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LATIN AMERICA IN A CHANGING GLOBAL ENVIRONMENT

by

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RÉSUMÉ

Un bouleversement historique est en train de se produire dans le processus d'insertion de l'Amérique latine au sein du système mondial des échanges. Le sens de ce bouleversement se manifestera par l'échec ou le succès des négociations de l'Uruguay Round sur les échanges multilatéraux, par un accroissement des échanges régionaux et, en Amérique latine, par une profonde libéralisation des systèmes d'échanges nationaux qui va également provoquer dans la région un net regain d'intérêt pour les modèles d'intégration sub-régionaux. L'interaction entre les changements se produisant dans les systèmes régionaux et ceux qui déterminent globalement l'investissement direct dans le secteur industriel a aussi des conséquences sur les avantages géographiques que représente l'Amérique latine en tant que bénéficiaire de l'investissement direct.

En Amérique latine, les effets de la régionalisation en Europe et dans l'hémisphère occidental sont , dans l'ensemble, bénins. "L'Europe de I992" devrait avoir un impact favorable net sur les exportations latino-américaines, sauf si — ce qui est peu probable — des mesures radicales et discriminatoires étaient prises à l'encontre des parties tiers dans le cadre du marché unique européen. L'éventualité de création d'une zone de libre-échange dans l'hémisphère occidental est considérée comme un facteur de développement extrêmement positif : non seulement cette perspective laisse espérer une augmentation des exportations vers l'énorme marché américain, mais elle donne aussi un nouvel élan au processus de libéralisation nationale et d'intégration régionale.

L'Amérique latine va également continuer à être un pôle d'attraction pour les flux d'investissement direct étranger dans la mesure où le recul de la stagnation et de la crise de la dette se maintient, sans tenir compte des nombreux autres facteurs intervenant dans l'utilisation de l'investissement global. L'intérêt pour la région peut même être renforcé si le degré des mesures discriminatoires à l'encontre des parties tiers était élevé — mesures implicites dans une zone de libre-échange de l'hémisphère occidental — car les firmes dont les activités sont orientées vers le marché américain pourraient alors envisager d'accroître sensiblement leurs investissements en Amérique latine. L'intégration sub-régionale et la libéralisation peuvent aussi entraîner une augmentation des flux d'investissement en contraignant les firmes multinationales déjà établies dans la région à restructurer leurs activités.

L'élément-clé qui caractérise le schéma d'insertion du processus de régionalisation et de globalisation actuellement en cours en Amérique latine, est la ferme volonté de la région d'accéder à un système d'échanges et d'investissement plus ouvert. Ces réformes se feront à des rythmes différents selon les pays et auront des envergures diverses selon les alliances stratégiques avec les autres pays voisins en fonction des spécificités structurelles de chaque économie (particulièrement la dimension du pays) ainsi que de la structure des échanges, (surtout la concentration géographique). Cependant ces réformes semblent quasi irréversibles et, en Amérique latine, leur succès permettra d'atténuer les menaces que les profonds changements qui affectent aujourd'hui l'économie mondiale, font peser sur le système des échanges multilatéraux.

SUMMARY

Latin America's insertion in the world trade system is entering a period of historical change. Driving that change will be the outcome, or failure, of the Uruguay Round of multilateral trade negotiations; the increasing regionalisation of trade relations; and the profound liberalisation in Latin America of national trade regimes, which is also leading to a strong revival in the region of sub-regional integration schemes. The interaction between changes in the region's trade regimes and changes in the global determinants of foreign direct investment in manufacturing are affecting the locational advantages of Latin America as a recipient of direct investment flows as well.

The effects on Latin America of regionalisation in Europe and in the Western Hemisphere are, overall, benign. "EC 1992" is likely to have a positive net impact on Latin America's exports unless dramatic, and unlikely, discriminatory measures against third parties are introduced in conjunction with the creation of the Single European Market. And the move towards creating a Western Hemisphere free trade area is seen from the Latin American perspective as a highly positive development: not only does the possibility of favourable discrimination raise the prospect of export growth to the huge US market, it gives further impetus to the processes of trade liberalisation at the national level and of sub-regional integration.

Latin America is also likely to continue to be an attractive location for foreign direct investment insofar as stagnation in the region and the debt crisis continue to recede, irrespective of the many other factors affecting the direction of global investment flows. The region's attractiveness may even be reinforced if the degree of trade discrimination against third parties implicit in a Western Hemisphere FTA turns out to be large, since firms targeting the US market would be likely to substantially increase their investment in Latin America. Sub-regional integration and liberalisation may also increase investment flows by forcing multinational firms already established in the region to restructure their regional operations.

The key element shaping Latin America's pattern of insertion in the current processes of regionalisation and globalisation is the region's earnest drive towards a more open trade and investment regime. These policy reforms are likely to proceed at a different pace in different countries, and with varied importance attached to strategic alliances with other countries in the region, according to certain structural characteristics of a country's economy (especially its size) and trade structure (especially its geographical concentration). The reforms appear largely irreversible, however, and through their success Latin America should be able to help stem the threats that the profound changes affecting the world economy today still pose for the multilateral trade system.

PREFACE

The Development Centre is carrying out a major research project on Globalisation and Regionalisation as part of its 1990-1992 Work Programme. The Project aims to provide a better understanding of the economic and political forces that are working for, and against, the formation of regional economic groupings in Europe, the Western Hemisphere and Pacific Asia, and how those forces interact with the forces (essentially microeconomic) that are driving globalisation. The purpose is to assess their implications for the strategies and policies of various categories of developing countries.

