherlands and Shell Transport and Trading Company Plc of the United Kingdom merged, it produced a huge FDI outflow from the Netherlands and a large inflow for the United Kingdom; however, real assets remained the same. In other words, it is very difficult to square available information on mergers and acquisitions with official FDI statistics. On the other hand, the difference between a direct investment in a company to establish managerial control and, for example, a private equity fund investment to earn profits can sometimes be very difficult to establish due to the standard for managerial control selected (10, 20, 50 per cent of capital shares) and the defining characteristics of indirect investments. In this case, it is difficult to draw a definitive line between direct and indirect investments.
- The widespread use of *financial centres or tax havens* to funnel investments into home or third countries produces very considerable distortions in the FDI statistics. For example, it is estimated that somewhere between 25 and 50 per cent of the FDI flows between Hong Kong and China is effectively 'round-tripped', that is, Chinese firms recycle their outward foreign direct investment through Hong Kong to obtain benefits available to foreign investors in China. In the case of Luxemburg, it is estimated that about 95 per cent of the FDI inflows during 2002-2005 were 'transshipped' to other destinations. Financial centres in the Caribbean alone accounted for 10 per cent of inward FDI to developing countries during 2000-2005. Since many financial centres or tax havens do not produce FDI statistics, it becomes difficult to identify the final destination of these important FDI flows.
- The B of P statistics do not provide a *sectoral classification* of the FDI. The information that exists is provided by the national central banks or the local investment promotion agencies and they do not use standardized classifications for activities. This results in limited comparability of economic activities.
- Many national central banks do not capture information on offshore investment projects that are *financed abroad*. For example, Japanese and Korean FDI in Mexico from their US subsidiaries with capital raised on international markets is usually not captured by their national statistical practices. This causes under reporting.

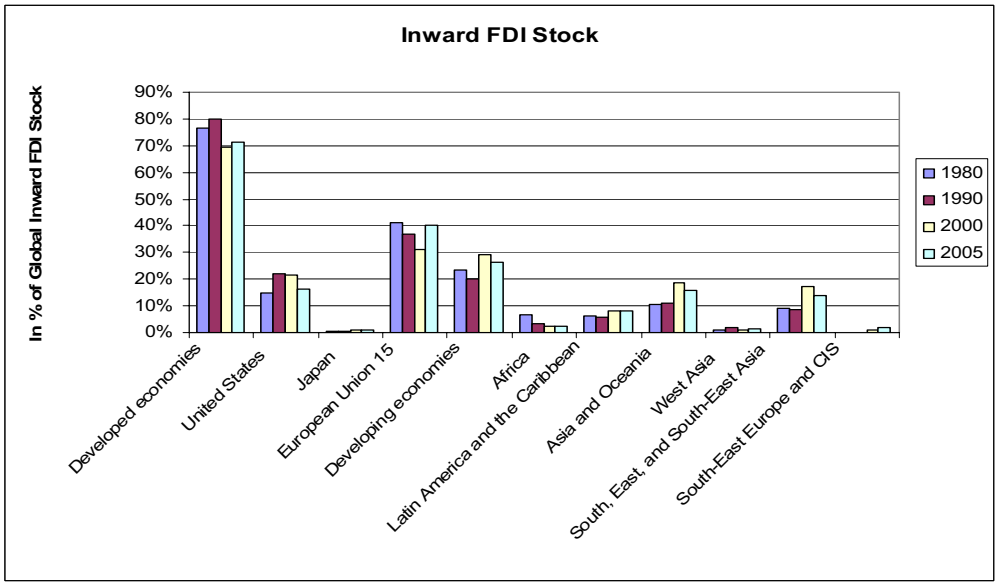
This brief examination suggests that these statistics are necessary for the analysis of FDI and TNC operations, however, they are not in themselves sufficient. They must be supplemented with complementary sources of information and more penetrating conceptual frameworks.

Source: Based on IMF (1993), OECD (1996) and UNCTAD (2006b).

The accumulated FDI inflows have resulted in a stock of global FDI that displays the characteristics indicated in Figure 2. With the exception of the recovery of the EU15, the overall tendency is for developed countries and transition economies to see their inward FDI stocks level off or decline and for certain groups of developing countries, such as those from East and South East Asia, Latin America and the Caribbean and to a lesser extent South East Europe and CIS, to see their inward FDI stock increase, especially if one compares 2005 to 1990.

Information on the sectoral composition of FDI is very weak. This stems from the fact that the Central Banks do not generally collect such information and, in the relatively few existing cases, the information is not collected according to a common sectoral classification, thus, international comparability is extremely limited. Again, the existence of tax havens complicates the picture in the sense that what appears to be a financial investment in a tax haven might actually be an investment in manufacturing in a third country. UNCTAD attempts to compensate by using complementary information on mergers and acquisitions. This helps to a certain extent, however, this approach includes only part of the FDI universe and there are significant differences in the statistics according to 'sales' or 'purchases'. In any case, the statistical information on cross-border M&As during 1987-2005 suggests that those in services (over 50%) have overtaken manufacturing (around 30%) and those in natural resources, while small are enjoying a comeback (almost 20% in 2005) (UNCTAD, 2006a, *World Investment Report 2006*, p. 8).

Figure 2: Global FDI stocks, by regions, selected years, 1980-2005 (billions of US dollars)



Source: UNCTAD, *World Investment Report, 2006*.

Latin America and the Caribbean (excluding financial centres)[1] experienced a FDI inflow boom around the turn of the century. South America received the larger part of the FDI to Latin America and the Caribbean in comparison to Mexico and the Caribbean Basin. Nonetheless, they tend to receive distinct kinds of FDI and for that reason it is relevant to distinguish their specific situations.

