Welcoming Foreign Direct Investment? A Political Economy Approach to FDI Policies in Argentina and Brazil

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WELCOMING FOREIGN DIRECT INVESTMENT? A POLITICAL ECONOMY APPROACH TO FDI POLICIES IN ARGENTINA AND BRAZIL

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Abstract

The purpose of this presentation is to develop a framework that enables us to discern the political economy determinants of FDI openness in emerging economies that received large flows of FDI during the past 15 years. Even tough the political economy field is recently thriving with contributions that help us understand the multidisciplinary aspects of foreign investment, our comprehension level is still behind that of international trade. This opens up the door for exciting research opportunities but it also constitutes a tremendous challenge. While the current literature has focused on the "ex-ante" political and economic conditions that can propel FDI openness, it has not considered the extent to which foreign investment, through its impact on the relative price of the domestic factors of production and on the market structure, can stimulate changes in the design of FDI policies. In addition, specific features of emerging economies have not been sufficiently explored in their relationship with FDI. This study seeks to fill in these gaps by using the specific cases of Argentina and Brazil.

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I. INTRODUCTION

The Argentinean and Brazilian economies are among those that suffered the great loss of a decade of economic growth and potential economic and social prosperity during the 1980s. While recovering from the trauma, these economies turned to democracy and the market as the knight in shining armor that could bring back the time lost in the 1980s. The rules of transition to democracy and the rules of the market propelled these economies into an adventure of reform that impregnated every aspect of the economic, social and political life.

The economic-policy changes and the revolution in the role assigned to the State were encouraged by sharp economic crises, deep ideological changes, and the pressure exerted by multilateral organizations. Foreign direct investment (FDI) was one of the Washington-Consensus prescribed antibiotics that would bring economic growth through technological, managerial, and know-how spillovers and through stable financing of external disequilibria. A mix of blind belief on the medicine prescribed and the need for stable financing encouraged many Latin American countries to embrace a set of reforms that would open up even their most strategic sectors to capital inflows from the rest of the world.

More than a decade after the liberalization of FDI, both the Argentinean and Brazilian governments still welcome foreign investors. However, there are incipient signals that attitudes towards opening might be changing. There has recently been a gradual increase in the number of investor-State disputes (UNCTAD, 2007). Echoes of restrictive-FDI measures adopted by Bolivia, Ecuador and Venezuela reverberate across the region. Moreover, Argentinean policy-makers have subtly introduced since 2003 slight changes to their foreign capital regime. Meanwhile, Argentine citizenry, maybe encouraged by a strong nationalistic political discourse, frequently use the imagery of Multinational Corporations (MNCs) as the representation of past and current economic policy failures.

The purpose of this presentation is to develop a framework that enables us to discern the political economy determinants of FDI openness in emerging economies that received large flows of FDI during the past 15 years. Even tough the political economy field is recently thriving with contributions that help us understand the multidisciplinary aspects of foreign investment, our comprehension level is still behind that of international trade. This opens up the door for exciting research opportunities but it also constitutes a tremendous challenge. The openness process has received scant attention perhaps due to the still relatively unexplored terrain of the distributional implications of FDI, considered by scholars as a research frontier (Frieden and Martin, 2002 and Kobrin, 2005).

Given the difficulties in evaluating FDI policies and the wide variety in national policy frameworks, it is still relatively soon to provide a systematic analysis on FDI policies in the aftermath of the Washington Consensus. However, discerning the determinants could help us predict whether changes to the relative degree of openness are likely in the near future and could improve our understanding of the relationship between foreign investment, the host state and domestic factors of production. Moreover, the reasons behind openness to FDI influence the regulations inherent to the liberalization regime and their implementation.

This paper contributes to the current literature by proposing the need for a dynamic analytical framework specific for emerging economies that liberalized their FDI regimes during the Washington Consensus era. While the current literature has focused on the "ex-ante" political and economic conditions that can propel FDI openness, it has not considered the extent to which foreign investment, through its impact on the relative price of the domestic factors of production and on the market structure, can stimulate changes in the design of FDI policies. In addition, specific features of emerging economies — such as their vulnerability to current account and exchange rate crisis, the presence of business groups (Khanna and Yafeh, 2007), a sharp barrier in the labor force between skilled and unskilled workers, and their relation with the international organizations — have not been sufficiently explored in their relationship with FDI. Emerging markets tend to have a sort of love-hate relationship with MNCs that has been widely acknowledge by the literature. Issues of national sovereignty and cultural identity, ownership of natural resources and property rights have encouraged tension between foreign investment and local attitudes. At the same time, many emerging markets compete fiercely through incentives to attract foreign multinationals.

This presentation is structured as follows. First I briefly introduce the stylized facts of FDI flows to both Argentina and Brazil within the wider context of the Latin American region. The purpose is to show the magnitude of the flows as well as the relevance for the recipient economies. Secondly, I review the political economy benefits and costs of opening up the economy to FDI. The results obtained enable the introduction, in the third section, of a dynamic political economy framework that considers both the "ex-ante" and the "ex-post" liberalization scenarios. The fourth section presents preliminary evidence for the specific cases of Argentina and Brazil. The results are limited by scarce and consistent data on FDI policies and the conclusions are, therefore, opened to further research.

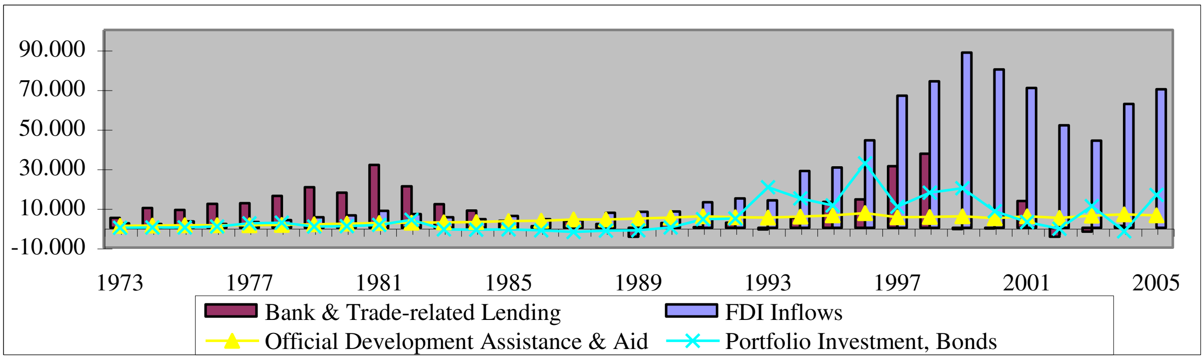
II. FDI FLOWS TO BRAZIL AND ARGENTINA: STYLIZED FACTS

Obstfeld and Taylor (2002: 24 and 25) have put together an historical description of world foreign capital stock that places current flows in a broader chronological context. Data provided by these authors show how in 1900 foreign stock liabilities in Latin America represented around 16% of global liabilities. This percentage increased to almost 20% by 1914 and reached a maximum of 23% in 1960. Interestingly enough, in 1995, Latin American foreign stock constituted just a mere 4% of global liabilities.

There is an appealing story behind these figures. First, the Latin American region has been relatively well integrated into the world economy since the beginning of the XXth century. Secondly, the relative decrease in the aforementioned percentage between 1960 and 1995 when contrasted with World Bank and UNCTAD data seem to indicate that capital flows were not simply displaced from Latin American to other developing countries but rather to the developed world. Finally, the numbers provided by Obstfeld and Taylor are a reminder that we should analyze with caution the vast amount of literature that praises the increase in capital flows to Latin America in the last decade of the XXth century.

The composition of capital flows to Latin American countries has significantly changed since 1970. First of all, there has been a shift in favor of private flows vis-à-vis official flows. Official flows played a significant role as an external financing source during the 1970s and 1980s. Although they reached several peaks during the financial crises of Mexico, Ecuador, Brazil, and Argentina respectively due to the intervention of multilateral financial institutions, official flows have exhibited a decreasing trend since 1991.