For Latin America, considerable uncertainty and potential volatility in the world economy has emerged at a time when redesigning national policies to achieve greater participation in global trade and investment flows is high on the political agenda of virtually every country in the region. Global industrial restructuring is seen as providing important new opportunities, but is also creating a sense of urgency in the region to overhaul defensive policies and design more open strategies to avoid exclusion from globalisation.

This paper focuses on the implications for Latin America of the moves towards greater regional integration in Europe and in the Western Hemisphere. Noting that "EC 1992" and especially European Union are potentially trade diverting, it argues that while the net impact of the Single European Market on Latin America is likely to be positive, the danger remains that it will induce changes in European trade policy which would have a significant negative impact on Latin America. In the Western Hemisphere, the Bush Administration's "Enterprise for the Americas" Initiative evokes bright prospects for guaranteed access to the huge US market, but also raises critical issues relating to the costs of structural adjustment for countries entering a free trade agreement with the United States.

In explaining why Latin America's remarkable drive towards liberalisation is nevertheless likely to produce a diversity of approaches to policy reform in the region, while at the same time feeding the renewed interest in sub-regional integration schemes, and in emphasizing the importance for developing countries of both a successful conclusion to the Uruguay Round and macroeconomic policies in OECD countries that generate a stable environment for world trade growth, this paper -- written by one of Latin America's foremost international economists -- constitutes an important contribution to the Centre's research on Globalisation and Regionalisation.

Louis Emmerij
President of the OECD Development Centre
May 1992

INTRODUCTION

Over the past decade, the acceleration of technical and organisational change in the OECD region has combined with a potentially unstable global macroeconomic environment to increase the volatility of the determinants of international competitiveness. These changes decisively alter the strategic decisions of developed countries' governments and internationalised firms, changing both the institutional framework of the world trading system (giving birth to protectionism and greater trade regionalisation) and global patterns of foreign direct investment (FDI).

This increase in the environmental volatility of the world economy comes at a time when, for virtually every country in Latin America, redesigning national policies to achieve greater participation in global trade and FDI flows is placed high on the domestic policy agenda. This coincidence is not fortuitous. Global industrial restructuring and transformations in the patterns of international trade in manufactures are seen as providing opportunities -- and, indeed, making it imperative -- both to overhaul established defensive trade policies and to design more open strategies of international integration throughout Latin America.

This paper discusses the interactions between global trends in trade and FDI flows and the national policy responses that will shape Latin American patterns of integration in the foreseeable future. The analysis is conducted at two distinct but complementary levels. The first two sections concern the effect on Latin America of the probable evolution of the world trading system and of global FDI patterns: the first assesses how protectionism and regionalisation -- especially the possible increase in regional integration around the EC and the United States -- may affect the region's export prospects, while the second addresses the impact of globalisation and the changing determinants of North-South FDI flows. The third section discusses how these exogenous conditionants will influence the reform of domestic trade policy and thus shape new patterns of integration into the international economy; it argues that distinct, identifiable sub-regional patterns of integration are likely to emerge, depending on the peculiarities of the current output structure of groups of Latin American countries and their present degree of insertion in the world economy. The last section summarises the main conclusions.

REGIONALISATION IN THE NORTH ATLANTIC AND LATIN AMERICAN TRADE

The protracted closing of the Uruguay Round raises some crucial questions concerning the evolution of the institutional framework of the world trading system. The most likely scenario in the near term, as argued by R. Lawrence (1991), is a renewed impetus to regional integration around the large markets of the United States, the European Community (EC) and Japan. Whether this will lead to greater liberalisation depends on whether the trading regions can be formed without jeopardising multilateralism.

In principle, there is no reason to believe that the move towards regionalisation indicates a weakening of the multilateral trade system, or that the multilateral system would break into three large protectionist blocs which would strongly restrict the access of Latin American exports to those markets. This is certainly true of the Asian and North American integration processes. On the one hand, the most recent concrete development in the United States' drive towards free trade areas -- the so-called Bush Initiative -- specifically contemplates the building of a hemispheric free trade zone. Although it is unlikely that such an ambitious aim will be realised in the near future, the free trade offer contained in the Bush Initiative raises the market access prospects of Latin American exports and is compatible with continued adherence to the basic rules of the multilateral trade system. On the other hand, it is also difficult to believe that the natural process of integration taking place in the Pacific basin -- a result of rapid industrialisation of the region's peripheral economies and the wave of Japanese FDI in response to the structural adjustment pressures of rising wages and yen appreciation[1], and in which high rates of growth prevail -- can have negative diversion effects on Latin American trade of the kind usually associated with the formation of a discriminatory bloc. The "threat" of the integrated Pacific basin stems rather from the productivity gains to be reaped by firms located in the area. This is quite different from a protectionist threat, since it can be countered by compensating productivity increases in their trade partners.

Both the background and the consequences of European integration are somewhat different. Europe 1992 is a natural development of past trends towards the consolidation of a trading bloc that, by any definition, already exists. The step now being taken by the EC-12 aims to reduce or abolish existing non-tariff restrictions on intra-Community trade. This move is a strategic response, which has already gained momentum, to the perceived decline of intra-Community trade in manufactures relative to that with non-members since the 1970s -- in European jargon, the slowing of the process of integration[2]. Not only does one increasingly hear of prospects for the expansion of the EC-EFTA arrangements into a customs union and for closer economic ties between the EC and Eastern Europe, there are also fears -- discussed in greater detail below -- that the structural adjustment costs of this last step towards European economic integration may lead to increased protection against third parties.

