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Integration Agreements, FDI and Structural Reforms. An Analysis of the Determinants of European Investments in Latin America.

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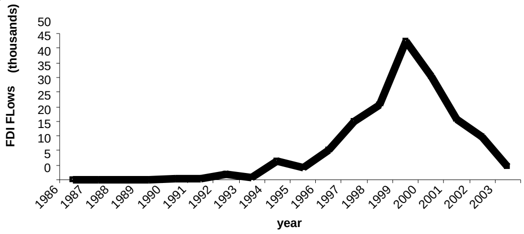
Abstract

This study addresses the topic of the determinants of EU FDI in Latin America, especially in MERCOSUR countries, having care to disentangle the role of the integration agreement from other national policies inspired from the general sub-continental reform effort occurred in the last decades.
The results obtained from the analysis suggest a strong role both for the policy frame of structural reforms and, especially, the MERCOSUR agreement in determining FDI inflows into the Latin American region.

1 Introduction

The evolution of trade and investment relations between the EU and MERCOSUR is the central focus of the ongoing negotiation process of the first inter-continental integrated bloc.
This paper aims at shedding some light on the determinants of European FDI in MERCOSUR and other Latin American and Caribbean (LAC)countries. The work finds its motivation in the relevant role plaid by European investors in the whole Latin American and Caribbean regions in the last decades.
The structural reforms boosted by the Washington Consensus and the integration of the internal European Market paved the way especially for the entrance of European investors into MERCOSUR countries. Figure 1 plots the evolution of EU FDI flows to Latin America. This figure witnesses the

Figure 1: EU FDI in LAC countries-Inflows.

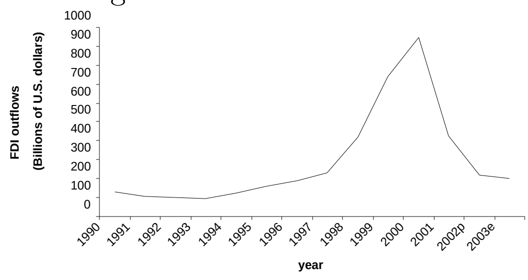


Source:ECLAC. Calculations by the author.

general phenomenon of the region as the major recipient of FDI in the 90s. Despite this the region as a whole loses ground during the last years because of another widespread phenomenon, i.e. the flow of investments into Asia, namely China.
During the 90s MERCOSUR countries, especially Argentina and Brazil represented the most favorite destinations for investments coming from the other side of the Atlantic.
Figure 2 shows the investment abroad for the all of the 15 EU countries. The 90s represent an intensification of outflows with outflows reaching the peak of about 900 billions of U.S. dollars in 2000, with net outflows of about 200 billions of U.S. Dollars.

Now, as an example of the general trend of all the second half of the 90s, IADB (2004) reports that in 1999 81% of European FDI was based in LAC countries with Argentina and Brazil counting respectively for a 42% and a 28% . European investments in MERCOSUR, differently from the US ones, were mainly directed to firms acquisitions and caused EU stock of FDI in

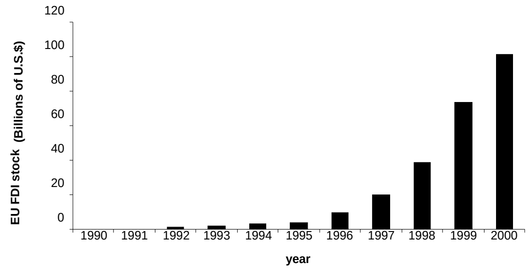
Figure 2: EU FDI outflows



Source:OECD. Calculations by the author

MERCOSUR to reach the level of more than 100 billions dollars in 2000 as represented in figure 3.

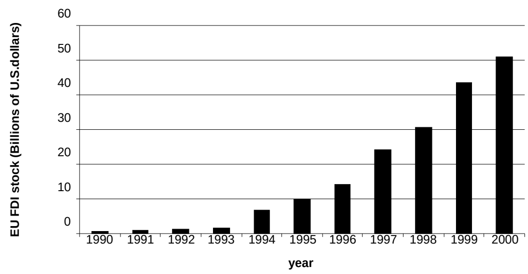
Figure 3: EU FDI stock in MERCOSUR countries



Source:ECLAC. Calculations by the author.

