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U.S. Financial Flows to Latin America

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INTRODUCTION

Most experts agree that financial flows from the United States are important for Latin America, but it is hard to review literature on the topic since, in general, authors do not separate flows by country of origin. I will therefore begin by summarizing recent trends in U.S. financial flows to Latin America, using the only comprehensive source available: the U.S. balance of payments as reported by the Commerce Department's Bureau of Economic Analysis. Particular emphasis will be placed on foreign direct investment (FDI) since more information is available on FDI than on other types of flows. Nonetheless, various kinds of long-term portfolio investment by U.S. residents will also be discussed, including bank loans to Latin American borrowers, the purchase of Latin American bonds, and investment in Latin American stock markets through American Depository Receipts (ADRs) on the New York Stock Exchange. Some brief comparative comments will be made about remittances, but this is too large a topic to be included in a systematic way. Following the data section, I review the debates on the determinants and impact of FDI, focusing as closely as possible on U.S. flows. I then consider the debates about portfolio flows and conclude with some recommendations for increasing the quantity and improving the quality of U.S. foreign capital flows to Latin America.[1]

Trends in U.S. Financial Flows to Latin America since 2000

In 2007, private-sector net capital flows from the United States to Latin America (excluding the Caribbean financial centers) were about $58 billion. As seen in Table 1, this total can be disaggregated as follows: 50 percent was claims on Latin American borrowers by U.S. banks and non-banking institutions; 37 percent was foreign direct investment; and the remaining 13 percent represented Latin American stocks and bonds issued in the United States. The total amount was up from only $22 billion in 2000, but the increase was far from monotonic. Indeed, in 2002-03, net flows were negative, and in 2001 and 2004 they were fairly small. The only type of flow that was positive throughout was FDI; the most volatile was bank claims. In addition to market flows, remittances added another $22 billion in 2007. This relatively new type of flow – sent by migrants living in the United States to relatives or home communities in Latin America – increased steadily throughout the decade from $14 billion in 2000.

Not surprisingly, the largest share of the funds (about two thirds) went to Brazil and Mexico, the two largest economies of the region. Of the 2007 total, Brazil accounted for 45 percent and Mexico for 22 percent. The rest of the region divided the remaining one third, with Argentina representing 9 percent and Venezuela 5 percent. The composition of the Brazilian and Mexican flows were quite different with Mexico dominated by direct investment and Brazil by bank loans. Remittances are nearly as important as market flows for Mexico, but insignificant for Brazil.

[1] An excellent historical background paper on these topics is Roy Culpeper, "Resurgence of Private Flows to Latin America: The Role of North American Investors," in Ricardo Ffrench-Davis and Stephany Griffith-Jones, eds., *Coping with Capital Surges: The Return of Finance to Latin America*, Lynne Rienner, Boulder, CO, 1995, pp. 1-40. See also Barbara Stallings, *Banker to the Third World: U.S. Portfolio Investment in Latin America, 1900-1986*, University of California Press, Berkeley, CA, 1987.

Table 1. Financial Flows between U.S. and Latin America,[a] 2000-07 (billions of dollars)

	2000	2001	2002	2003	2004	2005	2006	2007
U.S. Private Assets in Latin America (net)[b]	-21.9	-5.0	12.1	1.1	-8.4	-39.3	-40.9	-58.3
Direct investment	-14.3	-17.2	-4.9	-4.7	-9.5	-13.5	-18.6	-21.9
Foreign securities	-3.9	6.4	0.8	-0.8	-1.3	-23.8	-15.1	-7.7
Claims by non-banks	-1.0	0.3	0.6	1.3	-0.7	-0.6	0.6	-1.1
Claims by banks	-2.8	5.6	15.6	5.2	3.1	-1.3	-7.8	-27.7
Latin American Assets in United States (net)[b]	26.3	14.7	14.2	31.3	51.1	44.6	71.6	119.0
Official reserves	7.8	6.1	-5.9	15.9	24.5	5.7	36.8	74.5
Latin American Private Assets in the United States (net)[b]	18.5	8.6	20.1	15.4	26.6	38.9	34.8	44.5
Direct investment	4.8	-1.6	4.5	4.6	2.9	2.3	5.1	2.9
U.S. securities	13.5	15.8	12.1	11.5	21.0	13.6	14.4	7.3
Bank deposits	0.2	-5.6	3.5	-0.7	2.7	23.0	15.3	34.3
Memo:								
Income receipts	22.0	15.4	13	17.3	22.9	29.3	36.6	43.6
Direct investment receipts	9.1	6.4	6.2	10.7	15.5	20.0	25.1	29.4
Other private receipts	12.6	8.7	6.5	6.3	7.1	9.1	11.3	14.0
U.S. government receipts	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2
Remittances	-14.4	-16.7	-16.8	-16.8	-18.5	-19.7	-20.6	-21.6