The use of a modified version of the Dunning conceptual framework (Dunning, 1993) coupled with ECLAC's long research experience in the analysis of this phenomenon permits a more penetrating appreciation of the nature and essential purpose of the focal points of inward FDI in Latin America and the Caribbean (Table 1). In this sense, the primary purpose of

Table 1: Focal points of FDI in Latin America and the Caribbean, by corporate strategy

Corporate strategy and sector	Natural resource-seeking	Market-seeking (national or regional)	Efficiency-seeking for third markets	Technological assets-seeking
Goods	*Petroleum/gas*: Andean Community, Argentina, Trinidad and Tobago *Mining*: Chile, Argentina, Andean Community	*Automotive*: Mercosur *Chemicals*: Brazil *Food products*: Argentina, Brazil, Mexico *Beverages*: Argentina, Brazil, Mexico *Tobacco*: Argentina, Brazil, Mexico	*Automotive*: Mexico *Electronics*: Mexico and Caribbean Basin *Apparel*: Caribbean Basin and Mexico	
Services	*Tourism*: Mexico and Caribbean Basin	*Finance*: Mexico, Chile, Argentina, Venezuela, Colombia, Peru, Brazil *Telecommunications*: Brazil, Argentina, Chile, Peru, Venezuela *Retail trade*: Brazil, Argentina, Mexico *Electricity*: Colombia, Brazil, Chile, Argentina, Central America *Gas distribution*: Argentina, Chile, Colombia, Bolivia	*Administrative services*: Costa Rica	

Source: UN-ECLAC, *2006 Report on Foreign Investment in Latin America and the Caribbean*.

FDI in the region is clearly to access national markets ('market-seeking'), especially in South America, for manufactures, such as those from the food, drink, tobacco, automotive and chemical industries, and services, such as telecommunications, financial, electrical energy, retail and gas distribution. A more recent focal point of FDI is to establish an export platform to export to third markets ('efficiency-seeking') as takes place in Mexico and the Caribbean Basin with regards to the electronics, automotive and apparel industries. Natural resource-seeking FDI continues to be significant in Venezuela and Trinidad/Tobago in the case of petroleum and natural gas while that in minerals is concentrated in the Andean countries, Chile and Argentina. FDI in offshore services, such as administrative services has been detected recently. No internationally-significant technology assets-seeking FDI operations have been identified in the region.

2.1.2 FDI Outflows

Information similar to that of FDI inflows is available for FDI outflows; however, the volume of such data is more reduced in coverage and its quality is even more questionable. Several serious problems exist. First, at a global level FDI inflows do not equal FDI outflows, thus, unexplained differences exist. Second, the FDI inflow statistics can be complemented and reinterpreted according to the relatively good information from the principal investors (generally, OECD countries); however, that option is not as good for FDI outflows since non-OECD investors are more numerous and underreporting is notorious. Third, developing country investors seem to be even more prone to use tax havens, further complicating the statistics.

Available information on outward FDI flows (OFDI) from developing countries during 1970-2003 indicates that developing Asia is a far more important source of OFDI than is Latin America and the Caribbean (UNCTAD, 2006c). The principal point, nonetheless, is that the developing country share is severely underreported and therefore our understanding of this phenomenon is even more restricted.

Thus, the official statistics on FDI – both inflows and outflows – provide one basis to evaluate the FDI phenomenon. There are some notorious shortcomings of this information. For example, the inflow and outflow data indicate geographical distributions by investor and recipient countries, however, there is little in the way of information on the sectoral classification of these flows. To make these data meaningful, it is necessary to interpret them by way of a more comprehensive conceptual framework, as was indicated in the case of the statistics relating to Latin America and the Caribbean. These statistics must also be complemented by others kinds of relevant information.

3. TNC Operations: Global and Latin America and the Caribbean

Some of the most useful information to complement the balance of payments flows is that related to TNC operations (assets, sales, exports, employment, etc.). Table 2 provides some such relevant information on the FDI dimension, the TNC dimension and the global economy dimension of TNC operations. A comparative analysis of such demonstrates that while the global GDP and gross fixed capital formation have increased by a factor of 5 and exports by a factor of 7 over the 1982-2006 period, the indicators related to the global expansion of TNCs have risen by a factor of 7 regarding the exports of foreign affiliates, have rocketed by a factor of 10 or more in the case of FDI stocks, sales of foreign affiliates and receipts for royalties and license fees and have exploded by about 25 in the case of the total assets of foreign affiliates. In other words, the last quarter century has witnessed the emergence of powerful international systems of production of transnational corporations.

To fully appreciate the significance of the emergence of this TNC production system, it is necessary to better understand the characteristics of

Table 2: Indicators of TNC operations, 1982-2006 (US billions)

Item	1982	1990	2000	2005	2006
1) *FDI Dimension*					
FDI inward stock	647	1789	6314	10130	11999
FDI outward stock	600	1791	5976	10672	12474
2) *TNC Dimension*					
Sales of foreign affiliates	2620	6045	15680	22171	25177
Gross product of foreign affiliates	646	1481	3167	4517	4862
Total assets of foreign affiliates	2108	5956	21102	45564	51187
Exports of foreign affiliates	647	1366	3572	4214	4707
Employment of foreign affiliates (thousands)	19537	24551	45587	62095	72627
3) *Global Economy Dimension*					
GDP (in current prices)	10899	21898	31895	44674	48293
Gross fixed capital formation	2397	4925	6466	9420	10307
Royalties and license fees receipts	9	30	66	91	132
Exports of goods and non-factor services	2247	4261	7036	12641	14120

Source: Based on UNCTAD, *World Investment Report*, various issues. Consult original source for detailed notes on methodology.

the principal agents establishing such system, that is, the principal TNCs. The world's 100 largest non-financial TNCs in 2004, measured by external assets in 2005, consist of 56 European, 25 US, 9 Japanese, 3 Canadian and 1 Australian companies. Interestingly, 5 companies from developing Asia (1 each from Hong Kong, Malaysia, Singapore, Korea, and China) are found on this list. Almost 60 of the firms produce manufactures, while over 30 provide services and 11 are natural resource companies. Within manufacturing the principal activities are automotive (13), pharmaceutical (11) and electric & electronic equipment (10) industries. The principal service activities are telecommunications (10), electricity, gas and water (9) and retail trade (8). The natural resource companies focus on petroleum (9) and mining (2). The principal strategies driving TNCs to invest overseas are the search for market access for manufactures, such as automobiles, pharmaceuticals, and services, such as telecommunications and electricity; the search for efficiency in the production for export of automobiles and electric and electronic equipment; and the search for certain natural resources, mainly petroleum and minerals.