Figure 4 shows, instead, the evolution of European investment stock in the rest of Latin America in the 90s. From the comparison with the previous graph it is clear the greatest attractiveness of MERCOSUR countries.

Figure 4: EU FDI stock in other LAC countries



Source:ECLAC. Calculations by the author.

This situation is strictly related, on one hand, to the evolution of market structure and competition conditions inside the new-born European Common Market in the 90s and, on the other, to reform efforts accomplished by MERCOSUR countries and to the formation of MERCOSUR itself. These contemporaneous happenings paved the way for the huge inflow of foreign investments into the region. Although nowadays the investors' interest has left LAC countries for Asia, the European firms are still present in the region and the study of their determinants is useful to gather some reflections on this experience. The next sections, thus, will deal with the determinants of EU investments in MERCOSUR countries.

In this line, after presenting the general international environment which pushed and enabled European firms to enter Latin American markets, an empirical model will be estimated to test what host country features were determinant for the attraction of European companies.

The work is meant to give an overall view and some more specific explanations for the increasing European investors' presence in the LAC region in the 90s. The conclusive section will then try to highlight new avenues for research.

2 Determinants of European FDI to MERCOSUR

2.1 The General Frame.

Before starting with a classical focus on TNCs strategies in MERCOSUR, some words have to be spent on the prejudicial matter of why some European investors more than others flew with their capital to Latin America.

This aspect is relevant to understand why investments, especially by Spanish companies, were concentrated in services thus opening up a new era for the typical TNCs presence in MERCOSUR countries traditionally based in the manufacturing sector.

What firstly determined the decision of the Spanish companies to invest in the electricity, water, gas, banking, telecommunication and transport sector in Latin America was the deepening of the process of economic integration which Europe was undergoing at the beginning of the 90s. After a period of "Euro Sclerosis" which got to an end with the 1986 Single Act, the formation of the European Common Market in 1992 brought about an increased competition. This caused the restructuring, through liberalization and privatization, of many service sectors in all European countries with Mergers and Acquisition (M&A)playing the main role as tool to face the new competition rules no more made for a local market but for big global providers of an enormous market. In this general framework, Spanish service companies, like companies in other EU nations, were threatened to be swept away by bigger competitors based in the most advanced nations of the Common Market. In order to survive the wave of acquisitions Spanish companies decided to take advantage of what was occurring on the other side of the Atlantic and started acquiring the actives that were released, especially in Argentina, from the sharp process of privatization of state owned service providers.

To give an example, in the telecommunication sector the dismantling of national monopolies in Europe through privatization opened huge opportunities for competition through new technology innovations. Trade liberalization and economic integration gave a boost to the world-wide restructuring of this sector via M&A operations. In this frame the Spanish company Telefonica found an opportunity to exploit synergy in a market with high growth potential (Calderòn (1999)) in the privatization of LAC countries telecommunication. The same occurred in the electricity sector. The EU path toward liberalization of the national sectors, although at a slower pace than the telecommunication one, led Spanish companies again to look for the expansion into markets with high growth potential as the best strategy to survive globalization. The same goes for control of other energy sources like natural gas and oil.

More or less the same occurred in the banking sector where the concentration process brought about by its restructuring in Spain and the competitive pressure of the Common Market represented the basic impulse for Spanish banks to take advantages of privatization occurring in LAC despite the high risk associated to the countries in the region[1]. In a theoretical frame of oligopoly in general equilibrium Neary (2004) shows that differences in technology can lead to a wave of cross-border mergers where low cost firms buy high cost ones. In this respect they can serve as "instruments of comparative advantage" in the sense that they would move production and trade patterns to what would prevail in a competitive Ricardian world.

[1]The fact that FDI was realized by the less efficient EU providers affected the quality of services provided in the region. Another possible reason for LAC country to represent one of the most favored destinations of European investments might linked to exchange rate consideration. Assets might have turned to be convenient because of an appreciation of European currencies against the local ones and the dollar. This issue, though would need further investigation.

2.2 Host country determinants and TNCs strategies in MERCOSUR countries.

A feature which is common to all of the cases mentioned above is that European companies were looking for markets with high growth potential in order to consolidate their market position. The general theory on the determinants of FDI [2] distinguishes between horizontal and vertical FDI. The former is determined by market seeking reasons (i.e. the need to access a market avoiding trade costs) in presence of firm level scale economies, and the latter, in the presence of low trade costs, depends on the convenience to split the production system in phases due to the possibility of factor cost saving abroad[3].