Diagram I. Composition of Capital Flows to Latin America (current US$, millions)



Source: Author's own elaboration on data from WDI CD-Rom (2007)

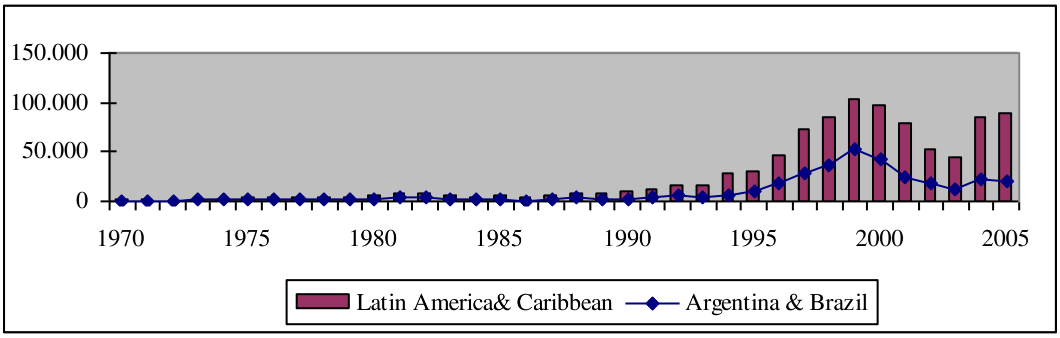
Secondly, there is a relative shift from debt to equity flows that begins at the end of the 1980s and has continued during the 1990s although not at the same pace. This shift reflects reduction in bank financing and the increase in FDI allocated to Latin American countries especially after 1991. According to Griffith-Jones (2000), the change is also a result of the increasing role played by mutual and pension funds as suppliers of foreign capital. Finally, FDI has gradually acquired a relevant role as a source of external financing. FDI flows have approximately multiplied by a factor of 20 between 1970 and 2005. In terms of GDP, gross FDI flows to Latin America increased from 1.15% of GDP in 1975 to 2.12% in 1995 and reached a maximum of almost 6% in 1999. The stock data is more revealing, FDI stocks as a percentage of GDP increased from merely 6.5% in 1980 to 10.4% in 1990 reaching 34% in 2005 (UNCTAD FDI Online Database).[1]

The aforementioned figures clearly reflect the crucial role played by FDI in the Latin American region. It is key to note that FDI during the 1990s has mainly flowed to just a few Latin American economies, mainly Argentina, Brazil, Chile, and Mexico. We will focus on the flows received by Argentina and Brazil within the broader context of MERCOSUR.

Diagram II evidences the importance of both Argentina and Brazil as recipients of FDI flows in relation to the total of Latin American and Caribbean countries. In 1970, FDI flows to both countries represented 41% of total FDI to Latin America (excluding the Caribbean). This percentage increased to almost 48% in 1980 and reached a maximum of 60% in 1999.

1 FDI stocks in Latin America accounted for 8% of the world's total in 2005.

Diagram II: FDI Inflows, Latin America and Argentina & Brazil, 1970-2005 (Current US million $)



Source: Author's own elaboration on data from UNCTAD online database

Argentina has been the pioneer among MERCOSUR countries in opening its economy to foreign investors. Widespread privatization, trade liberalization and opening of the financial account were among the reforms enacted in 1991 aimed toward the liberalization and stabilization of the economy. The relative success of these reforms, in terms of rapid economic growth until 1997 and historic low levels of inflation, the speedy liberalization of FDI legislation, the characteristics of the privatization program, and the attractiveness created by MERCOSUR all coincided with a propitious environment for foreign investment at the source countries, especially in the European Union. The deep debt and currency crisis that swept the country in 2001, the recession and political instability all precipitated a hefty reduction in the volume of capital flowing to the country.[2]

FDI inflows have helped to finance the increasing current account deficits that Argentina experienced during the 1990s. In 1980 FDI financed 16.5% of the current account deficit. This percentage augmented to 57% in 1992 reaching almost 80% in 1995. In terms of percentage of GDP, FDI represented 0.74% as an average of the period 1980-1990 increasing to 2.20% in 1990-2000.

According to data compiled from the Dirección Nacional de Cuentas Internacionales of the Ministerio de Economía y Producción, the privatization process that started in Argentina in 1990 explains a significant amount of the FDI inflows that entered the country between 1991 and 2000. 67% of the capital that turned to the privatization process during the period 1990 to 1999 was foreign. FDI represented around 51% of the total collected for privatization during the same period. Finally, the average FDI flows allocated to Argentina during the 1990s as a result of privatization processes is 22%. This percentage was higher at the beginning of the decade reaching 40% at the height of the privatization process.

Brazil has long been considered the "clumsy" reformer. The failures of successive stabilization plans in correcting the inflationary problem together with a relative delay in adopting market-oriented reforms overshadowed the attractiveness of Brazil as a host for FDI, particularly when taking into account the size of its market. However, the stabilization and economic reform package adopted during the mid-1990s, the

2 In comparison with other emerging countries, markets such as Brazil also suffered a vast reduction of almost 70% between 2001 and 2003. It is important to note that emerging markets such as China and India experienced increases of 4% and 8% respectively.

privatization process that started in 1994, and the relative liberalization of the external accounts, among other factors, propitiated a dramatic increase in FDI inflows.

As a percentage of GDP, the stock of FDI shows in Brazil an increase from 7.6% in 1980 to 25.1% in 2005. In terms of flows, FDI reaches its maximum record as a percentage of GDP in the year 2000 displaying a 5.4%. Between 1998 and 2002, FDI plays a key role financing increasing percentages of the current account deficit.

There are several FDI inflows features shared by both Argentina and Brazil that are worth mentioning. First of all, both countries attract "resource-seeking", "market-seeking" and relatively low levels of "efficiency-seeking" FDI. Secondly, linked to the privatization processes, entry through mergers and acquisitions has been significant in both countries with acquisitions more prevalent than mergers. Finally, in both countries FDI has played a key role in the financing of external disequilibria.

II. OPENING UP TO FDI: AT WHAT COST?

FDI liberalization is not an easy task from a political-economy point of view. Foreign investment is a more sensitive political issue than international trade since it implies foreign ownership of domestic resources. When policy-makers face the decision to open up the economy to foreign investment, they compare the marginal costs and the marginal benefits inherent to such liberalization. In this section, I will present a succinct summary of the political economy advantages and costs of FDI inflows for a emerging host economy aiming to improve the understanding of the choices faced by the policy maker. Additionally, grasping costs and benefits helps us discern winners and losers and forecast their reactions. I start by precisely defining the concept of FDI liberalization that will be used in the following sections.

Defining FDI Liberalization

FDI liberalization encompasses a wide range of issues that range from admission procedures to different types of incentives and even the macro and microeconomic policies that attract FDI to specific locations. UNCTAD (several years) distinguishes three generations of FDI liberalization policies:

(a) Liberalization policies: Policies geared towards the reduction of barriers that prohibit FDI flows from entering the domestic market. Liberalization also includes standards of treatment of foreign investment.

(b) Facilitation and Active promotion of FDI: This set of policies aim to actively attract general FDI by adopting instruments such as Investment Promotion Agencies.

(c) Adoption of targeted investment incentives: This more recent generation of policies seeks to draw specific types of FDI (from particular sectors, industries, and even countries) considered compatible with the host-economy development strategy.

This study focuses on the first generation policies given that it is the dismantling of barriers to FDI in specific sectors and the adoption of national treatment standards what allowed foreign investors to invest in emerging economies.[3] Furthermore, the adoption of liberalization policies is more complex and controversial than the other two sets of policies.