An examination of the 50 largest non-financial TNCs from developing countries in 2004 provides a view as to the characteristics of the up-and-coming TNCs from emerging markets that are challenging the dominant ones from the industrialized countries. Fully 37 of these TNCs are from developing Asia, while there are 8 from Latin America and the Caribbean and 5 from Africa (all from South Africa). Those from developing Asia came primarily from the overseas Chinese networks (Hong Kong – 10, China – 7, Singapore – 7, Taiwan province – 5) as well as Korea (4) and Malaysia (3). The Latin America TNCs originated in Mexico (4), Brazil (3) and Venezuela (1). According to activity, they were more or less evenly split between manufactures (18) and services (17), although both natural resources (8) and diversified (7) were noteworthy. The principal manufacturing activities concerned electric and electronic equipment (9), motor vehicles (2) and industrial chemicals (2). The main services were transport and storage (6), telecommunications (4), construction (2) and hotels (2). Thus, in comparison to the 100 dominant TNCs, some of these from developing countries emerge in similar areas of activity, such as petroleum/mining (8), electric and electronic equipment (9) and telecommunications (4); however, many more operate in areas not directly in competition with the former.

The overall situation in Latin America and the Caribbean encompasses the interrelationship between the operations of the principal TNCs operating in the region and the internationalization of emerging Latin American TNCs, or 'Trans-Latins'. The operations of the principal 50 TNCs in Latin America and the Caribbean in 2004, which is based on the cumulative sales (not assets) of the principal subsidiaries in the region, indicates the location of the principal affiliates and the proportion of total global sales realized in the

Latin America and the Caribbean (UN-ECLAC, *2005 Report on Foreign Investment in Latin America and the Caribbean*). One half of the subsidiaries pertain to European TNCs (mainly UK, Germany and Spain), 22 are affiliates of US TNCs and only three correspond to Asian TNCs (2 from Japan, 1 from South Korea). With regards to their activities, 30 are manufacturers, 11 provide services and 8 produce natural resources. Within manufacturing, the principal activities pertain to the automotive (9), electrical and electronic equipment (7) and chemical (3) industries. The dominant services activities were found in telecom (4), electricity (4) and retail trade (3). The main natural resource activities are petroleum (5) and mining (3). Five TNCs derive more than 40% of their global sales from the region, 6 fall within the 20-39% range and 39 derive less than 20% of their global sales from Latin America and the Caribbean, suggesting that the region is not central to the activities of most of these TNCs. Spanish TNCs, US auto part companies, and mining companies are the TNCs with the highest shares of sales from the region. In terms of their location within Latin America, Brazil and Mexico are the principal host countries.

Information on the 25 principal Trans-Latins in 2004 is limited but useful. Here, it was possible to assemble coherent information for those from the four principal home countries: Mexico, Brazil, Chile and Argentina. The principal Trans-Latins emerged from Mexico (12) and Brazil (9). Their activities are concentrated in manufactures (13), services (7) and natural resources (4). In manufacturing, they pursue diverse activities, such as steel (4), cement (2), food products (2) and other relatively low-technology commodity areas, with the exception of one aircraft manufacturer from Brazil. In services, they are focused mainly on retail trade (3) and telecom (2). In natural resources, they are split between petroleum (2) and mining (2). What stands out with regards to the Trans-Latins is that in general they do not operate in the same areas as the principal TNCs in Latin America and the Caribbean. In the past, in areas where they did, some of the dominant Trans-Latins were acquired by TNCs, as was the case for the Argentine petroleum companies, YPF and Perez Companc, the Chilean electricity company, Enersis, and the Brazilian beverage company, Ambev (UN-ECLAC, 2006). At present, Trans-Latins are becoming more active at acquiring the assets within the region of TNCs that wish to withdraw or downsize their holdings there, such as America Movil/Telmex's purchases of the assets in the region of Verizon and AT&T. Others are going to neighbouring industrialized countries, as is demonstrated by the acquisitions by Bimbo, Gruma and Grupo Mexico in the United States. Further afield, recent mega-purchases concern CEMEX's 12 billion dollar offer for Rinker Group of Australia, CVRD's 17 billion dollar offer for INCO of Canada and CSN's 10.6 billion dollar offer for British steel producer, Corus. Thus, the existing trend towards TNC acquisitions of emerging

Trans-Latins seems to have been replaced by a new assertiveness on the part of the Trans-Latins focusing mainly on industrialized countries. This new assertiveness by Trans-Latins is more muted than that of TNCs from other developing regions, especially Asia, and transition economies, especially, Russia, however, it is growing.

This analysis of the evolving situation of FDI and TNC operations permits a more comprehensive appreciation of the changes taking place in the policies of developing countries and transition economies.

4. The Need for New Inward FDI Policies in Latin America and the Caribbean

Many developing countries and transition economies are rethinking their situation with regards to FDI and TNC operations in an effort to better incorporate them into their developmental strategies. Until relatively recently, virtually all change in the realm of international rules and regulations on FDI came from industrialized countries and were extremely favourable to the rights of investors (UNCTAD, 2003), often based on the previously dominant view that FDI *was by its very nature good for development*.[2] A boom in bilateral investment treaties, investment chapters in free trade agreements and multilateral initiatives in services (such as the General Agreement on Trade in Services – GATS) produced concrete advances for the rights of investors in terms of standards, such as national treatment and most-favoured-nation, limits on national policy in the fields of trade-related investment measures, intellectual property and regulatory takings, and provided for more secure dispute settlement, such as the investor-state mechanism by which individual investors could take national governments to international arbitration (Moran, 2003). In this context, the Organization for Economic Cooperation and Development – OECD, which represents the interests of the most important home countries of FDI, attempted to consecrate these gains in a Multilateral Agreement on Investment – MAI in the late 1990s.

