



The MERCOSUR foreign direct investment boom in the 1990's: characteristics, determinants and impacts.

Research project coordinated by: Daniel Chudnovsky (CENIT)*

1. INTRODUCTION

The MERCOSUR, and particularly Argentina and Brazil- two of the four developing countries that have attracted more foreign direct investment (FDI) between 1994 and 1999- has been one of the main poles of attraction for foreign investors in the 1990's. FDI arrival was conceived, specially in these two countries, as a fundamental contribution for the structural reform program success, both for its contribution to financing the balance of payments and its capacity to favor technological modernization and improve competitiveness in the economies of the region. The expected FDI inflows actually arrived in substantial volumes to the region. From almost U\$S 1600 million in 1984-1989, MERCOSUR has received more than U\$S 40 million on average between 1997 and 1999. MERCOSUR's share as a percentage of the worldwide flows has raised from 1.4 to 5.9 per cent in the same period. Consequently, the presence of transnational corporations (TNCs) has grown substantially in the four MERCOSUR countries, whose economies, and particularly Argentina and Brazil, belong to the world's most "transnationalized", taking into account the foreign affiliates share in the sales structure and international trade.

* Participating Centers

(CENIT) *Centro de Investigaciones para la Transformación, Argentina*

(CADEP) *Centro de Análisis y Difusión de Economía Paraguaya, Paraguay*

(DE/FCS) *Departamento de Economía, Facultad de Ciencias Sociales, Universidad de la República, Uruguay*

2. ATTRACTION FACTORS

Which have been the main attraction factors for the FDI massive arrival? The basic determinant has been, as in the import substitution industrialization (ISI) period, the domestic market and its growth perspective, this time amplified at a regional scale as MERCOSUR. The incidence of MERCOSUR in the attraction of FDI has been higher in the smaller economies. The domestic market has been a decisive factor not only for services - that have attracted most FDI flows in the 1990's, but also for the bulk of manufacturing industry. In this way, market seeking strategies prevail. Only in some manufacturing sectors they are accompanied with relatively significant export flows, though strongly MERCOSUR oriented.

Only in some specific cases in Brazil, TNCs seek for strategic assets which are important for the corporation's global competitive position. If there is a component of strategic asset seeking in TNCs investments, it is almost always related to mergers and acquisitions (M&As) where foreign firms are interested in the market share of the enterprises that are being bought. On the other hand, in the recent FDI process, highly export oriented resource seeking investments reach a prevailing role only in Uruguay.

These structural attraction factors have been accompanied by a clearly "proFDI" attitude from the governments. Hence, apart from progressing strongly in FDI deregulation, intra-regional competition so as to attract investment has been observed, competition that in some cases is based on the use of incentives. Incentives based competition has been more broadly observed in Brazil (with the "fiscal wars" between states) and has been specially visible in the automotive industry, but the absence of disciplines has extended it gradually to the rest of the MERCOSUR countries and in particular to Argentina. On the other hand, the design of investment attraction incentives has privileged the creation of direct employment and, in some cases, exports increase, omitting almost in all cases other aims (linkages with suppliers, innovation activities, human resources training, etc.). Apart from this, although some sectoral regimes might have not been redundant (for example, mining in Argentina), in other cases, specially those related with investment projects already decided for MERCOSUR that are disputed by states or provinces of Argentina and/or Brazil, there has clearly been an income transfer towards foreign investors.

3. TNC STRATEGIES AND INVESTMENT IMPACT

The present FDI boom in MERCOSUR takes place in a very different context from the one prevailing in the ISI, when TNCs became the main agents in the industrialization process specially in Argentina and Brazil. At international level, the

1990's have seen the spreading of globalization, characterized by a strong growth in cross border capital and merchandise flows. At regional level, instead of the typical economic policy regime of the ISI, the MERCOSUR economies are substantially more liberalized and deregulated.

Nevertheless, both the FDI attraction factors and the TNCs strategies and their behavior in MERCOSUR generate a *deja vu* impression. While the motivation and performance of TNCs are different from the ones found in the ISI, the changes observed are not so radical. In this context, the FDI impact doesn't seem to be as positive as suggested in most of the received literature.