Political Economy Benefits and Costs of FDI Liberalization

The benefits inherent to FDI inflows have long been praised by the economic literature and particularly those related to technological spillovers and its medium and long-term influence on economic growth. The "traditional" arguments defending the positive economic contributions of FDI have generally focused on five principal categories:

(a) FDI contributes to closing the gap between domestic savings and investment demand. This is especially relevant for emerging economies that commonly face external disequilibria. It is noteworthy that the average Latin American rate of savings is relatively low, approximately 20 percent of GDP on average for the last two decades), when compared with that of East Asian countries, which surpasses 30 percent of GDP (WDI Database, 2007).

(b) The positive spill over effects related to technological advances and improvement of managerial techniques help domestic firms to overcome the deficits in technological and know-how inherited from decades of inefficient protectionism (Agosín, ed. 1995 and Blomström and Kokko, 1997 and 1998).[4] Moreover, foreign investment can complement domestic investment if it allows an enhanced use of the existing productive capacity and it brings in "missing" factors of production complementary to those available locally[5];

(c) FDI is advantageous to other forms of foreign capital given that such capital inflows are driven by fundamentals and not by high short-term profit seeking. Moreover, the fact that FDI is bolted down implies that the capital will remain in the host country, even in the event of an external shock or an adverse domestic political-economic environment.[6] Both features imply that FDI should be a relatively more stable source of financing vis-à-vis other capital flows (Lipsey, 2001 and Loungani and Razin, 2001);

(d) When operating in a regional free trade environment, FDI promotes the benefits of economies of scale and rationalization of production. In so doing, it increases the access of the host country to international export markets (Levy Yeyati *et al*, 2003);

3 Agosín and Machado (2006) find that approval procedures and the percentage of foreign ownership allowed are the variables that exert a larger influence on the volume of FDI inflows.

4 Borensztein, de Gregorio and Lee (1998) and Saggi (2000) have demonstrated that FDI contributes to economic growth by transferring technology, but only when the host country enjoys a minimum level of human capital.

5 Markusen and Venables (1999) analyze the conditions under which foreign and domestic investment are complementary. Under such conditions, FDI inflows can increase the number of domestic firms. According to Chudnovsky and López (2001) the inflow of FDI to MERCOSUR countries has in fact displaced domestic investment in several sectors.

6 Hausmann and Fernández-Arias (2000) highlight that FDI is just a firm's liability and, as such, is not fully bolted down to the host-market.

(e) By enhancing competition within the host country, FDI contributes to further economic liberalization and deregulation and diminishes the possibilities of retreat from the market-oriented reform processes, and

Finally, FDI flows engender distributional consequences through changes in factor and product prices. Following standard international economic theory, free capital movement generates a redistribution of income both at the home and the host economies. At the host economy, income pours from capital to labor since the additional capital (foreign) reduces the return to domestic capital while the labor factor experiences an increase in its marginal return.[7]

These arguments are constantly reviewed in the literature giving rise to interesting results. Many of the sources consulted coincide in attributing a potential positive effect of FDI on the economic growth of developing economies.[8] However, the empirical relationship between FDI inflows and economic growth is still subject to an intense debate.

The question that the benefits highlighted by the literature brings to mind is, if FDI is a stable source of financing of external unbalances and, under certain conditions, it enhances economic growth, why do developed and developing economies have had a historical tendency to remain closed to foreign investment?[9] A review of the economic, political, and economic-policy design costs inherent to FDI liberalization can shed some light on this question.

The economic costs related to opening up the market to FDI translate into incentives to modify both "ex-ante" and "ex-post" the course of policy-making. Within the potential economic costs, I have selected those prone to create incentives in economic agents to act "politically."

(a) Large FDI inflows could exert upward pressure on real exchange rates. This is especially relevant in the context of fixed exchange rates. The increase in real exchange rate can encourage an increase in imports and worsen the international competitiveness level of the host economy. This, in turn, propitiates changes in national income redistribution.

(b) Anti-competitive practices: Anti competitive practices by MNCs are particularly relevant in oligopolistic markets. The extent of such practices depends on the regulatory framework prevalent at the host. For the specific case of emerging markets that followed so-called first generation reforms, the design of competition law and regulatory frameworks was left for a second round of reforms.

(c) Crowding-out of domestic capital: The literature has identified two channels that explain the crowding-out of domestic capital, reducing the return to domestic capital and borrowing in the domestic market. The reduction in domestic capital returns is, in turn, explained by the reduction in factor price and the decrease in product prices. In

7 For an extension of this argument within an overlapping-generations model, see Alfaro (2004).

8 The World Bank has carried out a compilation of the literature on the effects of FDI on several economic and institutional variables. The surveys are available at http://rru.worldbank.org/PapersLinks/Impact-Foreign-Direct-Investment/

9 Lake (in Weingast and Wittman eds. 2006) argues that openness to FDI has been historically rare. Singh (2003) highlights that both the United States and Japan have strict rules governing foreign investment in strategic sectors.

market-seeking FDI the crowding-out effect is even more salient. Agosín and Machado (2005) highlight that the effect of FDI on domestic investment depends on the features of the sector(s) where it flows. The results of the econometric exercised developed by the authors suggest that crowd-out of domestic investment did indeed happen in Latin American economies between 1970 and 1996.

(d) FDI, if it flows to capital and technology intensive sectors, has an ambiguous impact on employment potentially displacing unskilled workers from the labor market. It is important to note that while economic theory predicts that labor should be pro-FDI, economic sociology argues that unions feel threatened by foreign capital since it weakens their bargaining position (Guillén, 2001). The author argues that organized labor's position vis-à-vis foreign investment is shaped by both the political regime type the economic attitude of organized labor that he classifies as either modernizing or populist.

(e) Financial volatility/ Reversal of FDI: Cutting edge literature has recently began to acknowledge that FDI might not be as stable as previously thought. New developments are based on the availability of alternative sources of data that show how MNCs can use financial techniques to divest from specific countries (Hausmann and Fernández Arias, 2000 and Razin, various years).[10]

The costs in terms of policy making are related to both the benefits and costs inherent to FDI calling for action in several fields.[11] First the inflow of foreign exchange could require the intervention of the economic authorities if it generates a disproportionate increase in aggregate demand together with an appreciation of the exchange rate. Both effects are relevant in fast-growing economies, which tend to receive high levels of capital flows. Secondly, the control of domestic firms by foreigners, especially in strategic sectors such as public utilities and banking, could entail the involvement of regulatory bodies and changes to the regulatory framework. Moreover, Rodrik (2000) argues that the liberalization of the foreign investment regime is not a matter of simply changing regulations but it requires drastic changes at the institutional level that entail, in turn, costs in financial, bureaucratic and even political terms. Finally, financial volatility has a significant impact on economic policy making, especially on those countries that display large current account deficits.

Another concern for the policy-maker regarding FDI is social stability which is a relatively unexplored issue. Borrowing from the political economy literature on trade (Krasner, 1976), I suggest that the adjustment of domestic production to international patterns and the movement of labor and capital across production sectors could introduce distortions into the social framework.

Finally, FDI entails foreign ownership of domestic resources. This brings to the table issues of national sovereignty that are particularly acute when FDI is materialized in mergers or acquisitions in sectors perceived as vital by the citizens.

To sum up, up until recently the literature on the benefits associated to FDI appeared more convincing than the scarce economic scholarly work on the costs that FDI could

10 While borrowing intensively from host capital markets against collateral has also been used to reverse the direction of FDI, this practice is less common in developing countries.

11 For a detailed description of the economic policies designed to deal with capital inflows, see Montiel (2003, chapter 15).

bring to the host economy. Both strands of literature suggest the following political economy outcomes that will be further developed in the next section. First, openness to FDI, if successful in attracting flows, increases the size of the economic pie in the long-term but it is associated, in the short to medium term, with distributive conflicts due to changes in the prices of factors of production and products. FDI can complement domestic labor raising its marginal productivity and therefore its retribution. Meanwhile, inflows of foreign capital can crowd-out domestic investment decreasing the income of capital owners. Secondly, FDI flows generate positive externalities (technological and managerial spillovers) and backward and forward linkages with domestic capital. I suggest that these advantages particularly benefit skilled workers and owners of non-specific assets that are easily transferable to other sectors of production. Finally, economic policy-making is severely affected by large capital inflows in their ability to manipulate the exchange rate; to exercise competition policy and to design regulatory frameworks.