Latin American commerce is much more integrated with Europe and the United States than with the Pacific Asian countries[3]. The aspects of regionalisation of world trade that are relevant to Latin America therefore lie in developments in the North

Atlantic: the evolution of the Bush Initiative and the impact of Europe 1992. The issues arising from the formation or consolidation of these two blocs are quite different. Europe 1992 is seen as potentially trade-diverting, and therefore as a threat. In contrast, the vision of a Western Hemisphere free trade area extending, as President Bush put it, from the port of Anchorage to Tierra del Fuego, can only evoke bright prospects as far as market access is concerned. By contemplating trade reciprocity among countries that differ greatly in size and factor endowments, however, it raises important issues relating to structural adjustment in member countries. The following sub-sections deal separately with the issues arising in these two contexts: the first evaluates the impact of Europe 1992 on Latin American exports, and the second assesses the likely outcome of the Bush Initiative.

Europe 1992 and Latin American Exports

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

A second, trade-creating effect stems from the rise in Community incomes owing to both the one-time effect of trade liberalisation on resource allocation and dynamic growth effects, especially those arising from faster productivity growth. The Cecchini Report[4] estimated the former as causing an increase of 2.5 to 6.5 per cent in the EC's GDP, depending on assumptions about the extent of liberalisation and underlying macroeconomic conditions. These estimates have been criticised by R. Baldwin[5], who claims that the report may have severely underestimated the output growth effects of Europe 1992. Baldwin argues that the report not only underestimated the static growth effects but, by ignoring the dynamic impacts of economy-wide economies of scale, failed to take into account an effect which could permanently add between a quarter and one full percentage point to the EC's growth rate[6]. Even if these estimates are taken with a grain of salt, the impact of Europe 1992 on the Community's GDP could be substantial in the medium term.

Finally, a third effect may arise from changes in the EC trade policy regime *vis-à-vis* the rest of the world -- the structure of import protection, preferential arrangements with third suppliers -- that occur as accommodating side effects of Europe 1992.

A quantitative assessment of the impact of Europe 1992 on Latin American exports lies outside the scope of this paper (see Page, 1992), but a glance at some basic features of the commodity composition of Latin American exports to the Community suggests several plausible *à priori* conclusions. The data on the direction of trade displayed in Table 1 show that the European market serves as an important outlet for Latin American exports: it accounts for around a quarter of the total foreign sales of most countries in the region, apart from the oil producers and the US trade satellites in the Caribbean.

The commodity composition of trade is more relevant to the present discussion. Table 2 shows the importance of the EC as a market for Latin American exports in selected product categories. It can be seen that primary commodities still account for 83 per cent of exports, and that non-oil commodities (items 1 to 3 plus 5) alone account for no less than 63 per cent of total shipments. As for manufactures, exports of goods requiring relatively sophisticated technology, such as machinery and transport equipment, have expanded in line with total manufactured exports since the 1970s, but labour-intensive goods such as textiles and clothing still account for a substantially larger share of exports. Thus the bulk of Latin American exports to Europe are either non-competitive -- such as oil, and tropical products or other food items not excluded from European markets by the operation of the Common Agricultural Policy -- or manufactures likely to have very low elasticities of substitution in relation to domestic production.

These data suggest that -- given the expected size of income changes and the magnitudes of the relevant substitution and income elasticities -- Latin American countries will benefit more from rising EC incomes stemming from Europe 1992 than they lose from the trade-diversion effects. One can therefore conclude that without accompanying changes in the Community's trade regime relative to third countries, the effect of greater European integration on Latin American exports is likely to be positive.

There are two problems with this optimistic argument. The first is that the static trade-diversion effect of traditional theory assumes given, neoclassical production functions, while the expected positive impact of greater European integration will come especially through induced technical efficiency and the economies of scale made possible by the larger common market. Indeed, this is the basic strategic motivation of Europe 1992 as repeatedly put forward by authoritative opinion in Europe. As firms based in Europe become more efficient, they are not only bound to increase their shares of EC markets but also likely to displace overseas suppliers in third countries.

The second problem is the likely intra-EC relocation of production to take advantage of the wide variance of labour costs within the Community. Greater efficiency here would stem mainly from classical comparative advantages, but it would have the same effect of decreasing the relative competitiveness of non-European suppliers.

The danger is not that these two effects raise the competitiveness of EC-based firms in relation to those located in Latin America, as this can be countervailed by trade and industrial policies in the latter region, but that they can affect the EC's trade policy towards third parties. It has been argued, for example, that the possibility of sizable economies of scale in the larger integrated market may justify strategic trade policies based on temporary protection[7]. Given the size of the European market, however, the argument for strategic trade policy on these grounds may be valid only in the few sectors where potential competitors are Europe's developed industrial rivals, not the Latin American NIEs.

The impact of intra-EC relocation of labour-intensive production facilities is a different matter, as present differences in labour costs within the Community are substantial. Even when corrected for productivity differentials, the existing wage gaps suggest that the use of best-practice equipment and, in some sectors, the attainment of higher economies of scale in new plants geared to the European market are bound to cause differences in unit labour costs large enough to induce the migration of labour-intensive industries towards low-wage areas in Portugal or Greece. If this spatial redistribution of efficient industrial plants within Europe occurs rapidly -- and depending on macroeconomic conditions -- it is likely to induce protectionist pressures in the high-wage Northern European countries in precisely the sectors of great actual or potential export interest to Latin America[8]. As suggested by Lawrence (1989), the demand for import protection may be reinforced in these circumstances by the present constraints on state aid, which reduce the scope for the use of subsidies in industrial restructuring schemes, as has been customary in Europe.