Although the predominance of market seeking strategies introduce an element of continuity with the ISI, and apart from having spread increasingly at a MERCOSUR level, these strategies are now combined with efficiency seeking measures to be able to compete in more open economies. This course of action is materialized in many cases through what is named in the received literature as "efficiency seeking" (with rationalized affiliates so as to take advantage of specialization and scale economies). However, an asymmetric role is visible: the MERCOSUR foreign affiliates produce for the internal market and, to some extent, for the regional one (including the rest of Latin America) and import inputs and in some cases final goods from developed countries (in a strong intrafirm trade scheme). In this way, productivity gains that should arise from this redefinition of the TNCs operational patterns, have not yet been translated into a significant increase in exports and even less in exports destined to extra-zone countries.

In this context, have the favorable expectations in respect with the FDI arrival to MERCOSUR been accomplished? The research findings on which this brief is based have covered a wide portion of the issues involved in the analysis of the FDI impact. In this connection the following basic conclusions have been reached:

i) Increasing FDI flows have contributed to finance the bulk of external requirements in the countries of the region and have exhibited a lower volatility than portfolio investments. Therefore, FDI is a central element of the current macroeconomic policy scheme. Nonetheless, the increase in FDI flows has been accompanied by higher dividend remittances. Thus, the positive impact on the balance of payments is diluted (in the case of Argentina it is estimated almost nil considering the FDI operations as a whole). At the same time, serious problems may arise in the future, given that the growth of fresh FDI inflows may not be ensured in the current macroeconomic situation, when higher profit remittances become a structural element for the regional economies behavior.

ii) TNCs do not seem to make a greater contribution than national firms to the growth of exports in the countries of the region, although they show a higher propensity to import compared to local enterprises. They have not either contributed to greater market diversification (in fact they are more MERCOSUR oriented than national firms).

Anyhow it is important to note that the FDI sectoral distribution and the TNCs trade patterns reflect the structural differences among the MERCOSUR countries. Thus, Brazil clearly appears as the country which attracts more FDI to more complex techno-productive sectors, while TNCs contribute to upgrade the country's export basket. However, the foreign affiliates performance reflect a specialization pattern where the bulk of goods with higher value added and/or technological sophistication is exported to MERCOSUR and to the rest of Latin America. At the same time those same goods are imported as parts, components, capital goods, inputs or final goods- from industrialized countries. The trade balance of the foreign affiliates in Brazil also in Argentina, and to lower extent in Uruguay, then shows a surplus with MERCOSUR but a deficit concentrated in the more complex activities- with developed countries, to which agroindustrial and mineral commodities and this is more notorious in Argentina and Uruguay- are still being essentially exported.

iii) The FDI flows strong increase has not reflected a parallel increase in the overall investment rates of the economies of the region. In part, this reflects the fact that great part of the FDI has arrived through M&As. Likewise, it would also indicate that national firms have not reacted with new investments to the TNCs increasing competition (that in this case, would add to the already strong pressures of operating in more open economies).

To sum up, the findings of the research project indicate that the FDI contribution to the economic development of the MERCOSUR countries is more limited than the one suggested by the received literature. Likewise, although other very significant issues related to FDI impact have not been examined, it is worth noting that the evidence collected in previous studies on MERCOSUR suggests that the positive spillovers or the linkages with local agents and institutions might have been relatively weak. Anyway, further studies on this topic and on the above issues are required.