III. A DYNAMIC POLITICAL ECONOMY APPROACH TO FDI LIBERALIZATION

FDI liberalization can be analyzed as a game between winners and losers determined by their access to the political system and, as any other policy, it is an equilibrium outcome of the political process. [12] The political process is, in turn, a result of the interaction of individuals constrained by institutional (both formal and informal) rules. Distinguishing between expected winners and losers and real winners and losers enables us to distinguish between the "ex-ante" (static approach) and the "ex-post" (dynamic approach).[13]

Expected winners and losers have incentives to exert pressure on FDI policy-makers before the liberalization measures are adopted. Real winners and losers have incentives to exert pressure on policy-makers to change the course of action. The bargaining process between winners, losers and the government is not a static game. Each player continually estimates the timing and extent of his concessions. Winners and losers tend to organize in groups to increase their degree of influence and any specific group will be able to exert more influence on the government the greater its internal cohesion and organizational ability is (Olson, 1965; Frieden, 1991 and Keefer, 2004). Moreover, a given group will invest more in exerting influence over policies the more difficult it is to transfer their assets to other uses (firms operating natural resources and capital-intensive firms with assets not easily transferable and unskilled workers).

In our ex-ante framework, we should expect, therefore, that firms who own non-transferable assets and unskilled workers in sectors where FDI can increase the demand for skilled labor would seek to influence the government not to liberalize FDI, to adopt a restricted-liberalization or to obtain compensations. On the other hand, skilled

12 The political economy literature widely acknowledges that agents will seek to influence government's decisions if the government policies are expected to impact private welfare (Przeworski, 2003).

13 This distinction is key in emerging economies, such as Argentina, where FDI liberalization was adopted "by surprise" bundled with a broader package of structural reforms and stabilization policies during the so-called honeymoon period.

workers and firms that could benefit by supplying MNCs or forming strategic alliances with them would favor liberalization.

The distinction between owners of transferable vis-à-vis non-transferable assets in emerging economies requires taking business groups into account. Diversified business groups are prevalent in emerging economies as a response to less developed institutions. Khanna and Yafeh (2007) argue that they normally develop under government protection but as the groups evolve the relations become more complex. One key feature of business groups is that their diversified activities allow them to transfer assets to other activities relatively easier. In this sense, if capital flows crowd-out domestic investment in one specific sector, firms that belong to business groups have the ability to transfer their assets to other activities.

From the perspective of the factors of production, I suggest that we need to take into account the following features of each production factor.

a) The labor factor stance towards FDI depends on several factors. First, the sector where FDI flows. When foreign capital flows to capital and technology intensive sectors it generates an increase in the relative demand and wages of skilled workers vis-à-vis unskilled workers. Secondly, it depends on the entry form. FDI through mergers and acquisitions tends to have a negative effect on employment. Finally, the effect on labor will depend on the proportion between high-skilled workers and low-skilled workers. As a result, if FDI flows to sectors that are intensive in capital and technology and enters through mergers or acquisitions it could result in a negative impact on employment. Such impact would be more salient for unskilled workers particularly in economies where there is scarce capital available to improve workers' capabilities and where labor market flexibility is restricted.

b) Domestic capital approach to FDI liberalization will depend on several factors. First, it will depend on the expected effect on the return to capital. Secondly, on the degree of asset specifity which, in emerging economies, is partially determined by the relation of each firm to business groups. Finally, the ability to extract rents from the liberalization process by, for example, becoming suppliers to the MNCs or participating, together with foreign companies, in the privatization process.

The traditional political economy argument that sustains that labor favors FDI liberalization while capital opposes has generally been followed by the prediction that, since labor usually enjoys a larger access to the political system when the left is in power, leftist parties are expected to welcome FDI. My analysis for emerging economies, suggests that this is not a clear-cut conclusion given that there is no such thing as a unified position vis-à-vis FDI liberalization neither by labor nor by capital.

As part of the approach, I also take into account the macroeconomic environment prevalent at the time of the announcement of FDI liberalization. The influence of this variable is probably higher in emerging economies given their tendency to volatile macroeconomic scenarios. In this sense, the political economy literature on economic reforms widely agrees that structural reforms are politically easier to adopt in a context of acute economic crisis (Kuczinsky and Williamson, 2003 and Paunovic, 2000).[14]

Kobrin (2005) identifies two principal and interrelated reasons that incite governments to open the door to FDI. First, the increasing opportunity cost of closure determined by the loss in terms of efficiency.[15] This concept is based on Garret's "increasing cost of closure". Garret (2000) highlights that despite the volatility and uncertainty associated to openness, the cost of closure is probably the most important determinant of the FDI liberalization process.[16] These arguments are in line with a non-utilitarist approach that assumes that the government is insulated from interest groups and seeks to maximize citizens' welfare by increasing output.

Secondly, Kobrin suggests that external pressures by developed countries partners in foreign trade and by multilateral institutions partners[17] also forces governments to liberalize their FDI regimes. Stallings (1992) suggests that the presence of external constraints increases the political influence of technocrats that are more internationally oriented and uses the example of the Argentine Peronist's alliance with internationally-connected groups. The debt crisis together with the failure of Keynesian economic recipes changed the approach used by multilateral institutions, such as the IMF, to analyze external disequilibria in Latin America. It is within this context that the conditionality clauses attached to loan granting and renewals incorporated the opening of the capital account. Within this external influence, I also include the indirect pressure exerted by the desire to comply with the prevalent economic model that incites governments to emulate policy choices of other countries.[18]

To adapt the analysis to emerging economies, I suggest that indicators such as the current account balance, inflation levels, and external debt should be taken into account to analyze both the opportunity cost of remaining closed and the degree of pressure that could be exerted by foreign governments and multilateral institutions.[19] Here, the dynamic approach also becomes relevant given that the higher the current account and fiscal deficits, the larger the influence and the bargaining power of international organizations and foreign firms.

While FDI is a long-term flow and therefore policies that tackle FDI are not perceived as short-term solutions to economic crisis, it is possible that the flows are interpreted as a partial way out of slow rates of economic growth. Additionally, various governments have *camouflaged* liberalization policies within a stabilization package deemed by the electorate as vital.[20] This is the case of privatization and FDI liberalization that in many emerging economies were adopted together with stabilization plans. Moreover, the stance of both capital and labor towards the liberalization process can change as the

14 It is important to mention that there are authors who partially disagree with this statement. Dixit (2003), for example, contends that deep economic crisis are sometimes not enough to suppress vested interests. Some interest groups can remain and even retain enough veto power to block reform legislation.

15 The opportunity cost of closure is calculated by considering: market size, level of development, GDP growth, trade openness, human resources, democracy.

16 Garret's concept is based on Krasner's analysis of the "relative opportunity cost of closure" for international trade (Krasner, 1976: 21).

17 The external pressure is measured by: dependence on the US (trade and FDI), dependence on international institutions (obligations to the WB or the IMF).

18 This reason to liberalize FDI regimes has been addressed by Kobrin and Xu n (2005)

19 In the specific context of emerging economies, the government shows a utility function that includes credibility restrictions related to "international obligations."