The OECD initiative marked the high-water mark for efforts to further improve and consolidate the gains of investors. Thereafter, the rush toward bilateral investment treaties cooled from an average of over 200 agreements a year in 1995-96 to less than 70 a year during 2004-05 (UNCTAD, 2005, 2006a, 2006d). The OECD MAI initiative itself stalled, then folded, due to differences of opinion among the principal investor countries. The initiative in favour of a Free Trade Area of the Americas, which appeared to include many of the advances in investors' rights, similarly collapsed, in part because of the opposition of Brazil to the investor protection clauses.[3] Subsequently, the 'investment' issue was taken off the Doha Round of negotiations at the World Trade Organization – WTO meeting in Cancun, Mexico in 2005. The

OECD in the same year recognized the nature of the change taking place by offering up a much more balanced framework for the protection of investors' rights, while respecting host developing country development goals more, known as the Policy Framework for Investment.

Two clear points of conflict between industrialized countries and developing countries and transition economies have arisen in the new century. On the one hand, some industrial countries showed great reluctance to respect the intent of existing investment rules and responded to attempts by the TNCs of developing country and transition economies to acquire industrial country TNCs. Their use of national security concerns often torpedoed such purchases or severely conditioned them. This has been the case in the United States with attempts by Lenovo (China) to acquire the computer division of IBM, by CNOOC (China) to purchase Unocal, and by Dubai Ports World (UAR) to run US ports after its acquisition of P&O Steam and Navigation Co of the United Kingdom. Something similar has taken place with regards to CVRD's (Brazil) purchase of INCO (Canada) and Mittel Steel's (India) purchase of Arcelor (Luxembourg). While some of these deals have gone through with stringent conditions (Lenovo, CVRD), developing countries and transition economies have been left with the clear sensation that the industrial countries do not play by their own rules.

On the other hand, industrial countries claim that developing countries and transition economies change the rules at will in their own domains, especially in the context of high international prices for the commodities that they produce. The latest mega-project to suffer setbacks in this regard was the oil and gas project in Sahkalin Island, Russia led by Royal Dutch Shell (including Mitsui and Mitsubishi). In this case, the Russian government used apparent environmental violations to modify existing contracts and shift control of the project to the Russian state-owned company, Gazprom (*The Economist*, 2006a). In Latin America, the government of Venezuela has renegotiated contracts in the petroleum sector in the framework of the 2001 Hydrocarbons Law, which requires majority shareholding by the state petroleum company, and additionally has raised tax and royalty rates. The Government of Bolivia has enacted its 2005 Hydrocarbons Law to renegotiate existing contracts in gas, after significantly raising royalties and taxes. Ecuador was doing something similar. In both Chile and Peru, the level of royalties on minerals has been raised but without affecting the ownership of TNC operations. While many if not most of the affected TNCs have reluctantly signed new contracts, some chose to exit, as was the case for Exxon Mobil, Statoil, Total and ENI in Venezuela, and Occidental in Ecuador (UN-ECLAC, 2007). In other words, industrial countries complain that developing countries and transition economies are not respecting existing contracts in natural resources.

In sum, both the industrial countries and the developing countries and transition economies are contributing to the weakening of international rules and regulations by not fully complying with the intent, if not the letter, of those commitments. This has contributed to a questioning of existing commitments by some governments in developing countries and transition economies.

One of the key areas in which existing commitments are being questioned by developing countries is the investor/state dispute resolution mechanism. The number of known investment treaty arbitrations has risen from next to none in the early 1990s to between 40 and 50 cases a year during 2003-05, to reach a cumulative total of over 225 cases in 2005. Most of the cases are dealt with by the International Centre for the Settlement of Investment Disputes (ICSID) of the World Bank Group, while others are administrated under the rules of UNCITRAL, the International Chamber of Commerce, the Swedish Chamber of Commerce, etc. according to the facilitating clauses of the pertinent bilateral investment treaties, investment chapters of free trade agreements, etc.

The investor/state dispute resolution mechanism has been roundly criticized for numerous shortcomings, among which the following are found (UNCTAD, 2005; Crosby et al., 2004; IISD-WWF, 2001; von Moltke and Mann, 2004; OECD, 2005):

- It provides protection to foreign investors that local investors do not enjoy;
- The cases are not cumulative such that different arbitrators dealing with similar causes can come to different decisions;
- There is no separate instance of final appeal;
- There is little transparency in the process, from the selection of the arbitrators through to the publication of the final decision;
- TNCs can abuse the process by 'forum or treaty shopping';
- Decisions related to the concept of 'indirect expropriation' have served to severely challenge a government's 'right to regulate';
- The cost of the administrative procedure and the awards can become astronomical.

These criticisms have provoked the ICSID into making certain adjustments to its procedures; however, it has not dealt with the more fundamental issues.

The case of Argentina became a lightning rod of how the investor/state conflict resolution mechanism could create havoc and lead to the questioning of investor protection itself (Mortimore and Stanley, 2006). To face up to a severe financial crisis in 2001, Argentine implemented a number of drastic measures, including the conversion of all contracts to the national currency followed by a mega-devaluation of that currency. That measure unleashed a plethora of investor/state arbitrations mainly due to the fact that TNCs operating privatized public utilities (gas, electricity, water, etc.) could not

raise their rates to the degree permitted in the clauses of their contracts with the public sector. Argentina faces 42 lawsuits that could entail liabilities in the order of 20 billion dollars. Only five decisions have been made so far, all against the Argentine government. That government is attempting to wriggle out of its difficult situation by way of foot dragging in the arbitration proceedings and pressuring the TNC operators that desire to continue in the country to come to a separate agreement and abandon their demands for arbitration under bilateral investment treaties. Following on the heels of the unilateral solution imposed on Argentina's financial creditors, the Argentine actions have aggravated certain tensions in the relations between industrialized countries and developing ones.[4]

This brings up an even bigger issue which has arisen for many developing countries and transition economies in the last few years and that has to do with the growing concern of host countries to ensure that FDI inflows effectively contribute to national development. As was suggested earlier, the focus of evaluations of the contribution of inward FDI to development has shifted from the original dominant premise that inward FDI is by its very nature a positive contribution to development to the more defensible view that inward FDI can bring both benefits and costs and therefore policy intervention is justifiable to attempt to maximize benefits and minimize costs (OECD, 2002), or more boldly, to establish a new agenda for such (Lall and Narula, 2006). There seems to be a growing consensus that FDI policy is but one element within a national developmental strategy and that its coordination and coherency within the overall development policy package is required.