A wider analytic framework for the study of FDI determinants is Dunning's eclectic approach where the policy framework[4], economic determinants[5] and business facilitation[6] jointly affect a host country attractiveness for FDI inflows.

The formation of MERCOSUR in the early 90s and the general structural reform process involving the LAC region in the very recent decades can easily explain European companies' choice of the Southern Common Market countries as destinations for their capital.

[2] See Barba Navaretti et al.(2001) for a thorough treatment of the theory and the empirics of FDI determinants.

[3] Duràn-Lima e Ventura-Dias (2001) clearly explain the different ways in which production can be split between the matrix and the affiliates: the original way was to reproduce abroad a company which was the copy in small size of the matrix company, here the affiliate produced for the internal market(market seeking, horizontal FDI) with inputs coming mainly from local market and some compulsory linkages with the matrix; the out-sourcing process, instead would reproduce the typical vertical FDI were, in presence of very low trade costs, the matrix develops parts of the production process abroad in order to exploit costs advantages present in other countries. Finally, in the International System of Production (ISP), not only parts of a vertical process, but a whole group of functions can be developed abroad thus coming to a kind of FDI which is something in between the other two.

[4] Political, social and economic stability, rules regarding entry operations, standards of treatment of foreign affiliates, competition and M&A policies, International agreements on FDI, Privatization policy, trade and tax policy.

[5] Market seeking investments where market size and growth, per capita income, access to markets country specific consumer preferences and market structures matter, resource/asset-seeking investments where the availability of raw materials, low-cost unskilled labor, skilled labor, already existing assets and physical infrastructure are relevant, efficiency-seeking where the cost of resources and assets adjusted for productivity for labor resources count together with the chance to establish regional corporate networks.

[6] Investment promotion, incentives, hassle costs, social amenities, after-investment services

With respect to the relative importance of the introduction of the structural reforms and the signing of the Treaty of Asunciòn, from an investigation conducted on a sample of 66 European firms present in Latin America (Dunning (2001)) emerged that the economic and policy determinants were the most relevant motivations for European investments in LAC countries, while being the host country part of a trade agreement with other neighboring countries was not that relevant.

Among the economic determinants the relevance of the market size and growth potential seems to be the most important determinant of EU FDI in the LAC region thus confirming a tendency towards the majority of market-seeking FDI consistent with the wide-spread empirical evidence on horizontal FDI(see Barba Navaretti et al.(2001)). However, in this respect Chudnovsky and Lopez (2004) underline how, despite the dominant feature of market-seeking FDI, transnational corporation strategies in MERCOSUR countries are, in a way, efficiency and asset seeking as well. Efficiency seeking strategies into MERCOSUR countries actually take the form of cost reducing rationalization initiatives through vertical disintegration, out-sourcing and personnel reduction. All this was made possible thanks to the more liberal environment. Asset seeking strategies, instead are related more to the acquired firms' market share than to their assets in human capital and learning process. This last feature, though, is true for Argentina, Paraguay and Uruguay, while for Brazil, existing learning assets seemed to be more relevant than market share in determining foreign investment.

As far as the policy framework is concerned, table 1 shows the general reform index calculated for the first time by Lora (1997), then extended by Morley et. al.(1999) and recently actualized by Escaith et al.(2003). This is the general index obtained by averaging five distinct indexes referring to the process of structural reforms in LAC. These concern trade and capital account liberalization, financial and tax reform and privatization. The indexes range between 0 and 1 with intense reform efforts resulting in values close to 1 and low reform intensity being instead represented by values close to 0. As it is evident from the table all the countries in MERCOSUR engaged in strong reforms in the 90s although the strongest reform effort was recorded by Argentina and Paraguay. Tables 2 and 3 report more in detail the process of trade and capital account liberalization that from the second half of the 80s involved all the countries in the sub-region with Brazil resulting the most moderate one among the four in the general reform effort. A related work[7] shows the extent to which trade liberalization, namely import liberalization,

[7]See Lo Turco(2004). Here trade relations between the EU and MERCOSUR are presented.