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

This long-term process of global structural change is irreversible. Although OECD countries still account for the bulk of change in import penetration in manufactures -- as measured by the share of imports in domestic apparent consumption -- penetration of the EC by developing countries not only has increased at a faster rate in the aggregate, but in many labour-intensive sectors shows larger ratios than those of the EC's developed trade partners[10]. This well-established trend may even be reinforced by European integration if the lure of the larger market prompts developing countries to target the EC to overcome the front-loaded learning costs involved in entering export markets, as they usually did with the United States[11]. The threat of continued indiscriminate use of voluntary export restraints (VERs) and anti-dumping actions in Europe may pose more problems for the Asian NIEs -- whose import penetration ratio in the EC-7 increased on average by 18.3 per cent a year between 1970 and 1987, as against only 1.4 per cent for Latin America and 3.6 per cent for the world as a whole -- but it is nevertheless a crucial issue for Latin America.

The single European market raises another issue in multilateral trade policy that is important for Latin America: the possibility that the need to harmonise national trade regimes within the Community will affect protection against third parties. This can happen in at least two ways. First, there may be changes in the trade preferences granted outside the GSP, especially those accorded to the ACP countries under the Lomé agreement, which will affect primary or semi-processed goods. At the time of writing, it is still not clear how Lomé preferences will be affected by Europe 1992. Second, and certainly more important for trade in manufactures, the harmonisation of existing national quotas on some goods of non-European origin -- the most important for Latin America being steel, autos and, especially, textiles -- may restrict access even further. This calls attention to the crucial importance of the Uruguay Round for the future evolution of Latin American exports of manufactures to Europe[12].

The principal conclusion to be derived from these arguments is that the direct effects of Europe 1992 are unlikely to have a net negative impact on Latin American exports, but that they may do so if they induce changes in trade protection against developing non-members. Thus, if the Uruguay Round succeeds in reversing the erosion (beginning with the Multi-fibre Agreement) of GATT discipline against the use of quantitative restraints, and if macroeconomic policies promote stable growth of world trade, integration between Latin America and Europe will continue to increase.

Challenges and Opportunities in a Western Hemisphere FTA

On 27 July 1990, the President of the United States made a speech at the White House launching what came to be known as the Bush Initiative. The principal trade-related aspect of the Initiative is the proposal of a hemispheric free trade area as a long-term objective, to be achieved through a series of bilateral agreements with either individual Latin American countries or the groups of countries that are forming integrated trade areas in the region. President Bush explicitly stated that despite its clear component of regional trade discrimination, the offer -- as in other American initiatives of this kind in the recent past[13] -- does not imply the abandonment of multilateralism as the preferred option.

The motivation of the Initiative is both strategic and tactical. As a strategic option, it has at least two chief objectives. The first is to resurrect a sort of economic pan-Americanism as a defensive response to the competitive threats posed by regional integration in Europe and the Pacific basin. The second, and perhaps more important as an immediate motive, is the will to give additional impetus to the process of trade liberalisation under way in almost all countries south of the Rio Grande. This move would have the additional advantage of promoting the *aggiornamento* of hemispheric relations in the post-Cold War world: the consolidation of the new democratic regimes in Latin America requires the replacement of anti-communism by positive economic help, granted in terms of commercial advantages and larger bilateral investment flows.

The chief tactical motive of the Initiative is to use the bilateral negotiating forum it creates to push trade liberalisation beyond the traditional measures affecting trade in goods and into the realm of regulatory policies in the areas of the so-called new themes in the GATT Round, so dear to US economic diplomacy. According to the American proposal, the free trade agreements should contemplate the exchange of secure access to the US market for the progressive elimination of trade barriers and the establishment of clear rules for protection of intellectual property rights and for regulation of both direct investment flows and trade in services[14].

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

For highly protected countries, the costs of structural adjustment (such as transitional unemployment costs or losses due to rigidities in capital mobility) entailed by trade liberalisation with a partner of the size of the United States are tantamount to those of a multilateral liberalisation[15]. If, however, the United States is not the most efficient supplier of the bulk of the country's imports, the static allocative benefits stemming from bilateral liberalisation are clearly smaller than those stemming from an equivalent multilateral liberalisation. Furthermore, the higher the level of protection in the country, the greater the trade-diversion effects on third parties caused by a bilateral liberalisation with the United States, and, thus, the greater the likelihood of opposition from other traditional OECD exporters that compete with American products in Latin American markets.

The net benefits of forming a free trade area with the United States also depend on the American trade regime, since greater potential gains would result from the guarantee of preferential market access relative to third partners facing the American most-favoured-nation (MFN) tariff. For a given product these gains would increase with (i) the level of the import barrier affecting it in the United States, (ii) the current volume of exports to the United States and (iii) the price elasticity of demand for that product in the American market. The discriminatory guarantee of market access would also increase the attractiveness of the FTA partner country as a location for export-oriented FDI, especially by firms located in countries which already face severe trade barriers in the American market or fear discriminatory protection in the future. One can therefore conclude *à priori* that forming an FTA with the United States which abolished binding access restrictions on products of export interest to a country and discriminated against exports from competing suppliers would bring certain benefits to that country.

It is reasonable to conclude that the choice of negotiations envisaging the immediate signature of a comprehensive FTA agreement will depend on specific country features. As is argued at greater length below, it will seem an optimal alternative for cases such as Mexico or some Caribbean countries, which trade chiefly with the United States, or Chile, which has already liberalised its import regime to an impressive extent and faces frequent access problems in the United States. In large and still relatively protected countries with a geographically diversified pattern of trade, such as Brazil, the response to the American offer was understandably cool.

The main attraction of the Bush Initiative is the guarantee of market access, but the extent to which this will be achieved is uncertain, for at least two reasons. First, until the negotiations in the Uruguay Round -- which may introduce changes in the United States' protection structure -- are completed, it is impossible to evaluate the gains stemming from preferential treatment in a particular product. Second, and perhaps more important, the credibility of the American offer of liberalisation is at issue. Experienced Latin American trade negotiators are almost unanimously sceptical about the possibility of a radical change in American protectionism in areas of great export interest to the region, such as labour-intensive manufactures or steel.