The analysis of the inward FDI experience in Latin America and the Caribbean has assisted in defining the concrete benefits and costs of inward FDI according to the different corporate strategies driving it (Table 3). In the region, there are examples of both the benefits and the costs, even with regard to strategic asset seeking FDI that is extremely scarce in Latin America and the Caribbean. Three representative examples of major problem areas in the region relate to market-seeking FDI in electricity and gas sectors of the Southern Cone, efficiency-seeking FDI in the Mexican automotive industry, and efficiency-seeking FDI in the Caribbean Basin apparel industry (Mortimore, 2006).

A huge amount (US$77.4 billion) of *market-seeking FDI* was registered in the electricity and gas sectors of the Southern Cone (especially Argentina and Brazil) during the 1990s. Unfortunately, three quarters of the investments went into the acquisition of existing assets, and only about one-quarter went for upgrading them and/or new greenfield investment. As a result the expansion and modernization of output did not prove adequate for local needs to expand capacity in spite of the large amount of FDI that entered the sector. This is quite ironic since as of the mid-1990s Southern Cone governments

Table 3: Latin America and the Caribbean: benefits and costs of FDI by corporate strategy

FDI Strategy	Expected Benefits of Host Country	Principal Problems that have Appeared
Primary material-seeking	Increased natural resource exports Improved international competitiveness of natural resources High local content of exports Employment in non-urban areas Tax and royalty income	Enclave-type activities not linked to host economy Low levels of local processing of resources Cyclical international prices Low tax income from non-renewable resources Environmental pollution
Market-seeking (national or regional)	New local economic activities Increased local content New/deepened production linkages Local enterprise development Improved services (quality, coverage and price) and improved systemic competitiveness	Production of goods and services not internationally competitive (not world class) Weak gains in international competitiveness Regulatory and competition problems Disputes related to international investment obligations Crowding out of local companies
Efficiency-seeking for export platforms	Increased exports of manufactures Improved international competitiveness of manufactures Transfer/assimilation of technology Training of local human resources New/deepened production linkages Local enterprise development Evolution from export platform to manufacturing centre	Becoming stuck in the low value-added trap Focus on static rather than dynamic host country advantages Truncated productive linkages: dependence of assembly operations on imported components Crowding out of local companies 'Race to bottom' in production costs (salaries, social benefits, exchange rate) 'Race to top' in incentives (tax, infrastructure) Limited cluster creation
Strategic asset-seeking	Strengthens domestic absorptive capacity through technology transfer, human resource training and local enterprise development Improved science and technology infrastructure	Unfocused national policy Low propensity to invest in science and technology Stagnation at certain level Tension between corporate objectives and national S&T policy goals

Source: Mortimore (2004 and 2006).

subjected the electricity/gas sector to strong privatization and deregulation policies precisely in order that TNCs invest to modernize the sector and thereby resolve existing problems of under-capacity. On top of the problem of relatively little *new* investment associated with the privatization of the State assets, numerous problems of a regulatory nature appeared. Difficulties in establishing realistic tariff rates during periods of macroeconomic dislocation led to low long-term profitability for the service providers which complicated the already weak financial situation of some of the major TNC operators (Enron, AES, etc.) and thwarted the presumed automatic expansion of the electricity/gas infrastructure with regards to generation, transmission and distribution. These countries reacted in different manners within the constraints that they faced.

The Argentine government was not able to respect established contractual commitments (i.e. the currency and the inflation adjustment mechanisms used to define tariff rates) and the economic chaos associated with the major devaluation of January, 2001 led many electricity and gas providers to implement the investor/state dispute settlement options available to them by way of bilateral investment treaties in order to seek international arbitration, especially in the International Centre for the Settlement of Investment Disputes (ICSID)[5] (Mortimore and Stanley, 2006). In the case of Brazil, the National Development Bank (BNDES) avoided similar chaos by acquiring a major shareholding in the AES operation and offering loans to other operators to keep the devaluation from provoking serious losses. With hindsight, it is now apparent that Brazil was able to better deal with the most serious problems of the electricity/gas sector in part because it could count on national institutions (the national development bank and the national petroleum company) to play a role in the solution and the fact that it never ratified the 14 bilateral investment treaties that it had previously negotiated thus the TNCs did not have recourse to the investor/state dispute resolution mechanism typical of the bilateral investment treaties. Argentina could not satisfactorily resolve the biggest problems of the sector in part because it then possessed no national development bank, it had privatized its national petroleum company and it had ratified about 50 bilateral investment treaties which permitted the electricity and gas TNCs operating there to initiate international arbitration proceedings (Stanley, 2004; Mortimore and Stanley, 2006). Thus, one host country, Brazil, was able to manage the situation. Another, Argentina, saw the situation collapse into chaos worsened by numerous cases of international arbitration brought before ICSID by the TNC service providers. In both cases, the goal of using huge amounts of market-seeking FDI to resolve the challenge of electricity/gas infrastructure under-capacity was not reached and lingering problems still complicate the new initiative to promote subregional integration in the electricity and gas industries (UN-ECLAC, 2005).