Table 1: MERCOSUR:General Reform Index

year	ARG	BRA	PAR	URU
1970	0.56	0.53	0.45	0.38
1985	0.61	0.48	0.47	0.79
1990	0.79	0.69	0.74	0.79
2000	0.86	0.81	0.84	0.83

Table 2: MERCOSUR:Trade Liberalization Index

year	ARG	BRA	PAR	URU
1970	0.54	0.49	0.47	0.00
1985	0.80	0.48	0.52	0.77
1990	0.88	0.76	0.88	0.84
2000	0.93	0.92	0.94	0.93

was important for the sub-region. The documented inflow of capital and the relevant reform effort in the capital account can be another hint to the importance of the policy framework in the attraction of FDI.

2.3 An empirical model of FDI determinants

Here a simple empirical model of EU FDI inflows determinants will be presented in order to draw a rough idea of which LAC country features were important in attracting EU FDI in the 90s.
The specifical hypothesis to test are the importance of reforms, especially of trade and capital account reforms, the importance market seeking strategies versus efficiency and asset seeking strategies and the relevance of the forma-

Table 3: MERCOSUR:Capital Account Liberalization Index

year	ARG	BRA	PAR	URU
1970	1.00	0.64	0.44	0.60
1985	0.40	0.42	0.62	0.80
1990	0.82	0.46	0.77	0.80
2000	0.98	0.73	0.79	0.90

tion of MERCOSUR. To this purpose, going with the empirical literature on the determinants of FDI, the following model will be estimated:

$$EUFDI_{it}^{*} = \alpha_0 + \beta' X_{it} + \eta_i + \epsilon_{it} \quad (1)$$

with $EUFDI_{it} = EUFDI_{it}^{*}$ if $EUFDI_{it}^{*} > 0$
and $EUFDI_{it} = 0$ if $EUFDI_{it}^{*} \leq 0$.
Here $EUFDI^{*}$ is a latent variable, i.e. a variable that we actually do not observe, that measures the flows of European FDI into Latin American country i at time t, and $EUFDI_{it}$ measures EU FDI effectively observed. This represents a censored regression model, i.e. a model where the dependent variable is censored at some value.
The reason to adopt such a modellies in the fact that observing European investments into a Latin American country year by year the value of the variable under analysis can occur to be zero and even negative in some years when it is the case that a net outflow of capital from the given country i is observed. The variable of interest, in the 1 the real European FDI inflows into LAC countries can take a positive a zero or negative value. This can be alternatively said as the variable of interest being "left censored". Now, if we only take care of those observations where inflows are positive and exclude the censored observations from the analysis, a simple linear regression model estimated through OLS would give an omitted variable bias. Instead, the inclusion of the censored observations allows to interpret the dependent variable as the expected amount of EU FDI a random LAC country with characteristics X would receive. To estimate model 1 the tobit maximum likelihood estimator has been used although Heckman two-step procedure would lead to the same results (see Amemiya(1985)).

2.4 Data Description.

The EU FDI series is drawn by ECLAC(Econoic Commission for Latin America and the Caribbean database on foreign investments while the remaining data are drawn from Escaith (2003) and consist of 30 yearly observation for 17 LAC countries. The selected variables are taken in logs and, actually, their first lags are introduced in the regression since it is likely that European investors direct their investment to a specific destination only after observing the specific country characteristics. As mentioned above the variables try to detect the relative importance of the different strategies of EU investors.
To this purpose the host country GDP (GDP_1)together with its GDP per capita ($GDPpc_1$)are inserted to detect market seeking strategies. The gross

capital formation (K_1)and the secondary[8] school enrolment rate of population (SEC_1) were inserted to detect asset seeking FDI, the distance of GDP per capita from the U.S. ($USDIST_1$) was inserted to detect efficiency seeking FDI and the share of GDP in primary production was inserted to control for resource seeking FDI. Finally, a dummy taking value 1 from 1991 onwards only for the four MERCOSUR countries was inserted in order to check whether being part of MERCOSUR meant a higher attraction potential for them. In other words, ceteris paribus, in the 90s EU investors might have preferred MERCOSUR countries just because the agreement would have granted a wider market. In this sense the dummy controlling for the effect of the agreement once again will detect market seeking FDI. Finally two period dummies were inserted, one taking value 1 for all the 80s and 0 otherwise, and the other taking value 1 for all the 90s and 0 otherwise, in order to control for likely time shifts occurred in the 30 year period.
Apart from the economic determinants of FDI, other variables were inserted in order to control for the policy frame which might have encouraged European investments into LAC countries. For this purpose the above mentioned reform indexes were added to the regression.
The indexes are five and measure the reform effort in trade[9]and capital account[10] liberalization, in the financial[11] and fiscal sector[12]and in the privati-

[8]In a relevant work on FDI growth effects Borenzstein, De Gregorio and Lee(1998) use the average years of male secondary schooling as from Barro and Lee(1993) as a proxy for human capital claiming in in their results that FDI affects growth if a country is endowed with a threshold level of human capital. The relevance of this work for the literature on FDI justifies the choice to use secondary school enrolment rate as a proxy for human capital.