Finally, the Initiative may give new impetus to the integration processes within Latin America. In bilateral negotiations carried out on the basis of reciprocity, as envisaged in the Initiative, bargaining power depends on the size of domestic markets; this incentive to negotiate by groups promotes the formation of new institutions such as Mercosur -- the projected common market joining Argentina, Brazil, Paraguay and Uruguay -- and gives a new lease of life to old sub-regional integration associations.

GLOBAL TRENDS IN FDI FLOWS AND LATIN AMERICA

Over the past ten to fifteen years, a wave of technological and managerial innovations has coincided with the growing environmental instability described above; the combination has produced marked changes in the determinants of strategic decisions of internationalised firms and, thus, in the dynamics of global FDI flows. Within the developed world, the spatial and sectoral distribution of global FDI flows has recently undergone great changes -- of which the most remarkable feature is the rapid growth of Japanese investments in the auto and electronics industries of the larger North Atlantic economies -- but this trend still follows the logic of American and European post-war internationalisation: Japanese firms holding a position of global industry leadership, owing to the possession of intangible assets in the form of trademarks or technology, are responding to real or perceived protectionist moves in their strategic export markets.

The same period witnessed an important change in the determinants of FDI flows towards the semi-industrialised periphery, resulting from the operation of two distinct processes. The first is the "globalisation" of multinational firms: the change in the spatial configuration of their operations which replaces the traditional scheme (relatively autonomous subsidiaries serving relatively segmented national or sub-regional markets) by a new configuration with a high degree of integration among productive operations in different locations. This restructuring of global production networks is not likely to be reversed soon, as it represents the competitive response of leading firms to pressures stemming from the greater environmental volatility mentioned above and the long-term reduction of co-ordination costs made possible by advances in telematics[16]. Second, a growing share of FDI came as a structural adjustment response to the rapid shifts in international competitiveness between industries located in different countries, stemming either from sharp exchange-rate fluctuations or, as in Japan and some East Asian NIEs, rapidly rising labour costs. These direct investments abroad were made mainly by export-oriented but not yet internationalised exporting firms -- that is, not MNCs, but firms which still operated from a single national production base.

This dual pattern of globalisation-induced and structural adjustment-induced FDI, which have entirely different dynamics, has important implications for the analysis of the impact of changes in trade policy on current investment flows. Both processes lead to a locational logic which tends to deploy new plants according to perceived longer-term comparative advantage, fundamentally determined by the interaction of technology and factor costs. However, as these plants will be designed either to fit a regionally wide network of integrated production (FDI by globalised firms) or to target export markets which could no longer be reached from the home base (structural adjustment investment), these strategic decisions will also be crucially affected by perceived locational advantages stemming from trade, exchange rate and, more generally, integration policies. Thus there may be a strong link between the size and direction of FDI flows and perceptions concerning the future of regionalisation, as it affects frontiers of free trade and related currency areas.

The foregoing analysis implies that moves towards the formation of a Western Hemisphere FTA may provide inducements to inward FDI flows to Latin America. To assess these inducements, however, one must distinguish between investments by already established MNCs and those by newcomers, that is, between the two processes outlined above.

For inward FDI of a "structural adjustment" nature, the prospect of an increasingly integrated area encompassing the three Americas is likely to be favourable, for two basic reasons: the importance to exporting firms of guaranteed access to the US market, and the privileged location of Latin American countries -- which sit firmly in the dollar area, have relatively low wage levels and, in some instances, have built a reasonably sophisticated industrial infrastructure -- for companies targeting Western Hemisphere FTA markets. The logic of these investment flows does not differ much from the old tariff-jumping FDI: inducements will be higher, the stronger is the belief that a United States-centred FTA will discriminate against third parties. For this inducement to be credible, however, real FTA agreements must be concluded. Indeed, these FDI flows will be sizable only if FTA members are granted durable access to the American market in manufactured product lines in which they hold clear competitive advantages, and this will pose difficult domestic adjustment problems to the United States, as the negotiations of the Mexico-United States agreement demonstrate[17].

MNCs already established within a discriminatory hemispheric FTA for a few decades may see no incentive to invest further. As Louis Wells (1992) convincingly argues, US MNCs are not excited about the threats of an aggressive regionalism precisely because they are already spread over Latin America and Europe. It is therefore unlikely that regionalisation in Western Hemisphere markets will cause a dramatic shift in large MNCs' global investment patterns, but one should note that the spatial logic of old MNC investment and export flows from their plants in Latin America was shaped by large national trade barriers which are now falling as a result of changing national trade policies and faster regional or sub-regional integration. Thus, growing integration within the area will affect investment relocation, plant specialisation and export strategies even by already established multinationals, and this may have important effects on national economies.

Assessing the likely impact of European integration on FDI flows is somewhat more complex, as the discussion raises two different issues. The first relates to the inducement given by Europe 1992 to direct investment decisions of Latin American firms in Europe -- that is, its impact on Latin American outward FDI. The second bears on the extent to which the opening up of investment opportunities in Europe will reduce the attractiveness of Latin America as a location and thus divert FDI flows from it -- that is, its impact on inward FDI flows to the region.

Outward FDI flows towards the EC induced by the prospect of the integrated market will be principally determined by expectations of (i) enhanced profitability as result of integration and (ii) increased protection or other forms of discrimination against the supply of goods and services by firms located abroad. As the first motive is especially relevant to already established firms, it is not a fundamental determinant for Latin American companies, with their very low degree of internationalisation. The crucial determinant of direct investment by Latin American firms in the EC is the threat posed to exporters.