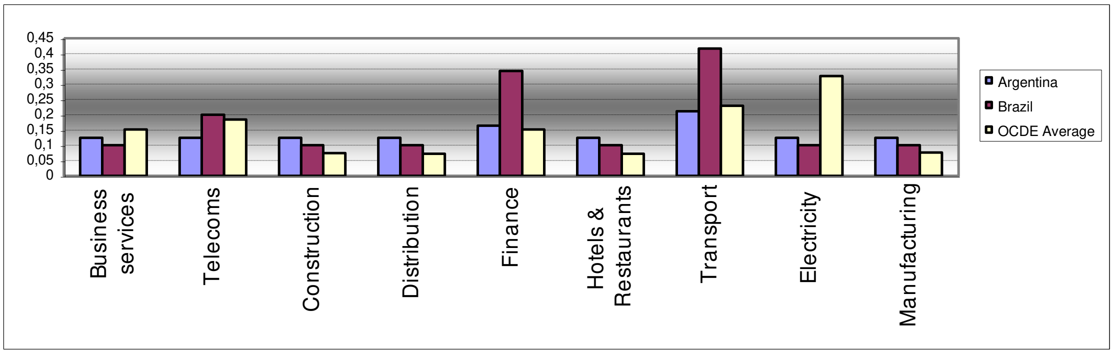
20 It is worth mentioning that of 33 governments that implemented market-oriented reforms between 1982 and 1995, only 17 announced it during their campaigns (Stokes cited in Lora and Olivera, 2005).

inflow of foreign capital alter their preferences through the impact on their share of income.

IV. AN INTRODUCTORY SURVEY TO RESULTS IN ARGENTINA AND BRAZIL

This section presents a brief analysis of the FDI liberalization processes in both Argentina and Brazil and a proposal for the analysis of its determinants. It is important to keep in mind that in both countries FDI liberalization was adopted within the framework of structural reform packages. It is, therefore, complicated to isolate both the effects of foreign flows and the attitude towards FDI liberalization. Trade liberalization, privatization, different exchange rate arrangements and the drastic reduction of the role of the State in the market all interact with the liberalization of capital flows.

Before introducing the results, it is interesting to review OECD's FDI Regulatory Restrictiveness Index for both countries for 2006.[21]



Source: Author's own elaboration on OECD index (2006). The index ranks between 0 and 1 (0 open, 1 closed).

These figures indicate that FDI restrictions in the OCDE are higher in sectors such as business services, telecommunications and transport (higher than Argentina's but lower than Brazil's) and electricity. It is key to highlight that the former were completely closed to foreign capital in both Argentina and Brazil until the early 1990s suggesting that the liberalization effort has been massive and has not been reverted so far.

ARGENTINA

Argentina is considered a textbook case regarding its alternation in liberal and restrictive FDI policies. While in the 1940s under the Peronist regime MNCs were accused of looting natural resources and exploiting labor, this attitude was abandoned in times of economic crisis and replaced by a relative acceptance of foreign capital.

During the democratic transition that took place after 1983 under the Alfonsín government, the unions opposed the opening of the economy. However, the desperate economic situation of the late 1980s opened the door for liberalization of both trade and

21 Unfortunately, OECD only provides time-series data on the index for OECD countries.

capital flows speedily transforming Argentina in one of the most foreign capital-opened emerging economies. Foreign companies may invest in Argentina without registration or prior government approval, and on the same terms as domestic investors. Investors are free to enter Argentina through merger, acquisition, greenfield investment, or joint venture.

Table I shows that Argentina's policy framework was, in 1996, more FDI-friendly in every category than the average for the most important recipients of FDI in the Latin American region.

Table I. FDI REGIME-RELATED BARRIERS IN LATIN AMERICA[22]

	ARGENTINA	BRAZIL	LAC (a)
Acquisition of Control (1)	9.6	7.0	8.2
Equal Treatment (2)	8.6	7.9	7.8
Employment of Foreigners(3)	9.2	7.1	8.1
Strategic Alliances (4)	7.2	6.7	6.5
Cross Border Ventures (5)	9.4	6.8	7.9
Investment Protection (6)	6.5	5.1	5.8
Overall Assessment (7)	8.4	6.8	7.4

Source: IFC, 1996. Scaled from 0 (least favorable) to 10 (most favorable).

The following table summarizes major changes to the FDI regime and the adoption of measures that affect FDI.

Table II. ARGENTINA: FDI LIBERALIZATION PROCESS & RELATED POLICIES (1989-2005)

Year	Measure	Type
1989	State's Reform	Law 23696
1990	Start of privatization	
1991	Deregulation of domestic and international trade	Decree 2284
1991	Convertibility Law	
1991	Creation of MERCOSUR	
1992	Promotion of domestic and foreign mineral investment	Decree 815
1993	National Treatment Unrestricted access to all sectors No performance requirements No registration and approval	Executive order 1853
1993	Deregulation of public utilities	Gas Act. Executive Decree 2731
1993	Brady Plan	
1994	ICSID Member	
1996	Provincial banks privatization	
2000	Patent Law	
2000	Limited labor reform	
2001	Capital Controls	Decree 1570

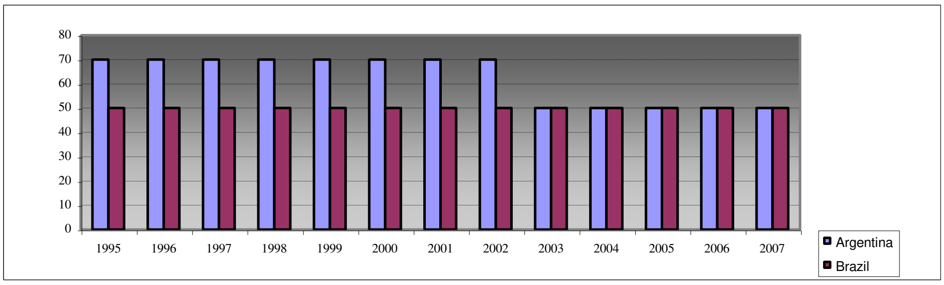
22 (a) Average for Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. (1) Foreign investors may not acquire (0)/are free (10) to acquire control in a domestic company. (2) Foreigners are not treated (0)/are treated (10) equally to citizens. (3) Immigration laws prevent (0)/do not prevent (10) your company from employing foreign firms. (4) Strategic alliances are not common (0)/ are common (10) between domestic and foreign firms. (5) Cross border ventures cannot being negotiated with foreign partners without government imposed restraint (0)/ can be negotiated freely. (6) Investment protection schemes are not (0)/ are available for most foreign partner countries (10). (7) Average assessment according to criteria (1)-(6).

2002	Pesification of bank accounts and contracts Renegotiation of public utility services agreements	Public Emergency Law
2003	Restrictions to foreign ownership of cultural goods	
2003	Limited capital controls (short-term capital)	Decree 285
2004	Limited labor reform	
2004	Software promotion regime	Law 25922

Source: Author's own elaboration on data from UNCTAD (various years), American Chamber of Commerce (Argentina), Heymann (2000), and US Department of State (2006).

Argentina does not seem to have introduced radical changes to its liberal FDI regime adopted during the Washington Consensus era. However, the country has indirectly altered the FDI-related policy framework by frequently changing regulations, especially since 2002, that affect foreign investors such as the bankruptcy law, foreign exchange regulations for oil and gas companies, mandatory reductions in energy exports, as well as changes to the conditions for renegotiation of public utility contracts. As a result, there has been a large increase in the ICSID number of cases against the country and, at least in five procedures, it has been considered that it has violated specific dispositions contained in investment agreements signed by the country. These events explain why the Heritage Index of Economic Freedom reflects a decrease in the investment index.

Diagram III: Argentina and Brazil: Investment Freedom Index

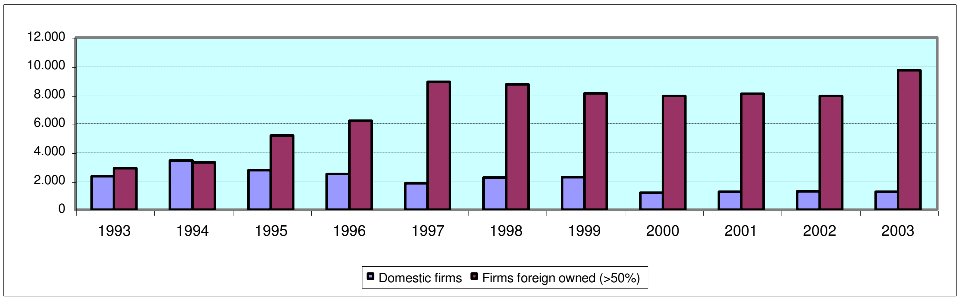


Source: Author's own elaboration on Heritage's index of economic freedom. The category used is the investment score defined as "an assessment of the free flow of capital, especially foreign capital."[23]

From a political economy perspective, Argentine business groups have traditionally partnered with MNEs. Under President Menem, the groups suffered from increased competition as a consequence of the liberalization of international trade but they were "compensated" with a reduction in union's power, renewed ties with MNEs and participation in the privatization process (Guillén, 2001 and Bambaci et al, 1999). The data on fixed investment by capital origin points to a relative crowding-out effect on domestic investment.