Significant amounts of *efficiency-seeking FDI mainly by US automobile TNCs* in the Mexican automotive industry created a large (2 million unit capacity) and internationally competitive automobile industry where a small, inefficient and poor quality one had existed. Mexico currently provides about 13 per cent of US automobile imports. The FDI in new plants produced a huge burst in export earnings, however, it did not assist the Mexican industrialization process as much as was expected. The local productive linkages were weak due to the dependence of the assembly operations on imported components. This, in turn, resulted in very limited cluster formation. For that reason, at present, it is extremely difficult for auto assemblers in Mexico to meet the rules of origin of the numerous free trade agreements entered into by Mexico other than with North America (especially with Europe and Japan) because the supplier base is North American-centric. This situation severely limits industrial and technological upgrading of the automobile industry in Mexico. In effect, the US automobile TNCs focused primarily on static (low salaries, geographic proximity, and preferential market access) rather than improving dynamic host country advantages (such as skilled human resources and local technology capabilities). The Mexican government did not do enough to close the gap between national industrial goals and corporate strategies by designing a strategic vision for the industry that is in keeping with both, by attracting major investments from automobile TNCs (both vehicle assemblers and auto part manufacturers) that are not yet present in the country (such as industry leaders Toyota, Honda and Hyundai, and their global suppliers), and by implementing measures to integrate the supplier base and deepen the value chain within Mexico (Mortimore and Barron, 2005; UN-ECLAC, 2004). This case reflects many of the principal shortcomings that can result from efficiency-seeking FDI in medium technology industries in host countries that do not possess coherent national development strategies.

Efficiency-seeking FDI in the Caribbean Basin to establish apparel assembly operations in the framework of the Multifibre Arrangement, which allowed major importing countries to apply quotas to exporters and, with regards to the United States market, was complemented with strict rules that favoured the use of more expensive US-made inputs (yarn, fabrics, thread, buttons, etc.). The Caribbean Basin came to supply about 15 per cent of US apparel imports of knitted and crocheted goods (HTS 61) and many Caribbean Basin countries depend on the export of apparel assembled in their export processing zones for a high proportion of their total exports of goods. Nevertheless, the effect on that subregion has been referred to as 'illusory competitiveness', that is, improved international competitiveness evident in increased export earnings and rising US import market shares is accompanied by only very minor ripple effects in the host economies (Mortimore, 2002, 2003; UN-ECLAC, 2004). These apparel assembly

operations focused primarily on static (wage levels, social benefit costs, preferential market access, exchange rate) rather than improving dynamic (skilled human resources and local technological capacity) host country advantages and thereby similarly truncated productive linkages and limited cluster formation because of the very high dependence on imported US inputs. Moreover, the fiscal benefits from the operation of the export processing zones were minimized due to the ability of the larger apparel TNCs with operations in several Caribbean Basin countries to play one site off against another in order to demand continued tax incentives. This situation, in turn, inhibited the expansion of domestic companies that attempted to combine local apparel manufacture with subcontracting for the foreign companies because they were tied inextricably to their domestic competitive situation. Finally, the Caribbean Basin model for apparel assembly lost relative advantages to Mexico when the latter entered NAFTA in 1994[6] and the new DR-CAFTA initiative does not significantly improve that situation.[7] In fact, the recent opening of the US market to apparel from more competitive countries with integrated textile and apparel operations, especially China and India, by way of the Multilateral Agreement on Clothing and Textiles severely challenges the competitiveness of the assembly operations in the Caribbean Basin. This case reflects many of the shortcomings of efficiency-seeking FDI in low technology industries, which in the case of the Caribbean Basin limited even the most elemental forms of industrial and technological upgrading.

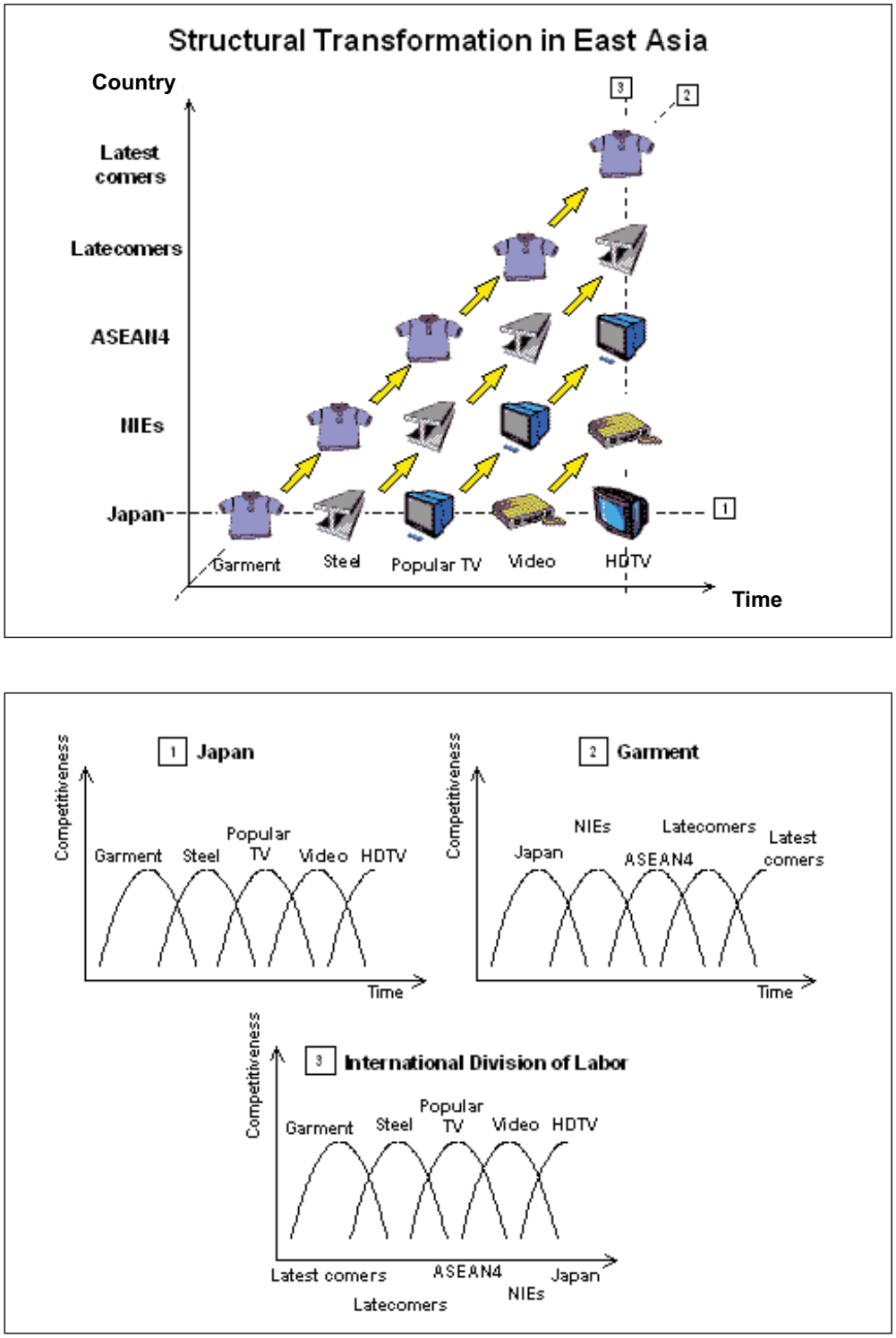
These three examples of some of the principal problems arising from different FDI strategies in Latin America and the Caribbean demonstrate the kind of frustrated expectations that have occurred in that region.