A survey of the direct investment motives of a sample of Brazilian firms showed that reactions to Europe 1992 did not reflect a sectoral logic but are firm-specific and depend on the importance already taken by foreign markets in the firm's growth strategy[18]. According to this study, there are two basic patterns of behaviour. Some firms adopt a defensive strategy aimed at defending already established positions in the European market. Examples of such behaviour are the building of a blending unit for orange juice concentrate in Italy by a group of large exporters in association with local entrepreneurs, the joint venture established in Germany by Brazil's largest exporter of wood agglomerate or the plants being built by two leading national exporters of car parts. The second pattern, more offensive, aims at building a base on which to learn so as to expand the firm's European operations. This strategy has typically been used by firms in the clothing industry, for which Europe is still a relatively unimportant market, absorbing less than 10 per cent of Brazilian sales as opposed to over 80 per cent in the United States. Indeed, the chief characteristic of the vast majority of recent Brazilian direct investment in the EC is the resort to "new forms" of FDI as opposed to wholly owned subsidiaries[19]. This reflects either the relative smallness or the lack of international experience of the new entrants to the European markets, a phenomenon also identified in the recent pattern of American direct investment in Europe[20].

As for manufacturing FDI flows towards Latin America, the effect of Europe 1992 -- coupled with liberalisation in Eastern Europe -- is supposed to be the diversion of global flows to European locations. The operation of this effect depends, however, on the relative *ex ante* profitability of manufacturing investment in Latin America and in low-wage Europe, which is more likely to be determined by domestic policies and the investment climate in these regions. Given the large penetration of foreign business in Latin America, the crucial medium-term determinant of FDI flows to the region is the sustained recovery of its normal rates of output and investment growth.

TOWARDS DIVERGING SUB-REGIONAL PATTERNS OF INTEGRATION IN LATIN AMERICA

In nearly all Latin American countries there is today a clear perception that, given the poor prospects for foreign financial assistance and the return of voluntary lending, the solution of their severe external adjustment problems requires rapid export growth and that, in view of global trends, trade liberalisation is a necessary ingredient of trade expansion. In each country, however, the definition of new strategies for trade and industrial policy will be decisively influenced by the peculiarities of the country's present output structure and its degree of insertion in the world economy.

During the past few decades certain structural differences among the economies in the region grew more marked, and today Latin American countries display widely differing degrees of insertion in the international trading system. The heterogeneity of trade structures is twofold. First, there are the traditional differences in the direction of trade. The South American countries -- irrespective of their size and commodity composition of trade -- are much less dependent on the US market than Mexico or many Caribbean economies (see Figure 1). This is extremely marked in the case of the Southern Cone countries -- Chile and the Mercosur members -- and former European colonies such as Surinam and Guyana. Indeed, geography counts in explaining the direction of trade patterns.

Second, the commodity composition of trade varies widely within the region. The very uneven spread of industrialisation, to a large extent conditioned by the size of domestic markets, gave birth to a few large semi-industrialised economies among a large number of small primary producers. The extent of import substitution industrialisation has advanced far more in countries with large domestic markets. Moreover, traditionally inward-looking trade and industrial policies in these larger and more self-sufficient countries have also given birth to more technologically sophisticated and more integrated industrial structures, which in turn affected the sectoral composition of their trade. This group of countries is very small: it comprises Argentina, Brazil, Mexico and, if one excludes the larger South American oil exporters, perhaps Colombia, Peru and Uruguay. Trade heterogeneity is pervasive even among the big three: Argentina's export interests lie chiefly in temperate agricultural products; Brazil is a large exporter of manufactures; and Mexico is today a major exporter of oil as well as a rapidly growing exporter of manufactures.

An important consequence of this increasing heterogeneity of the trade and industrial structures is that, although the region shows a general tendency to adopt more liberal trade and FDI regimes, this move is likely to be accompanied by considerable differentiation in the design of trade and industrial policies across groups of countries. Thus, in contrast to the more or less common style of policy followed up to the 1970s -- which, except for a few short-lived experiments with trade liberalisation, was based on a combination of import repression and export incentives -- and a more or less united front in multilateral trade negotiations, the present drive towards trade expansion is likely to generate a diversified approach towards reform of trade, industrial and FDI policies in different groups of countries and may give rise to opposing stances regarding crucial issues in world trade policy.

Three distinct patterns of trade policy strategy -- which one could label "orthodox", "integrated" and "selective" -- seem to be emerging in the region. The first is marked by a uniform and large reduction of existing trade barriers and restrictions on foreign capital. This strategy is increasingly followed by the majority of countries in the region that possess regionally diversified markets. It is justified as an attempt to explore static comparative advantages and, eventually, to generate dynamic efficiency gains by overcoming the limitations of a small domestic market through greater export orientation, thus replicating the successful experience of some small nations of South-East Asia. A clear example of this strategy is Chile, which underwent thorough liberalisation in the 1970s and has not reversed that policy in the 1980s.

The "integrated" strategy would be that followed by Mexico, a country that is extremely dependent on the US market for its exports. In addition to the characteristics of the orthodox strategy, it would have the peculiar feature of tight commercial integration and growing industrial complementarity with the US economy. What distinguishes it from the orthodox strategy is the relative unimportance of export markets other than the United States. The distinction is, therefore, likely to blur as long as national trade barriers against third parties are low and integration within a United States-centred FTA is compatible with multilateralism.

The "selective" strategy is the one likely to be followed by the larger, semi-industrialised economies of Latin America, which have a regionally diversified export pattern. They would follow the general drive towards a radical reform of their protectionist import regimes. These reforms are to be accompanied, however, by some margin of sectoral selectivity in tariff levels; protection levels will remain higher than in the OECD countries, though they will reflect greater concern with productive efficiency than heretofore. The most representative countries in this group are those of the Mercosur, where, because of Brazil's very large size relative to the other members, the common multilateral tariff envisaged for 1994 will be strongly conditioned by Brazil's commercial policy.