Source: U.S. Department of Commerce, Bureau of Economic Analysis (on-line)

[a] Excludes Caribbean financial centers.

[b] Negative = increase in U.S. assets; positive = increase in U.S. liabilities

The stock of U.S. direct investment in the region, as seen in Table 2, is consistent with the flow data. In 2006, the last year with full FDI data, the stock was $173 billion; again this excludes the Caribbean financial centers. Mexico's share was highest at 49 percent of the total, and Brazil followed with 19 percent. The next largest recipients were Argentina (8 percent), Venezuela (7 percent), and Chile (6 percent). For Brazil, it is possible to get a detailed sectoral breakdown of FDI stock from the United States: 50 percent is in manufacturing, 19 percent in finance (banks and non-banking), 13 percent in non-bank holding companies, 8 percent in mining, and 9 percent other. For Mexico, the breakdown is more partial since data in several important categories are withheld to avoid identifying particular U.S. firms. Even with this handicap, however, it is clear that a different pattern exists. Only 30 percent of U.S. FDI stock in Mexico is in manufacturing, while 18 percent is in non-bank finance. It can be assumed that another large chunk is in the banking sector, which is almost wholly foreign-owned. (Evidence for this assumption is that in 2005, when data were available, 25 percent of U.S. FDI in Mexico went to the banking sector.) Of the remainder in 2006, 9 percent of FDI to Mexico was in non-bank holding companies and 4 percent in mining. Thus 39 percent was in other sectors, including banking. In general, FDI to Brazil is for production of goods, while in Mexico services are more important.

Table 2. U.S. Direct Investment Position in Latin America,[a] 2000 and 2006 (billions of dollars)

Country	2000						2006					
	Total	Mining[b]	Mfg	Finance[c]	Holdings	Other[d]	Total	Mining	Mfg	Finance[c]	Holdings	Other[d]
Latin America	154.5	7.8	46.7	65.1	n.a.	34.9	173.1	14.2	54.9	48.6	25.5	29.9
Mexico[e]	37.3	0.2	18.8	10.1	n.a.	8.2	84.7	3.4	25.5	36.2	8.0	11.6
Brazil	39.0	1.0	18.0	12.5	n.a.	6.5	32.6	2.7	16.3	6.3	4.2	3.1
Argentina	15.6	0.6	3.9	7.2	n.a.	3.9	13.1	0.3	2.4	2.0	6.7	1.7
Venezuela	9.5	3.0	1.4	0.7	n.a.	4.4	11.6	1.1	4.9	0.7	0	4.9
Chile	9.5	0.1	1.4	n.a.	n.a.	8.0	10.2	1.0	1.6	4.0	0.3	3.3
Panama	29.3	0.4	0.2	28.2	n.a.	0.5	5.7	0.1	0.1	1.5	2.7	1.3
Peru	3.5	0.4	0.2	n.a.	n.a.	2.9	5.0	3.1	0.4	0.2	0.8	0.5
Colombia	4.6	0.9	1.3	n.a.	n.a.	2.4	4.9	0.6	1.3	0.3	0	2.7
Other	6.2	1.2	1.5	n.a.	n.a.	n.a.	5.3	1.9	2.4	n.a.	2.8	n.a.

Source: U.S. Department of Commerce, Survey of Current Business, July 2001 and July 2007 (on-line)

[a] Excludes Caribbean financial centers

[b] Includes petroleum in 2000.

[c] Includes real estate

[d] "Other" includes items listed as n.a.