4. POLICY IMPLICATIONS

¿Which are the possible explanations for these findings? Schematically, three explanations can be distinguished (from which various policy recommendations arise).

i) The FDI boom is still a very recent phenomenon so as to be

able to perceive its fruits. As time goes by, macroeconomic and institutional stability is preserved, the market is expanded and market friendly macroeconomic policies - including a progressive increase in the level of openness of MERCOSUR - are implemented, the FDI positive impacts would materialize and would guarantee the continuity of new FDI flows.

ii) The weakness of FDI positive impacts is only an additional confirmation of the fact that globalization is a negative phenomenon for developing countries, which are inevitably asymmetrically integrated and subordinated in the world economy. Thus, the solution would be to reject globalization, closing again the local economies and severely limiting the role of TNCs.

iii) The problems behind the still weak positive contribution of FDI in the MERCOSUR are essentially structural problems of the host economies, and FDI only contributes to solve them marginally. Given that this is the explanation to which the authors of this work stick to, it is worth exploring in detail its logic and consequences.

The capacity to attract FDI must be taken, itself, as a valuable asset of the MERCOSUR countries. In the present conditions of functioning of the economies of the region, it seems difficult to make progress in the development process without FDI inflows. In fact, keeping on attracting significant flows of FDI is a sine qua non condition to compensate the deficit with which the TNCs affiliates already in the region operate.

However, it should not be assumed that FDI will necessarily bring the positive contributions that most of the received literature suggest. From our point of view, this will happen not only after time passes and reforms consolidate- although that would eventually generate positive results- but also with the introduction of some specific policies, which tend both to overcome host countries deficiencies and to stimulate the TNCs so as to modify the strategies and behavior of their affiliates already in the region.

The competitive conditions in which local firms operate should be improved. Policies aimed at improving the access to finance, stimulating the use of qualified human resources, supporting export activities and contributing to the improvement of technological, productive and organizational capabilities in national enterprises and SMEs in particular, would also increase the possibilities of the last ones to take advantage of possible TNCs spillovers, both as suppliers or as clients, and even as competitors. In this way they will respond "offensively" with new investment and technological modernization actions to the competitive challenge derived from openness and the presence of foreign affiliates.

In regard to policies towards FDI, without adopting policies

that would violate the “national treatment” that is currently given to TNCs, and keeping inside the boundaries of “WTO-compatible” policies, it is possible to move forward in the design of initiatives that can favor greenfield investments or capacity expansion, as well as the ones with strong export content and/or important spillover generation for the local economy. Another desirable aim is to attract investments that can improve the productive and export profile of the countries of the region, in particular in those areas linked with the so called “new economy”. Likewise, TNCs should be stimulated to enhance the linkages between affiliates and local agents. In this way, it would be possible to enter a phase where quality and not only quantity receives priority.

This new focus on FDI should be coordinated at a MERCOSUR level. Four areas are important in this sense: i) incentives and FDI attraction policies should be harmonized so as to generate externalities and don't lead to bidding wars that could end up dilapidating public resources in favor of TNCs; ii) cooperation in the competition policy field, following the EU example and considering that the growing weight of TNCs in the economies of the region -that is often translated into growing supply concentration levels in certain markets - could bring negative allocative and welfare effects; iii) coordinated design and implementation of sectoral or horizontal policies aimed at improving the FDI contribution according to the aims mentioned above; 4) joint actions to attract quality investments according to what was suggested above.

These suggestions do not cover all the policies towards TNCs, which should also include sensitive areas as employment or environment. Apart from linking domestic firms to the TNCs either as suppliers or partners- though the latter is not very frequent pattern in the MERCOSUR in the 1990's to strengthen local firms should also have a strategic role in the economic development process of the region. Consequently, the incipient transnationalization processes of some Argentine and Brazilian firms that are

already intensively spanned in MERCOSUR should receive priority as well in the “pro-development” agenda of the countries of the region



Daniel Chudnovsky and Andrés López prepared this brief.

Researchers: Andrés López (CENIT, Fernando Masi (CADEP), Mariano Laplane, Fernando Sarti, Célio Hiratuka and Rodrigo Sabbatini (IE/UNICAMP), Gustavo Bittencourt and Rosario Domingo (DE/FCS).



Red de Investigaciones Económicas del Mercosur: Zelmar Michelini 1220
tel. (598.2) 900 7194 ext.16/ fax (598.2) 900 7194 ext.18 / 11100 Montevideo - Uruguay
E-mail: redmsur@adinet.com.uy www.redmercosur.org.uy