Some of the larger Andean Pact countries may also follow a "selective" strategy. But it is more difficult to forecast the strategies of the Andean Pact countries, and also the Central American countries, because of the currently rapid changes in their trade policies and uncertainty regarding the pay-offs of their strategic options. In both groups of countries there has been a marked revival of interest in sub-regional integration -- this time emphasizing the formation of customs unions -- along with significant recent progress toward trade liberalisation. While liberalisation and a relatively multilateral or diversified structure of trade in these countries suggest their adoption of the "orthodox" pattern, by enlarging internal markets greater sub-regional integration may give rise to "selective" experiments with industrial promotion in these countries.

Indeed, what differentiates the "selective" from the "orthodox" strategy is the degree of concern with the costs of domestic adjustment to trade liberalisation. The degree of such concern varies fundamentally with the size of the economy, which is the single most important determinant of the extent of import substitution in manufacturing and, thus, of resistance to rapid change in the import regime.

The situation of the Central American and Andean Pact countries is made even more complex by the natural excitement with the prospects of obtaining free access to the US market in the wake of the US-Mexico deal. If supported by a fast drive towards liberalisation, that deal would bring these countries closer to the "integrated" strategy described above, and increase the prospects for the formation of a large hemispheric FTA. Such a positive response to integration with the United States will nevertheless depend decisively on the earnestness of the US offer to grant market access guarantees in products of their export interest. That earnestness is being put to the test in the early free trade negotiations.

The choice among these strategies will depend on a complex interaction between the perceptions of governments and those of the relevant domestic actors concerning the advantages to be derived in each case. A general drive towards liberalisation seems certain, owing to the quest for trade expansion and the opportunities opened by the rapid transformation of the world industrial economy, but the present large heterogeneity of national economies is likely to produce a greater variety of approaches to trade and FDI policies than was the case in the past.

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

As far as the main issues in multilateral trade policy are concerned, Latin American countries have both overlapping and conflicting interests. Consider first the market access problems related to the reform of Article XIX, which regulates the application of safeguards against rapid import penetration. The main dividing issue here -- as was the case in the Tokyo Round -- will be "selectivity", i.e. whether discrimination against particular ("disrupting") suppliers will be allowed or whether the safeguard will be applied on an MFN basis. The position of large and small developing countries on this issue is traditionally different: the safeguard is usually introduced in response to high rates of import penetration from the former, but if it is non-discriminatory, it also affects exports from the latter. Small exporters of manufactures therefore tend in practice to favour selectivity, and this division of opinion based on self-interest is likely to arise within Latin America. It is also interesting to note that selectivity in the application of safeguards will provide a legal cover for discrimination in the application of VERs, increasing the attractiveness of the "integrated" strategy for large countries such as Mexico.

The other divisive issue is agriculture. On the one hand, liberalisation of world trade in temperate agricultural products is high on the agenda of the Latin American members of the Cairns Group of efficient agricultural producers, and it is by far the most important issue in the Round for specialised exporters such as Argentina and

Uruguay. On the other, as the phasing out of the subsidies of the Community's Common Agricultural Policy will imply a rise in prices before a new equilibrium level of world supply is attained, agricultural liberalisation has been opposed by most, and especially the larger, developing net food importers. In Latin America, Mexico has long taken a very clear stand in this direction.

Finally, as far as the so-called new themes -- trade-related investment measures (TRIMs), trade-related aspects of intellectual property rights (TRIPs) and services -- are concerned, there seem to exist no contradictory interests among the Latin American countries. Since they are not substantial foreign investors, innovators or efficient producers of capital- or skill-intensive services they are all likely to take a cool view on these issues. Their support of the US (or OECD) position on these issues may vary, however: small countries are likely to present little opposition to greater liberalisation in trade in services or the enforcement of stricter intellectual property rules, as they are prospective substantial importers -- not producers -- of both sophisticated services and technology. One should also expect support on the issue of TRIMs from those countries following a strategy of greater industrial integration with the United States under the Bush Initiative, because of the importance attributed by the American government to the elimination of some trade and industrial policy instruments that affect the trade flows of foreign companies. As argued by Fishlow and Haggard (1992), however, these countries are likely to adopt non-discriminatory liberalisation of FDI rules.

Differences are also to be seen in the response to the proposal of free trade and industrial integration with the United States contained in the Bush Initiative. One could expect it to be warm not only in those countries which have already opted for the "integrated" strategy, but also in those which have already liberalised trade to a large extent, as lower levels of protection imply lower structural adjustment costs. On the other hand, as argued above, for countries that maintain high levels of protection and regionally diversified trade flows, bilateral liberalisation with the United States would certainly provoke a flurry of protests or even retaliation from their other leading suppliers and, in terms of static benefits from resource reallocation, is a second-best alternative after multilateral liberalisation.

It is therefore reasonable to presume that immediate negotiations aiming at broad free trade agreements with the United States will be sought by countries in the "integrated" and "orthodox" groups -- for instance, Mexico and Chile, respectively. The reaction of the "selective" group to the recent US government signals for greater hemispheric integration should be cooler than that of the rest. From their viewpoint, the only potential benefits of a free trade zone stem from the attainment of preferential treatment in the American market relative to suppliers facing the US tariff. Thus, a positive response from these countries will decisively depend on the credibility of the American offer to grant market access guarantees for products in their export interest, a point which is being put to the test in the early free trade negotiations.