23 The index moves between 0 and 100 with 50 meaning "Foreign investors face restrictions on their ability to purchase real estate. All investors face bureaucratic impediments and corruption. Residents and/or non-residents face some restrictions on access to foreign exchange or their ability to conduct international payments. Transfers or capital transactions are subject to obvious restrictions."

Diagram IV: Fixed Investment of Large Firms: Domestic and Foreign Firms
(millions of constant pesos)



Source: Author's own elaboration on data from INDEC

The possibility of crowding out does not seem to have affected capital's attitude toward foreign investment even in a post-privatization context where opportunities for "compensation" are fewer. In this sense, private business groups such as Fundación Invertir have renewed their efforts to attract foreign investment to the country.[24]

Regarding labor, data for the 500 largest firms (excluding financial firms) indicates that between 1993 and 2004 there was a reduction of 46% in jobs in firms owned by domestic capital while there is a 40% increase in jobs in foreign firms. A large percentage of the stock of FDI in 2004 concentrated in manufacturing and in the oil sectors where labor needs are relatively less skilled than in other sectors such as services. However, the services sector also received large flows of FDI increasing the demand for skilled labor. The results are, therefore, unclear. [incomplete]

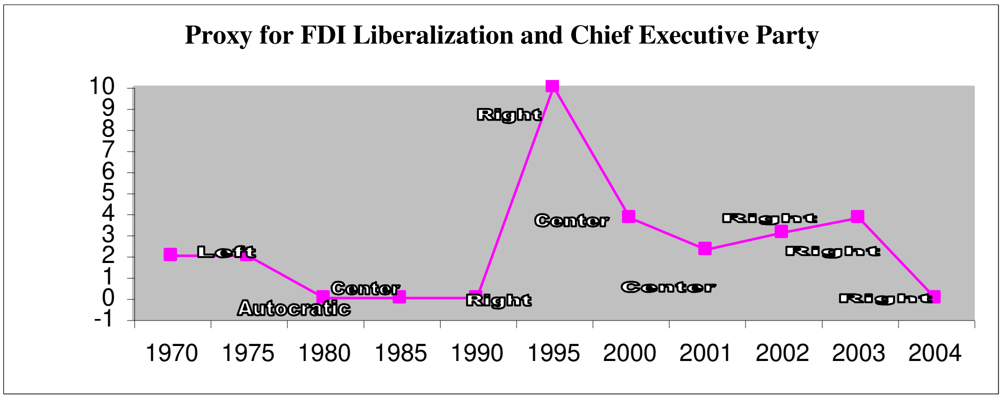
Guillén (2001) classifies the Argentine labor unions as populist and sustains that they perceive foreign capital as a necessary evil. Moreover, their political affiliation with the Peronist party and Menem´s strategy of division and delaying labor market reform diminished their incentives to act against economic policies.[25]

The relation between the political orientation of the executive party and FDI liberalization is measured by plotting a proxy for FDI liberalization against the political orientation of the chief executive party. This exercise delivers results that differ from the political economy conclusions given that it is the right (capital factor of production) who liberalizes FDI. However, given the prevalent influence of the Peronist party in Argentine politics, it is complicated to define chief executive party orientations along the lines of center, left and right. Moreover, the index is affected by the temporary adoption of short-term capital controls.

24 See Fundación Invertir web page at www.invertir.com

25 A survey conducted in 1991 found that 68% of the population supported privatization and 77% favored a more open economy. Workers under the CGT, the most influential Argentine union, also favored these policies (Cardoso, 2004). In 2003, support for privatization was just above 10% (Panizza and Yañez, 2006).

Diagram V. Argentina: Executive Party Orientation and FDI Liberalization



Source: Author's own elaboration on data from Fraser Institute (2006) and World Bank Political Institutions Database. Index for FDI liberalization measures restrictions in foreign capital market exchange (Index of capital controls among 13 IMF categories). The index moves between 0 (restrictions in most categories) and 10 (liberalized regime). There is a change on the index's methodology after the year 2001.

The analysis of the relative influence of the "cost of closure" and external pressures will be conducted at the end of this section to incorporate the results for Brazil.

BRAZIL

Da Motta Veiga (2004) characterizes the Brazilian FDI regime of the ISI period as stable and relatively liberal despite the political changes.[26] Only during the 1980s did the policies retracted from the liberal regime. As Table III suggests, the most important step in FDI liberalization took place in 1995 when the Cardoso government amended the Constitution to give FDI national treatment. A comparison with Argentina indicates that the liberalization process started later, as the other policies of the Washington Consensus, and it was implemented on a more gradual fashion. Despite the acute political change that took place when Lula took office in 2003, no liberalizing measures have been reversed so far although international investors complain about regulatory risk.

Table III. BRAZIL: FDI LIBERALIZATION PROCESS & RELATED POLICIES (1989-2005)

Year	Measure	Type
1990	Privatization process	Law 8031
1990	Competition law	Law 8002
1991	Foreign investors allowed to invest in stock market	
1991	Removal of entry restrictions in information-technology	
1994	Real Plan	
1994	Antitrust law	Law 8884
1995	National Treatment Entry restrictions (specific sectors) Entry in financial sector allowed ad hoc	Constitution Amendment

26 UNCTAD (2005) sustains that FDI was accepted in sectors where it did not interfere with state and private sector activity.

	Required registration and review Performance requirements (employment, national content)[27] Reduction of state-owned monopolies	
1997	Telecommunications Liberalization Creation of the regulator ANATEL	General Telecommunications Law
1999	Devaluation of the real	
2000	Foreigners allowed to invest in capital and financial markets	Resolution 2689 (Brazilian Monetary Council)
2000	Registration of foreign investment no longer subject to Central Bank review	Circular 2997
2002	Foreign ownership in media outlets limited to 30% (previously closed)	Law 10610
2002	Creation of Investe Brasil	
2004	APEX Brasil creates an investment unit	

Source: Author's own elaboration on data from UNCTAD (various years), Da Motta Veiga (2004), ECLAC (various years), US Department of State (2006),.

Although Da Motta Veiga (2004) states that "foreign capital is viewed with sympathy by the large majority of political currents and parties" a principal labor union, the CUT, opposed the market-oriented reforms. Population surveys drastically differ from the ones conducted in Argentina displaying that public opinion did not favor economic reforms.[28] According to ECLAC (2004), MNCs in Brazil employ relatively few people. In the manufacturing sector, foreign firms tend to pay relatively higher wages given their superior technologies. The Brazilian labor market is among the most flexible ones in Latin America in terms of reallocation of jobs and wage flexibility. [Incomplete]

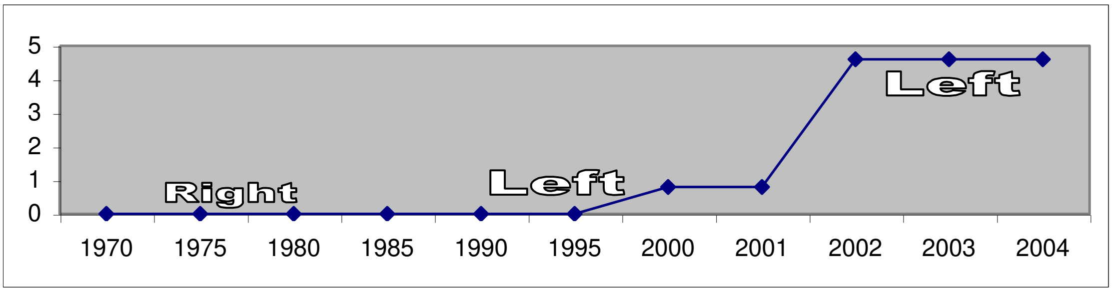
Regarding capital, Brazilian legislation does not define or distinguish business groups for fiscal purposes. This complicates the analysis due to the lack of data. Bonelli (1998) and Siffert Filho *et al* (1999) find that FDI inflows allowed business groups to bypass the financing restrictions that had traditionally characterized their performance by forming alliances between themselves and with foreign capital. Such reaction could indicate that large business groups do not have enough incentives, in a dynamic approach, to exert influence to reverse the FDI liberalization process.