5. Better FDI Policies are Feasible

These Latin America and the Caribbean experiences contrast sharply with those of some countries from other regions, especially developing Asia, which have been very successful in using inward FDI in a conscious manner to accelerate their ambitious national development strategies in order to make progress in closing the gap with industrial economies. The experiences of these countries provide a guide for Latin American and Caribbean countries since their performance has been far superior (Mathews, 2004), in making headway in terms of increasing their share of global value-added in manufactures (UNIDO, 2005) and in better integrating their inward FDI promotion policies into their distinct national development strategies (Gligo, 2007).

Their starting point is the concept of *catching up*. This implies more than simply reaching a given level of GDP per capita. Figure 3, which admittedly is somewhat dated, provides the essence of the analysis. The fundamental aspect of the concept of catching-up concerns the structural transformation of East

Figure 3: Structural transformation in East Asia



Source: Mathews (2004).

Asian developing countries so that they become competitive in increasingly more technological complex industrial undertakings. In this vision from the 1990s, Japan advanced from garments to high definition TVs, the newly industrializing countries (Korea, Taiwan, Singapore) reached video cassette recorders, some members of the Association of South East Asian Nations (Thailand, Malaysia, Philippines), other latecomers (China, India) arrived at the stage of steel production and the latest comers are recently initiating activities in garments. Three vectors in Figure 3 assist in comprehending this concept. Vector 1 demonstrates how Japan was able to continually improve its competitiveness by advancing from one industrial activity to another more technologically-challenging one. Vector 2 shows how one industrial activity – garments – shifts from relatively more advanced to relatively less advanced economies according to their emerging competitiveness. Vector 3 indicates the international division of labour in which leader Japan possessed more competitiveness in the higher technology activities, exemplified by high definition TVs in this case, while the less competitive countries are dedicated to lower technology activities according to their relative competitive situations. In other words, in order to increase productivity over the long term, developing countries need to introduce more complex technologies and dominate more difficult functions within given technologies; otherwise, competitiveness erodes in the face of rising wages and exports stagnate. Using new technologies is not a simple or automatic process, rather it entails the conscious building of 'technological capabilities', that is, a mixture of information, skills, interactions and routines that firms need in order to handle the tacit elements of technology (UNCTAD, 2003). Outside of Asia, competence building has yet to be given the centre-stage position it warrants both in the formulation of development policies and in the conceptual framework underlying these policies (UNIDO, 2005).

Latecomer firms, like latecomer nations, are able to exploit their late start to development in order to tap into advanced technologies, rather than having to replicate the entire previous technological trajectory. They can accelerate their uptake and learning efforts utilizing various forms of collaborative processes and state agencies to assist with the process, bypassing some of the organizational inertia that holds back their more established competitors. They thus strategize around the possibilities inherent in their latecomer status. The strategic goal of the latecomer is clear: it is to catch up with the advanced firms, and to move as quickly as possible from imitation to innovation (Mathews, 2004). There is no unique path to success: some implemented focused policies while others did not, some used autonomous policies while others opted for FDI-dependent ones, as is suggested in Table 4. The Asian countries generally combined different orientations and varied them over time (UNCTAD, 2003).

Table 4: Strategic choices for East Asian countries attempting to catch up to industrialized ones

	Focused	Unfocused
Autonomous	– based on the development of domestic firm capabilities; – extensive industrial policy (trade, finance, education, training, technology and industrial structure); – restrictions on FDI, active promotion of technology imports and transfers; – examples: Korea, Taiwan Province of China	– lack of a clear and coordinated policy to develop export competitiveness; – haphazard support for skills, technology, institutions and infrastructure; – examples: China, India
FDI-dependent	– driven by FDI and exports to TNC global networks; – included policies to upgrade TNC activities according to strategic priorities by directing investments into defined higher-value activities and inducing existing affiliates to upgrade their technologies and functions; – extensive policy interventions in factor markets (skill creation, institution building, infrastructure development and supplier support), encouragement of R&D and technological institutions and attracting, targeting and guiding investments; – example: Singapore	– driven by FDI but relying largely on market forces to upgrade the structure; – included policies to provide a welcoming FDI regime export incentives, good export infrastructure and cheap, trainable labour; – skills upgrading and domestic technological activity were relatively neglected and the domestic industrial sector tended to develop in isolation from the export sector; – examples: Malaysia, Thailand, Philippines and the Special Economic Zones of China

Source: Based on UNCTAD, 2003.