CONCLUSIONS

Prospective exercises about Latin America's insertion in the world economy today have to deal with compound uncertainties deriving from the convergence of deep processes of institutional change in trade policies at the global, regional and national levels. The reshaping of the world trade system in the Uruguay Round, increasing regionalisation of trade relations and changing global patterns of FDI flows are superimposed on the effects of a profound liberalisation of national trade regimes and a strong revival of sub-regional integration in Latin America.

Despite this state of flux, some conditional statements are possible regarding the likely impacts of regionalisation and global trends in FDI flows on the region. As for regionalisation, the effects of the perceived current trends seem, by and large, benign. On the one hand, Europe 1992 is likely to have a positive impact on the region's exports, unless dramatic (and unlikely) discriminatory measures against third parties accompany the creation of the single market. On the other, the move towards a Western Hemisphere free trade area is an extremely positive development for Latin America. Not only does it raise the prospects of export growth through discrimination in the huge American market, it gives added impetus to the processes of national trade liberalisation and sub-regional integration.

Regardless of the many influences on the direction of global FDI flows today, Latin America will continue to be an attractive location for direct investments, especially as the long period of stagnation since the debt crisis recedes into the past. The region's attractiveness will be reinforced if there is much trade discrimination against third parties in a Western Hemisphere FTA. In this case, FDI inflows to the region by firms targeting the large American market are likely to increase substantially. Moreover, sub-regional integration and liberalisation, by forcing already established MNCs to restructure their regional facilities, may also lead to renewed investment flows.

Although regionalisation and globalisation create challenges and opportunities that will undoubtedly help shape a new pattern of insertion into the world economy for Latin America, for the foreseeable future the key element in this new pattern is the region's earnest drive towards a more open trade and FDI regime. It is the success of these reforms -- which will proceed at different paces and with different emphasis on strategic alliances with regional partners depending on certain structural characteristics of groups on national economies, but which seem on the whole irreversible -- that will enable the continent to contribute actively in stemming the threats to the multilateral trade system still present in the profound changes affecting the world economy today.

NOTES

1. See Urata (1991).

2. The evolution of the share of imports in apparent consumption of manufactures shows that, on the whole, integration has slowed since the late 1970s, but the reasons are not at all clear. This phenomenon could, as argued by Jacquemin and Sapir (1988), have been caused by the existence of impediments to intra-EC trade greater than those affecting EC trade with the rest of the world. This argument supported the widely held notion that Europe was lagging behind the United States and Japan in terms of competitiveness in new industries and that the negative effect of internal impediments to trade on optimal scales was to blame. Neven and Roller (1990, p. 26) have shown, however, that existing non-tariff barriers in the Community hamper its trade with the rest of the world more than intra-EC trade. This suggests that the cause of slower integration might lie in the increased competitive advantage of non-members.

3. While the shares of developing Western Hemisphere countries' total exports going to the United States and the EC in 1990 were, respectively, 41 per cent and 23 per cent, the combined share to Japan, the Asian NIEs and Thailand, Malaysia, the Philippines and Indonesia was only 9.5 per cent.

4. See M. Emerson *et al.* (1988).

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

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

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

8. See M.J. Peck (1989, p. 294). This will depend on how fast wages in the South converge towards the high levels prevailing in the North and on the extent to which the so-called social dimension of Europe 1992, which promises the harmonisation of labour market arrangements, is actually implemented.

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

10. World Bank (1987, Table 8.8).

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

12. The discussion here concerns only trade in manufactures. It goes without saying that liberalisation of agricultural trade -- a central issue in the Round -- would

have an enormous impact on temperate agricultural exports from Latin America, especially from the region's members of the Cairns Group.

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

14. *Iniciativa para as Américas*.

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

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

17. See W. Peres Núñes (1990).

18. See E.A. Guimarães (1990).

19. See C. Oman *et al.* (1989).

20. See R.E. Lipsey (1990).

Table 1

EC SHARE OF EXPORTS FROM SELECTED LATIN AMERICAN COUNTRIES, 1990

Country	Share (in %)
Argentina	30.5
Bolivia	30.9
Brazil	30.9
Chile	34.7
Colombia	26.2
Dom. Republic	17.8
Ecuador	9.6
El Salvador	22.8
Guatemala	15.3
Haiti	14.2
Honduras	19.0
Jamaica	24.8
Mexico	10.2
Nicaragua	32.5
Panama	29.2
Paraguay	28.1
Peru	28.5
Surinam	39.6
Uruguay	29.9
Venezuela	12.3

Source: IMF, *Direction of Trade Statistics*.

Table 2

COMMODITY COMPOSITION OF LATIN AMERICAN EXPORTS TO THE EC AND THE WORLD: 1985-86 AVERAGE

Product class	Value of exports ($ million)		EC share in total (in %)
	EC	World	
1. Food	8 373	31 181	26.9
2. Agric. raw mats.	677	2 565	26.4
3. Crude minerals	1 619	5 056	32.0
4. Mineral fuels	3 554	29 977	11.9
5. Non-fer. metals	984	3 610	27.2
6. Chemicals	575	4 153	13.8
7. Iron and steel	380	3 049	12.5
8. Manuf. goods	2 088	20 351	10.2
8.1 Mach. and Transp. equipment	785	9 101	8.6
8.2 Text. & clothing	695	3 447	20.1
9. Total exports	18 251	99 943	18.3

Source: UNCTAD, *Handbook of Trade and Development Statistics*.

Figure 1

US SHARE OF EXPORTS VERSUS SHARE OF NON-US SUPPLIERS IN IMPORTS, FOR WESTERN HEMISPHERE COUNTRIES WITH EXPORTS TO THE US GREATER THAN $150 MILLION, 1990

Source: IMF, Direction of Trade Statistics, 1991 Yearbook.

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