The relationship between chief executive party orientation and the degree of FDI liberalization shows, contrary to the Argentine case, that FDI liberalization is implemented by a leftist political party. As already mentioned, the general population and some of the trade unions opposed the reform process. As displayed in table III, the liberalization coincides with the gradual implementation of market-oriented reforms.

27 It is difficult to account for all the performance requirements since a vast majority are not enacted by law but rather by administrative procedures.

28 In 1990, just 30% of Brazilians favored privatization. By 1998 that rate had increased to 52% (Cardoso, 2004).

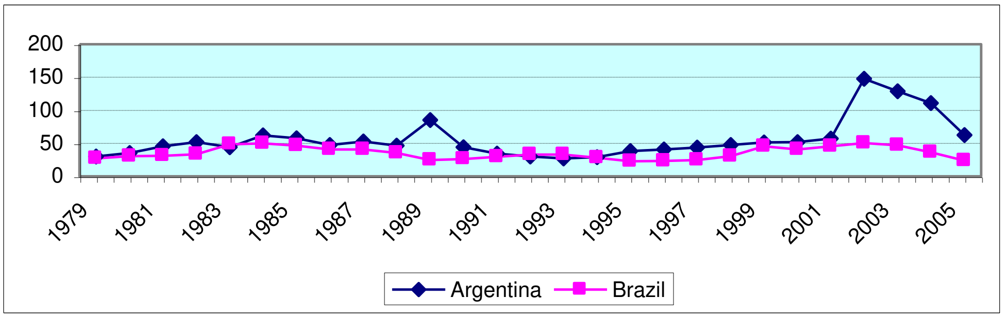
Diagram VI. Brazil: Executive Party Orientation and FDI Liberalization



Source: See diagram V

To complete this section, I introduce a comparison of the role played by the cost of closure in times of economic crisis. As mentioned before, I consider that Kobrin's opportunity cost of closure and the pressure of external players are intimately related at the time that Argentina and Brazil liberalized their FDI regimes. Diagram VII shows that both have displayed since the early 1980s soaring levels of external debt.

Diagram VII. Argentina and Brazil: External Debt (% of GDP)



Source: Author's own elaboration on data from WDI CD-Rom Database, 2007

As a proportion of GDP, the Argentine economy experiences three drastic increases in its external debt levels in 1982, in 1989 and again in 2001. While the episodes during the 1980s did in fact encourage the liberalization of capital flows, the last one is followed by an increase in the tension with foreign investors regarding specific regulations and negotiations of tariffs. In the Brazilian case, external debt increases at the beginning of the 1980s and again at the beginning of the 1990s. The adoption of reforms, including the liberalization of FDI, is to a certain extent a response to very high levels of external debt.

External debt levels should not be used in isolation from other variables to measure the influence of external actors on the liberalization of FDI policies. To be sure, both Argentina and Brazil used debt for equity swaps to deal with the external debt problem. These instruments are a domestic option that requires a relative degree of openness to international capital flows and, therefore, liberalization. Debt from official creditors and the principal rescheduled of official debt offer a more transparent picture of the relationship with multilateral organizations. Diagrams VIII and IX display these variables for both countries.

Diagram VIII. Argentina & Brazil: Debt from Official Creditors (US $ billions)

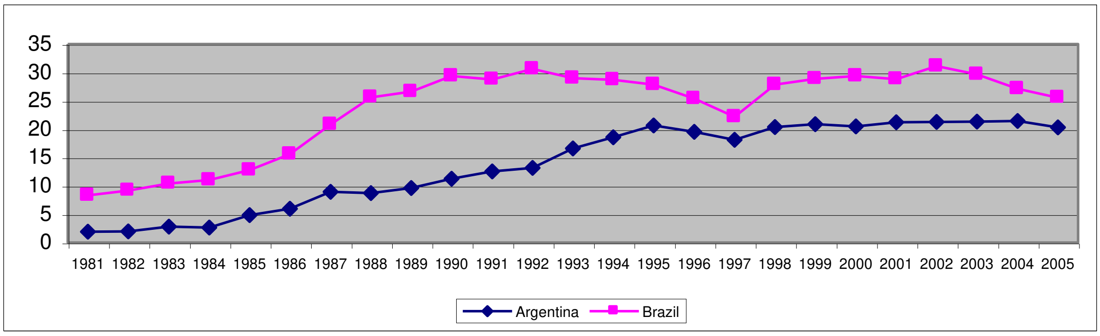
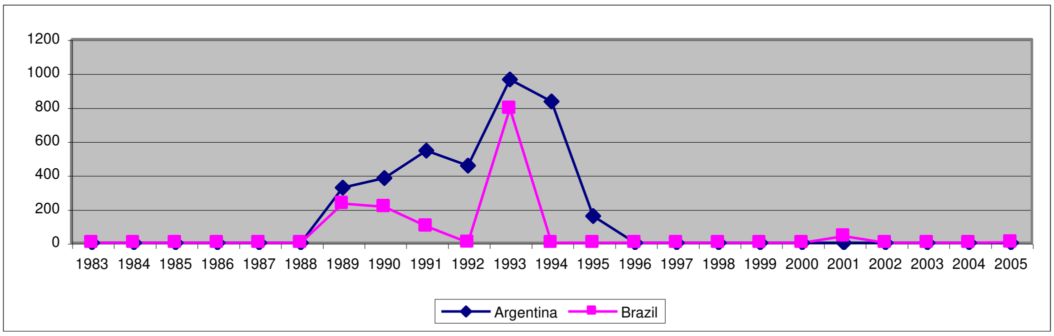


Diagram XI. Argentina & Brazil: Principal Rescheduled, Official Debt (US $ millions)

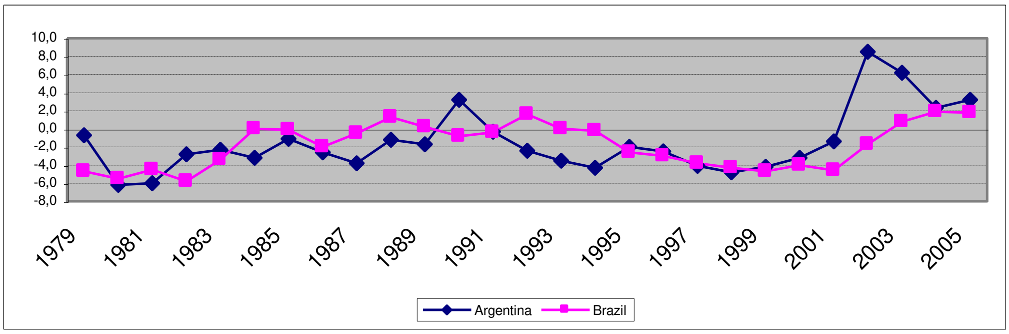


Source: Author's own elaboration on data from Global Development Finance Online Database

This data indicates that the amount of debt from official creditors increases sharply in both countries during the pre-reform period. The reschedule of official debt is particularly relevant between 1990 and 1993 potentially suggesting that the conditionality attached to these operations could have exerted a large influence on the design of the reform process, including the liberalization of FDI. The question is whether such influence was large enough to compensate for the economic and political costs inherent to FDI liberalization.