[9]The index measuring changes in trade policy is obtained by the average of two components: the average tariff rate and the dispersion of the tariff rate. Non tariff measures are not included and although they are said to have proved more effective in the 70s and 80s than in the 90s, it is difficult to evaluate the intensity in its change because of a lack of information.

[10]The index for the capital account liberalization is obtained by the combination of four different pieces of information: FDI sectoral control, limits to repatriation of profits and interests, controls to external credit coming from national lenders and controls to capital flows.

[11]The financial policy reform was measured through three indicators: controlled or free interest rate on deposits, controlled or free interest rate on credits and the rate of reserve on bank deposits.

[12]The index measuring fiscal reform is made up of four different components: the maximum marginal rate on firm income, the maximum marginal rate on personal income, the value added tax rate and the efficiency of the value added tax. The last index id the ratio between the VAT rate and the collection of the VAT as share of GDP.

zation[13]process. Results from the estimation of the model are described in tables 4 and 5.
Table 4 shows the effect of economic determinants on Eu FDI inflows to LAC. Here all the coefficients are significant and with the expected sign apart from the coefficient on per capita GDP and on the share of GDP in primary products. The former shows a negative sign thus supporting more the idea of efficiency seeking FDI than that of market seeking. As a matter of fact, the GDP per capita distance from the U.S. shows a negative sign representing the fact that, ceteris paribus, the closer is a country per capita GDP to the developed world one the lower is the incentive in investing there. In this sense, the negative sign on the per capita GDP coefficient would reinforce the same concept.
The presence of natural resources seems to be negatively correlated with the EU presence in LAC countries while the signing of MERCOSUR seems to have boosted the attraction of EU FDI in the area thus confirming the prevalent market seeking nature of EU FDI going to the sub-region. Table 5 introduces the country policy frame through the reform indexes. The general findings of the previous table are confirmed apart for the asset seeking strategies proxies, i.e. gross fixed capital formation and secondary school enrolment rate, which become insignificant. This does not necessarily mean that this kind of strategy was not relevant, instead it might be caught by the introduction of the reform indexes. As a matter of fact, the privatization process, with the acquisition of national assets by foreign investors, actually represents a path through which existing assets in terms of human and physical capital attracted EU presence in the region. As a matter of fact, the coefficient on the privatization index is positive and highly significant. From all the indexes the trade and financial reform ones show a negative coefficient. For the former it would mean that more trade liberalization is associated to a lower EU presence in LAC countries. This result reveals how the deep process of trade liberalization in the region led, in a way, to a substitution between FDI and trade liberalization. All the production processes once developed within the protected national boundaries for the production of intermediate and final goods are now substituted by import from outside. This finding is consistent with what in general is observed on trade flows[14]. Moreover, the negative sign on the trade reform index might as well indicate that, being EU FDI relatively more important in LAC service sector, the relevance of trade liberalization is secondary.

[13]Privatization are measured as 1 minus the ratio between the added value of state owned companies over non-agriculture GDP.

[14]Again see Lo Turco(2004) on the evidence of the burst of LAC imports from Europe in the 90s.

The financial reform, then, might be negatively related to EU presence in LAC countries because financial instruments might be a substitute for direct investment. In other words, the availability of local credit undoubtedly represents a substitute for capital from abroad. Financial liberalization with the chance to find credit in the local markets, gives a foreign firm the collateral benefit of avoiding exchange rate related risks.
Finally MERCOSUR is still significant and positively related to EU FDI.
Summing up, estimation of model 1 confirms that market, efficiency and asset seeking strategies are at the base of EU FDI inflows to LAC countries. The policy framework, though, plaid a relevant role especially through tax reform, capital account liberalization and privatization with the latter meaning an important acquisition of assets by foreign investors and, thus representing the importance of asset seeking strategies of EU investors. An interesting extension of this model would be to insert a lag of the dependent variable on the right hand side in order to check how important is EU FDI inflow in one country in determining future EU FDI inflows. This would represent a sort of signalling effect of FDI but since it would involve a dynamic panel data model the estimation technique adopted here is not the most suitable so this extension is left for further research[15].