The countries of Latin America and the Caribbean are far behind the Asian countries in terms of their national development strategies for catching up with the industrial countries and for consciously utilizing inward FDI and TNC operations to do so. Even with regards to attracting FDI, Latin America and the Caribbean is still in an infant stage of policymaking relying primarily on passive policies based on horizontal incentives that do not distinguish between priority and non-priority investments. Globally, increased competition for quality FDI and the desire to ensure concrete benefits has led many countries to adopt active inward FDI policies that target the investments that they consider most coincide with national development priorities (Lowenthal, 2001; Lall and Narula, 2006). Latin America and the Caribbean does not yet have the legal framework, the institutions (especially well-financed investment promotion agencies that not only attract FDI but interact with such by way of after service and impact evaluation) or the professional staff to do so. One telling indicator is that in Latin America and the Caribbean only 2 of 18 investment promotion agencies have policies to actively attract inward FDI in R&D compared to 15 of 16 that do so in developing Asia.

In sum, the Latin America and Caribbean region is in a quandary and is in need of better FDI policies. Its comparative performance is weak with regards to the two most important aspects of inward FDI policy, that is, to successfully compete for quality inward FDI (Oman, 2000; Gligo, 2007) and to ensure that the FDI it receives effectively produces benefits defined by national development priorities (OECD, 2002; Mortimore, 2006). The experience of the more successful countries suggests that the contribution of inward FDI to national development can be greatly increased by way of inward FDI policies that combine the right blend of promotion, incentives, targeting and coordination and coherence with the overall national development strategy (Mortimore and Vergara, 2006; Gligo, 2007; UN-ECLAC, 2007).

6. Learning from Developing Asia

FDI and TNC operations in the right conditions and guided by a coherent policy framework can make a very significant contribution to national development. In the wrong conditions and lacking a coherent policy framework, FDI and TNC operations can have the opposite effect. In different ways, both industrialized and developing countries have demonstrated that in certain situations they do not respect existing international commitments and, as a result, FDI-assisted development as a concept in increasingly under question. There is a real danger that the benefits of FDI-assisted development be lost in the process.

Without falling into stereotypes, it would seem to be the case that many Asian developing countries have been successful with the FDI-assisted

development concept while many Latin American and Caribbean ones have not. The crux of the matter appears to relate to six major differences in the developmental experiences of these two developing regions:

1. The more successful developing countries in Asia define their developmental priorities clearly; most of the less successful Latin American and Caribbean ones do not. Thus, having a clear picture of national development priorities seems to be a requirement for success in this area.
2. The more successful developing countries in Asia design and implement national development strategies based on their developmental priorities; most of the less successful Latin American and Caribbean ones do not. Thus, having a design and implementing a national development strategy which reflects those national development priorities appears to be another requirement for success in this area.
3. In the context of 1 and 2, the more successful developing countries in Asia define nature and degree of the FDI-assisted development that they consider relevant; the less successful Latin American and Caribbean ones do not. Thus, defining the nature and degree of FDI-assisted development seems to be a further requirement for success in this area.
4. The more successful developing countries in Asia operationalize their FDI-assisted development scheme by way of coherent FDI policies (focusing on the priority FDI that they seek); most of the less successful Latin American and Caribbean ones do not. Thus, implementing coherent FDI policies appears to be another requirement for success in this area.
5. The more successful developing countries in Asia in the course of their development process have tended to shift their FDI policy objectives from the *quantity* of FDI to the *quality* of such; most of the less successful Latin American and Caribbean ones have not done so. In the process, the more successful Asian developing countries designed and implemented increasingly active FDI policies, in which the role of an investment promotion agency is central, that were progressively integrated into the overall development strategy. The less successful Latin American and Caribbean developing countries for the most part are still stuck in the infant stage of FDI policies. Thus, moving from FDI quantity to FDI quality in the context of increasingly active and integrated FDI policies administered by way of a progressively more sophisticated institutional framework also seems to be a requirement for success in this area.
6. Finally, one of the most important lessons from developing Asia's experience with FDI-assisted development is that the most effective overall orientations to such are functional and technical, based on the defined developmental priorities, not any initial ideological predisposition. The developing Asian countries achieved success with FDI-assisted development employing different combinations of autonomy/dependence

on FDI and focused/unfocused FDI policies to make advances in catching-up with the industrialized countries. Thus, a final requirement for success appears to be to deal with FDI-assisted development in a functional and technical manner linked directly to the attainment of the defined priorities of the development strategy.

These findings would appear to be a useful basis for rethinking inward FDI policies in Latin America and the Caribbean. Too bad that we can no longer count on Professor Lall's insight and penetrating analysis to do so.

Notes

1. As was mentioned, the use of financial centres or tax havens as financial intermediaries for foreign direct investments greatly distorts the FDI statistics. ECLAC eliminates the principal ones (Cayman Islands, British Virgin Islands and Bermuda) from its analysis so as not to include FDI that passes through these centres but does not necessarily remain in the region.
2. One publication from the region that broke that mould was Dussel, Galindo y Loría (2003).
3. During the 1990s, Brazil negotiated 14 bilateral investment treaties; however, the Brazilian Congress never ratified any of them.
4. Reviewing the ICSID process, the Attorney General of Pakistan advised governments to thoroughly scrutinize investment treaties before signing them and even went so far as to suggest that "the current system of investor-state arbitration is not a forgone conclusion, and that some new treaties are being concluded without such an investor-state mechanism" (i.e. Philippines-Japan) (*Investment Treaty News*, December, 2006).
5. About half of the known arbitration proceedings of Argentina stem from the situation in the energy sector.
6. NAFTA eliminated the trade restrictions and rules of origin that locked Mexico into exclusively an assembler role. It allowed for the incorporation of other operations (textile production, cutting, washing, etc.) into the value chain such that Mexico now possesses the potential to become more of a 'full-package' producer (ECLAC, 2004, Chapter 2).
7. DR-CAFTA does provide two *potential* improvements. One, locally-produced fabrics can be incorporated into many apparel products for the US market and, if the subregion can produce cheaper fabrics than the US ones, that could improve their competitiveness. Two, Nicaragua (and to a lesser extent, Costa Rica) negotiated a special 'tariff preference level' which allows them, within certain stringent limits, to import fabrics from third countries for their apparel exports to the US market.

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