[e] Mexican banking sector share in 2006 is based on data for 2005

As a complement to the data on capital outflows from the United States to Latin America, it is important to consider flows in the opposite direction (see Table 1 again). The total inflow to the United States in 2007 was $119 billion, which is more than twice as much as outflows. This figure rose dramatically from 2000, when it was only $26 billion. Slightly over 60 percent of the $119 billion represented international reserves,[2] mainly from Brazil, which began to run up large trade surpluses in the period when the inflows accelerated. The remaining 40 percent of inflows were from private-sector sources in Latin America – what has sometimes been called “capital flight.”[3] These flows include 21 percent invested in Treasury securities with the rest about equally divided between bank deposits and investment in the U.S. stock market or U.S. corporate bonds. Excluding international reserves, outflows to Latin America ($58 billion) exceeded inflows to the United States in 2007 ($45 billion) for a “net” flow of $13 billion.

The term “net” is a confusing one, since it is used in several different ways in discussions of foreign investment flows. One is investment outflows from the home country minus investment withdrawal. A second is outflows from the home country minus withdrawals and inflows from the host country. And a third is outflows from the home country minus withdrawals and remittance of interest and dividends from the host country. To give an idea of the magnitude of the third definition, income from U.S.-owned assets in Latin America in 2007 was $44 billion compared to the $58 billion in new outflows to Latin America. About two thirds of the income consisted of dividends on the stock of FDI in the region, while the rest was interest payments on loans or dividends on stock holdings. Dividends exceeded new direct investment flows before reinvested earnings are considered. It was negative net flows in this third sense that was often a basis for

[2] This assumes that the full $75 billion that the Commerce Department reports as Latin American reserves comes from South and Central America rather than the Caribbean financial centers. Otherwise, the amount would be lower.

[3] There is no generally accepted definition of capital flight. Most of it is legal movements to protect or increase the value of assets, but some (unknown) share involves illegal efforts to avoid taxes, launder money, or hide illicit gains.

the attacks on FDI in the 1970s, not taking into account the contributions that the investment makes to the local economy.

How should these financial flow figures be interpreted? One way to get a handle on whether they are “large” or “small” is to compare them to other aggregates. Table 3 shows some possible comparisons. First, we could ask about Latin America’s share of total U.S. capital outflows and how this figure has changed over time. The table indicates that Latin America accounted for 3.8 percent of total outflows in 2000, rising to 4.9 percent by 2007. In terms of direct investment stock, the share is larger but the trend is falling: from 11.9 percent in 2000 to 7.3 percent in 2006.[4] As a share of the Latin American regional GNP, foreign investment outflows from the United States to the region were 2.0 percent in 2006, and as a share of gross capital formation in Latin America, FDI from the United States was 10.1 percent. Both of these percentages were below the comparable ratios of U.S. capital flows to the world as a share of world GNP and capital formation. In other words, despite its Western Hemisphere location, Latin America lags behind other regions in this regard. In the concluding section, we discuss ideas to increase flows to Latin America. A final comparison shows that the U.S. share of total capital flows to Latin America has been falling. The U.S. share of total FDI stock in 2000 was 38 percent, falling to 23 percent in 2006. (In 1990, the share was 45 percent.) For bank claims on Latin American borrowers, the U.S. share was smaller and also declining: 21 percent in 2000 versus 18 percent in 2007. (It was 26 percent in 1990.)

Table 3. Perspectives on U.S. Capital Flows to Latin America,[a] 2000 and 2007 (billions of dollars and percent)

	2000	2007
U.S. private capital outflows to the world	579.7	1183.3
U.S. private capital outflows to Latin America	21.9	58.3
Latin American share	3.8%	4.9%
U.S. FDI stock in the world[b]	1293.4	2384.0
U.S. FDI stock in Latin America[b]	154.5	173.1
Latin American share	11.9%	7.3%
U.S. private capital outflows to the world ÷ world GNP[b]	1.8%	2.4%
U.S. private capital outflows to Latin America ÷ Latin American GNP[b]	1.1%	2.0%
U.S. private capital outflows to the world ÷ world GCF[bc]	8.4%	12.2%
U.S. private capital outflows to Latin America ÷ Latin American GCF[bc]	5.9%	10.1%
U.S. FDI stock in Latin America[b]	154.5	173.1
World FDI stock in Latin America[b]	404.8	763.3
U.S. share	38.2%	22.7%
U.S. bank claims on Latin America	108.6	165.5

[4] The decline in Latin America’s share was partly due to a decline in FDI stock in Brazil (because of early worries about the Lula government that took office in 2002) and a much larger drop in Panama (presumably related to sales of property in the Canal Zone). More important, however, U.S. FDI was simply growing much faster in other regions, especially Europe and Asia.