3 Conclusions

The present work has meant to provide an overall view and some more precise explanations of the determinants of EU investments in MERCOSUR and other LAC countries.
After presenting the origin and the evolution of the European presence in LAC countries, this study has presented and estimated an empirical model where both economic and policy determinants, within the Dunning eclectic approach, have been put at a trial and what emerged is that, despite efficiency, market and asset seeking strategies were important reasons to direct FDI to LAC region, the policy framework has proved to be the most important EU FDI determinant in Latin America. The negotiation of MERCOSUR and the structural reform process are by far the most important events. Especially, the fiscal reform, the privatization process and the capital account liberalization proved to be effective on attracting European FDI. A substitution effect has been detected between EU investments and trade and financial tools.

[15]Actually the variable accounting for the gross capital formation might indeed include some foreign capital in it. This means that the presence of this lagged variable in the regression already controls for this signalling effect.

Table 4: EU FDI Determinants:table A

$EUFDI^a$	Coef.	Std. Err.
MERCOSUR	5.64^{***b}	.84
K_1	6.25^{***}	1.12
GDP_1	3.05^{***}	.40
SEC_1	2.52^{***}	.76
$USDIST_1$	-9.49^{***}	1.17
$GDPpc_1$	$-.99^{***}$	.46
$GDPPRIM_1$	-3.44^{***}	.88
$dummy80s$	-2.07^{***}	.95
$dummy90s$	4.82^{***}	.78
$cons$	-16.42^{***}	4.33
obs	510	
$Groups$	17	
$Wald$ chi2(9)	246.49	P-value=.00

[a]-Dependent Variable Log of EU FDI inflows to MERCOSUR. [b]-***, ** and * respectively indicate signifcance at 1, 5 and 10% level.

In the whole the main theoretical results are strongly supported from the above analysis which is anyway in line with what emerged from previous studies (Dunning(2001), Chudnovsky et al.(2004)). Considering data on disaggregated EU outflows, namely EU firms' in order to model a first step of firms' decision to go abroad depending on some firms' and home countries' features, would then be an interesting extension to the above analysis.
Another piece of research is needed, i.e. the one related to European FDI effects in the region with special care to MERCOSUR countries.
Since EU FDI are mainly concentrated in the service sectors, further research is needed to specifically analyze both how deeply EU presence affected market structure and, consequently, how market structure affected price levels in the privatized sectors. The most difficult task then is to measure how EU presence in the services sector affected overall productivity in host countries. A promising avenue for research, here, might be the one of Alfaro and Rodrigués-Clare. An extension of their backward linkages index might help detecting how widely the availability of more modern telecommunication infrastructures has affected the existing production units.
Finally, another extension of this work would be to highlight how the formation of MERCOSUR affected the concentration of industrial production in the larger countries with the smaller specializing intra-regionally in primary

Table 5: EU FDI Determinants:table B

$EUFDI^a$	Coef.	Std. Err.
MERCOSUR	5.64^{***}	.86
K_1	.26	.98
GDP_1	5.63^{***}	.50
SEC_1	.57	.63
$USDIST_1$	-6.33^{***}	1.04
$GDPpc_1$	-2.60^{***}	.41
$GDPPRIM_1$	-1.76^{**}	.83
$TRADE_1$	-6.02^{*}	3.18
TAX_1	11.89^{***}	2.51
FIN_1	-2.84^{***}	1.53
CAP_1	8.69^{***}	1.67
$PRIV_1$	8.54^{***}	1.67
$dummy80s$	-2.54^{***}	.907
$dummy90s$	2.45^{***}	.89
$cons$	-23.09^{***}	4.18
obs	510	
$Groups$	17	
$Waldchi2(14)$	314.36	Pvalue=.00

^{a}-Dependent Variable Log of EU FDI inflows to MERCOSUR. ^{b}-***, ** and * respectively indicate signifcance at 1, 5 and 10% level.

products as Venables(2002) predicted. If this is the case, as actually it seems to be[16], an interesting implication might be the need for a redistribution process within MERCOSUR.

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