A look at the current account balance evolution could partially answer the last question. As diagram XII displays, current account deficits have plagued both the Argentine and the Brazilian economies

Diagram XII. Argentina & Brazil: Current Account Balance (% of GDP)



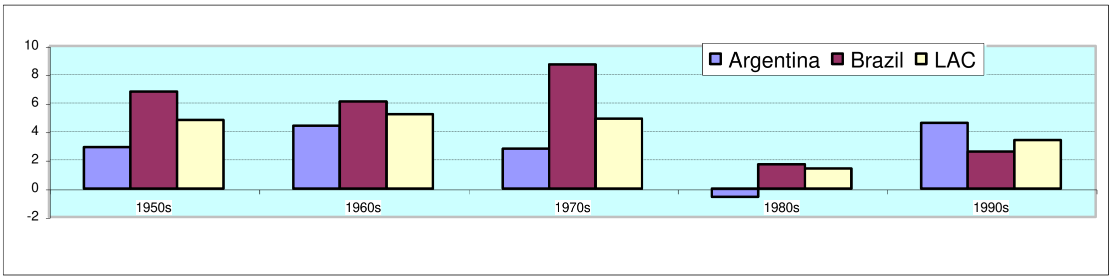
Source: Author's own elaboration on data from WDI CD-Rom Database, 2007

Both countries display at the end of the 1980s suffocating external imbalances. While current account deficits around 4% of the GDP might not be worrisome for healthy economies, Argentina and Brazil were experiencing at the same time increasing levels of external obligations. If international reserves were not flowing to the economies through exports, then the opening of the capital account probably seemed like the only game in town. Curiously enough, the current account surpluses experienced by the Argentine economy since 2002, largely due to the devaluation of the peso, appear to coincide with a relative degree of "relaxation" in the FDI liberalization process. As evidenced in diagram VIII, the surpluses also coincide with a reduction in official external debt potentially indicating that the ability of the Argentine economy to deal with its external obligations has been enhanced while the capacity of international actors to exert FDI-liberalization related pressures has diminished. The Brazilian economy follows similar patterns although the current account surpluses are not as "healthy" as the Argentine ones.

I introduce two final variables, the evolution of GDP and inflation. The first one is used to ascertain whether disappointing results in terms of economic growth may have encouraged FDI liberalization. The second one is used as an indicator of the willingness of the citizens to accept stabilization programs. The stabilization programs were accompanied, in many emerging economies, by market-oriented policies that included the liberalization of FDI flows.

Economic growth by decade shows disappointing and extremely volatile results in Argentina, lower than the Latin American average in every decade but the 1990s. The opposite is true for the Brazilian case that experiences relatively high rates until the 1980s.

Diagram XIII. Argentina, Brazil & LAC: GDP Growth by Decade

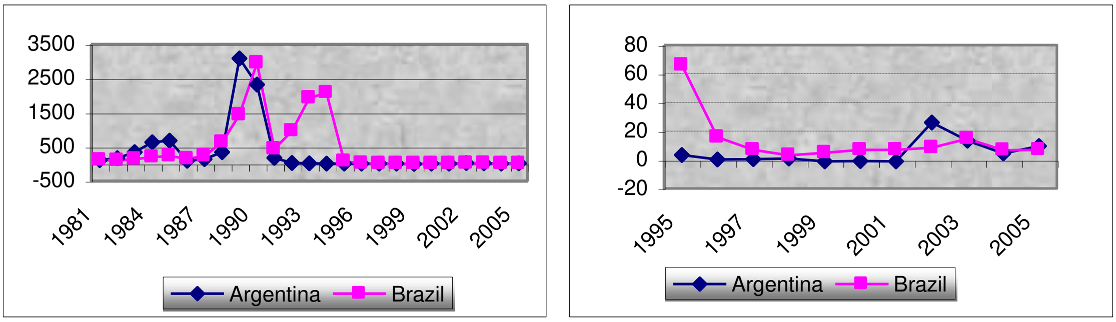


Source: Paunovic, 2000

The results in terms of economic growth contribute to explain the constant search for new development strategies in Argentina. In the Brazilian case, despite the sharp decline in economic growth during the 1980s, the fairly satisfactory results of the state-led model of economic growth sustain the aforementioned opposition to market-oriented reforms.

For much of the second half of the XXth century, frequent bouts of high inflation have characterized Latin American economies. Diagram XIV shows that both Argentina and Brazil suffered from hyperinflation episodes during the late 1980s and the beginning of the 1990s. Figures have been split in two diagrams to illustrate the markedly different behavior in consumer prices between the 1980s and the 1990s.

Diagram XIV. Argentina & Brazil: Inflation, consumer prices (annual %)



Source: Author's own elaboration on data from WDI CD-Rom Database, 2007

As widely recognized by the literature on market reform, hyperinflation episodes enable political leaders, even populist ones, to adopt structural reforms sometimes disguised with the implementation of stabilization measures designed to fight distorting levels of inflation. A quick look at tables II and III and Diagram XIV suggest that political leaders in both countries started to liberalize FDI regimes at the same time that they implemented stabilization measures anchored in fixed exchange rates.

V. FINAL REMARKS

According to political economy hypotheses, capital should have opposed the liberalization of the FDI regime in both Argentina and Brazil. Furthermore, from a dynamic perspective, as the reforms introduced in the 1990s generated relatively disappointing results, their attitude toward FDI should have heightened. Meanwhile, labor, should have supported FDI liberalization at the beginning of the reform process and, depending on their skill-degrees, they should have reviewed their attitude. The preliminary results obtained in the previous sections indicate the following

a) Business groups have probably taken advantage of FDI in Argentina and Brazil by diversifying activities and forming strategic alliances with foreign capital.

b) Labor has expressed opposition to FDI liberalization in both countries. The impact of FDI on skilled and unskilled labor income is not clear. In Argentina there is a reduction in employment by large domestic firms while firms owned by foreign capital increase their labor demand. In Brazil, the relatively higher flexibility of the labor market could have compensated for any distortions created by foreign capital inflows [complete with article}

c) Ideology by itself cannot explain policy preferences and policy-making. FDI liberalization has been adopted, and continued, by leftist and conservative political parties.

d) The role played by external forces in imposing FDI liberalization cannot be isolated from the influence of domestic economic variables such as current account deficits and the general macroeconomic environment. Facing high levels of external debt, Argentina drastically liberalized its FDI regime at the beginning of the 1990s but upset foreign investors with changes to the regulatory environment since 2002.

e) In both countries the liberalization of the FDI regime was inserted in a general framework of market-oriented structural reforms. In this sense, it is complicated to discern the effects of FDI on domestic factors of production. For example, trade liberalization had already weakened the bargaining position of domestic capital and labor in the tradable sector. FDI affected fundamentally the non-tradable sector of the economy. Moreover, at the end of the 1990s and beginning of the 2000s both countries experienced devaluation and financial crisis (in the case of Argentina) that altered the income of the factors of production.

f) Brazil adopted a more gradual, and perhaps stable, approach to FDI liberalization than Argentina. Such difference responds to a variety of factors: higher opposition to market-oriented reforms, less disappointing economic growth results, slower political decision and execution making process, and lower dependence on multilateral institutions.

While the results provided in this paper seem to suggest that the liberalization of FDI took place in both countries as a political design isolated from the pressures of labor and capital, it is key to highlight that, at least, in Argentina the implementation of "compensation" mechanisms probably appeased the rejection of unskilled workers, specific-asset firms and business groups hurt by the reforms.

The need for a dynamic approach that takes into account the distributional consequences of FDI and their political economy consequences has been highlighted throughout the article. Further research should also include the role played by MNCs already operating in the country. Caves (1996) sustains that given that MNCs lack election-voting rights, the government will tend to favor domestic firms vis-à-vis foreign firms. However, in the specific case of emerging economies suffering from "original sin", the MNC can become a powerful political player. The "traditional" Vernon's obsolescing bargaining has been recently enhanced with interesting political economy contributions. See Desbordes and Vauday (2007).

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