World bank claims on Latin America	516.0	922.9
U.S. share	21.0%	17.9%
U.S. private capital outflows to Latin America	21.9	58.3
Private capital inflows from Latin America to the United States	18.5	44.5
Investment income paid to US by Latin America	22.0	43.6

Sources: U.S. Department of Commerce, Bureau of Economic Analysis (on-line) for capital flows; World Bank, World Development Indicators (on-line) for GNP and GCF; UNCTAD, World Development Report (2007) for world FDI stock; Bank for International Settlements (on-line) for banking data.

[a] Excludes Caribbean financial centers.

[b] Final year is 2006 for FDI and for GNP and GCF.

[c] Gross capital formation.

Foreign Direct Investment (FDI)

The literature on FDI, both for the U.S.-Latin American case as well as for FDI more generally, focuses mainly on determinants and impacts. Since, as mentioned above, analyses of FDI from the United States to Latin America are few and far between (and are not always the most sophisticated studies), we will also draw on some of the more general literature to complement the U.S.-Latin American analysis.

<u>Determinants of FDI</u> can be divided into socio-economic, political, and institutional factors. Competition from other developing countries may also be relevant. Of course, it goes without saying that natural resource investment will be largely determined by resource endowments in potential host countries, but the other factors discussed below are also relevant even in those cases.

With respect to the first set of factors, studies on Latin America coincide with others: macroeconomic stability and openness, growth, and human capital are crucial to attracting foreign investment. For example, analyzing U.S. FDI to 15 Latin American countries, Tuman and Emmert find significant positive relationships between FDI and GDP growth rates, trade as a share of GDP, and secondary school enrollment – although the most significant link is with lagged FDI flows. Surprisingly, they do not find a significant (negative) relation with inflation, given that they are studying the period 1979-96, which includes some very high inflation episodes. Nor do they find a link with regional trade agreements to which we return below.[5] Gallagher and Birch add the size of the host economy as an additional factor for U.S. investment to Latin America, which is often cited in the broader literature on FDI determinants.[6] Another kind of economic variable focuses on the impact of economic reforms on FDI. Biglaiser and DeRouen test the importance of five reform variables (trade reform, financial liberalization, privatization, capital account opening, and tax reform). They find that only the first two are significant in explaining FDI in Latin America. Others, however, find that privatization is positive

[5] John P. Tuman and Craig F. Emmert, "The Political Economy of U.S. Foreign Direct Investment in Latin America: A Reappraisal," *Latin American Research Review* 39, 3 (October 2004): 9-28.
[6] Kevin P. Gallagher and Melissa B.L. Birch, "Do Investment Agreements Attract Investment? Evidence from Latin America," *Journal of World Investment and Trade* 7, 6 (December 2006): 961-74.

and significant,[7] which would seem logical since much of the FDI in the 1980s and 1990s came into Latin America to participate in the privatization process. Intellectual property protection is also found to be important for U.S. direct investment.[8]

Tuman and Emmert also study the impact of several political variables on U.S. FDI to Latin America. A negative relation is found between FDI and political instability (proxied by anti-government riots or deaths caused by rebel movements) and a positive link with human rights abuse and military coups. Their argument is that foreign investors prefer authoritarian governments that will suppress unions and protest. Others disagree. Biglaiser and DeRouen present evidence that U.S. foreign investment is positively correlated with democracy – although also with regime durability and with the presence of U.S. troops.[9] Daude, Mazza, and Morrison weigh in on these issues with a study that combines U.S. and Japanese FDI in Latin America. In addition to economic variables, their model includes several political factors: strikes, political rights, and core labor rights. Numbers of strikes and political rights both have negative relationships with FDI, thus reinforcing the Tuman and Emmert conclusion. Nonetheless, the study also finds that greater respect for two of the International Labor Organization's core labor standards – protection of civil liberties and decrease in discrimination against women – is associated with larger FDI flows.[10] In other words, while the economic findings are generally accepted, the political ones are more controversial, perhaps because they are harder to measure. All agree that political stability is important, but there is disagreement about how investors want to see stability achieved.

A third set of factors generally found to be relevant for attracting FDI involves institutions. Institutional development is important to support economic and political development, but it appears also to have an independent impact on FDI. Two overlapping institutions of potential relevance are free trade areas (FTAs) and bilateral investment treaties (BITs). Although Tuman and Emmert, as mentioned earlier, did not find a significant relationship between FDI and trade agreements, this outcome may have been because they included NAFTA together with other sub-regional agreements where the United States is not a member. These different arrangements would be expected to have different impacts on U.S. direct investment. Virtually all analysts agree that NAFTA was crucial for the increase in FDI in Mexico, especially from the United States – although it was not the only relevant factor. Thus, Graham and Wada found that the trend break in 1989 toward higher FDI in Mexico was mainly explained by Mexico's unilateral economic reforms, especially with respect to trade. Reform of FDI regulations, both in the NAFTA treaty itself and in treaties in the late 1980s, was an element of the package but not necessarily the most important. The continuation of high FDI flows is attributed, in part, to NAFTA.[11] The U.S. government's Overseas Private Investment Corporation (OPIC) also claims that the new Central American FTA is increasing investment in that sub-region.[12] The BITs

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[7] Len J. Trevino, John D. Daniels, and Harvey Arbeláez, "Market Reform and FDI in Latin America: An Empirical Investigation," *Transnational Corporations* 11, 1, 2002: 29-47; Daniel Chudnovsky et al, *Integración regional e inversión extranjera directa: el caso de Mercosur*, Serie Red-INT, INTAL-IADB, Buenos Aires, 2002.

[8] Jeong-Yeon Lee and Edwin Mansfield, "Intellectual Property Protection and U.S. Foreign Direct Investment," *Review of Economics and Statistics* LXXVIII, 2 (May 1996): 181-86.

[9] Glen Biglaiser and Karl DeRouen, Jr., "The Effect of Democracy on U.S. Foreign Direct Investment," paper presented at conference on The Political Economy of Multinational Corporations and Foreign Direct Investment, Washington University, St. Louis, June 2005.

[10] Christian Daude, Jacqueline Mazza, and Andrew Morrison, "Core Labor Standards and Foreign Direct Investment in Latin America and the Caribbean," Inter-American Development Bank, Washington, DC, October 2003.

[11] Edward M. Graham and Erika Wada, "Domestic Reform, Trade and Investment Liberalization, Financial Crisis, and Foreign Direct Investment in Mexico," *The World Economy* 23, 6 (June 2000): 777-97.

[12] See Eric Green, "Free Trade Pact Spurring Foreign Investment in Caribbean Basin," U.S. Department of State, May 14, 2007. Available at www.america.gov/st/washfile-english/2007/May/200705141647021xeneerG0.533581.html.

agreements, by contrast, do not seem to have had much impact on U.S. FDI to Latin America, although they are a significant factor in explaining overall direct investment to the region.[13] This result is probably due to the fact that countries that have FTAs with the United States do not have BITs (since the provisions are incorporated into the FTAs themselves); those that do have BITs agreements are not major economic partners and the agreements are mostly from earlier years.[14]

Finally, it is worth considering the issue of competition with other developing regions as a determinant of FDI flows to Latin America. Latin American countries themselves, both through governments and the private sector, have pointed to this issue as a concern. Asia in general, and China in particular, have been singled out as providing competition for U.S. investment, and Eastern Europe is seen as a serious competitor for investment from the European Union. Both the Inter-American Development Bank (IABD) and the World Bank have done studies to address FDI competition from Asia. The IADB study focuses on China and discounts investment competition. It indicates that most of Latin America's FDI comes from the United States, while most of China's comes from Asia. Likewise the sectors differ: a focus on manufacturing in China and services in Latin America. It does, however, suggest that Mexico and Central America may face greater competition than South America because of the former's emphasis on manufacturing exports. The World Bank looks at both China and India and does not find that either has posed a significant threat to Latin America in recent times with respect to foreign direct investment. In addition, there is some FDI from Asia itself to Latin America.[15]

<u>The impact of FDI</u> in developing countries is a controversial topic in general, and it is also controversial with respect to U.S. investment in Latin America. In what is perhaps the best book on this topic to be published in recent years, Moran, Graham, and Blomstrom begin by asking: "What is the impact of foreign direct investment (FDI) on development? The answer is important for the lives of million – if not billions – of workers, families, and communities in the developing world…. Yet determining exactly how FDI affects development has proved to be remarkably elusive."[16] The book makes a number of important points. First, it is not possible to find a universal answer to the question. Host countries' experiences with FDI vary according to their own characteristics, especially human development, private-sector sophistication, and government policies. Second, different impacts are associated with different types of FDI; in particular, direct investment in closed economies is likely to be less beneficial to host countries than if it operates in an open-market context with more competition. Third, the impact is more positive (in many cases) than has been reported in previous studies. Given the caution with respect to the first point, we will look at a few examples of Latin American countries and their experience with FDI to draw some conclusions about impact.

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[13] Gallagher and Birch, "Do Investment Agreements Attract Investment."

[14] Nine Latin American countries have BITs with the United States that have actually entered into force: Argentina (signed in 1991), Bolivia (1998), Ecuador (1993), Greneda (1986), Honduras (1995), Jamaica (1994), Panama (1982), Trinidad & Tobago (1994), and Uruguay (2005). Data are available at http://tcc.export.gov.

[15] Robert Devlin, Antoni Estevadeordal, and Andrés Rodríguez-Clare, eds*., The Emergence of China: Opportunities and Challenges for Latin America and the Caribbean*, David Rockefeller Center for Latin American Studies, Harvard University, Cambridge, MA, 2006, especially chp. 6; Daniel Lederman, Marcelo Olarreaga, and Guillermo Perry, *Latin America and the Caribbean's Response to the Growth of China and India: Overview of Research Findings and Policy Implications*, World Bank, Washington, DC, 2006, especially chp. 9. For background, see Riordan Roett and Guadalupe Paz, eds., *China's Expansion into the Western Hemisphere*, Brookings Institution Press, Washington, DC, 2008.

[16] Theodore H. Moran, Edward M. Graham, and Magnus Blomstrom, eds*., Does Foreign Direct Investment Promote Development?* Institute of International Economics and Center for Global Development, Washington, DC, 2005, p. 1.

It is interesting to note that foreign direct investment was previously considered to be the worst kind of financial flow. Indeed, in the 1970s, a substantial amount of FDI was nationalized with the charges that it sucked capital out of a country (through profits exceeding new investment, as mentioned above), crowded out local firms, increased inequality, and drastically restricted the policy space of local governments. In the current period, this opinion has changed substantially – although not completely – with the more open and more privately-oriented development strategies that characterize most of the region. In this new context, foreign firms are seen as making important contributions, especially by providing access to markets and technology. FDI is also seen as being more stable than other kinds of capital flows, although there is disagreement on this point.[17]

One of the main controversies about FDI is whether it creates positive externalities (often called "spillovers") in host countries. Positive externalities can be defined as benefits created by an FDI project, which are not appropriated by the investor, the workers, or the suppliers but rather accrue to other parts of the host economy. In the literature on U.S. FDI in Latin America, Waldkirch looks at spillovers in Mexico after NAFTA, focusing on productivity, wages, and inequality.[18] A major point is that highly aggregated variables often hide impacts, which may differ by origin of investment and the type of sector to which it is directed. Thus, he looks at U.S. versus non-U.S. investment and at investment directed to the *maquiladora* (assembly) sector versus the non-*maquila* plants. The most positive conclusion is that FDI from the United States has a positive impact on total factor productivity although non-U.S. investment does not. A much weaker relation was found with labor productivity. U.S. FDI was negatively correlated with wages for both skilled and unskilled workers, meaning that wages did not move with productivity as is usually expected. No significant link was found with inequality, modeled as the share of wages to skilled workers. Paus and Gallagher offer a more critical view of the lack of spillovers through incorporating local firms into the production chains of foreign corporations.[19]
While Mexico is the country that has received the most foreign capital from the United States, Brazil has been quite different. It has been more reluctant to rely on foreign investment, and U.S. firms have played a lower role than European companies. Motta Veiga analyzes the Brazilian experience with FDI where strong debates are taking place about what role it should play and what kind of government policies would maximize the benefits of FDI: spillovers, access to technology, and expansion of exports. One reason for negative views about FDI, he suggests, goes back to the earlier point about the negative impact of FDI in closed economies such as Brazil had until recently. Brazil's well-known weaknesses in education, infrastructure, and finance have made it difficult for national firms to compete with foreign ones – which are often seen as having unfair advantages. While Motta Veiga takes a neutral stand on many of the debates, he sees interesting possibilities for foreign firms to make positive contributions on environmental issues.[20]

One of the best-known cases of U.S. FDI in Latin America involves the large Intel investment in Costa Rica in the late 1990s.[21] Various authors agree that this arrangement provided significant

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[17] A key article that challenged the assumption of FDI "exceptionalism" is Stijn Claessens, Michael P. Dooley, and Andrew Warner, "Portfolio Capital Flows: Hot or Cold?" *World Bank Economic Review* 9 (1995): 153-74.
[18] Andreas Waldkirch, "The Effects of Foreign Direct Investment in Mexico since NAFTA," MPRA Paper No. 7975, Munich, Germany, 2008; available at http://mpra.ub.uni-muenchen.de/7975.
[19] Eva A. Paul and Kevin P. Gallagher, "Missing Links: Foreign Investment and Industrial Development in Costa Rica and Mexico," *Studies in Comparative International Development* 43, 1 (Spring 2008): 53-80.
[20] Pedro da Motta Veiga, "Foreign Direct Investment in Brazil: Regulation, Flows, and Contribution to Development," International Institute for Sustainable Development, Manitoba, Canada, 2004.
[21] This case has been extensively studied. See, for example, Debora Spar, *Attracting High-Technology Investment: Intel's Costa Rican Plant*, Foreign Investment Advisory Service Occasional Paper No. 11, World Bank, Washington, DC, 1998; Felipe Larraín, Luis López-Calva, and Andrés Rodríguez-Clare, "Intel: A Case Study of Foreign Direct

externalities to the Costa Rican economy. Among the most important were support for the education system and particularly technology training, upgrading and expanding the country's exports, attracting other high-tech investments to locate in Costa Rica, and large local expenditures on wages, investment goods, and other procurement that provided demand for other parts of the economy. While some experts are critical that the linkages did not go far enough, it is clear that the benefits went well beyond Intel itself.[22]

Portfolio Investment

If there are few recent studies on U.S. direct investment in Latin America, there are almost none on U.S. portfolio investment. The flows no longer lend themselves well to differentiation by country of origin. In earlier periods, single foreign markets dominated portfolio flows to developing countries, including Latin America – London in the nineteenth and early twentieth centuries, New York in the 1920s. In the 1970s, however, the markets became much more internationalized with the development of the Euromarkets for bank loans, bonds, and stock issuance through Global Depository Receipts (GDRs). The New York market continues to be very active, but there is little to distinguish its financial products from those of Europe or Asia.[23]

Three topics have emerged as of particular concern with respect to portfolio flows to Latin America as well as other emerging market economies. First is volatility. This topic covers both "normal" volatility of flows and the relationship between foreign flows and financial crises. A second topic is bank ownership, which is a part of foreign direct investment, but we discuss it here because of the implications for portfolio investment. Third, perhaps to an increasing extent, domestic finance is beginning to rival international finance in some Latin American countries and in some other developing regions.

As is well known, portfolio flows are particularly volatile. Table 1 shows the difference between direct investment and portfolio flows in Latin America since 2000, but much more dramatic differences occurred in Mexico during the financial crisis of 1994-95 (and the Asian crisis in 1997). Papers in the book edited by Ffrench-Davis and Griffith-Jones focus on the issue of volatility in emerging economies with special emphasis on Latin America.[24] The macroeconomic implications have been at the heart of the concern over volatility. The flows can be so large in comparison with the size of the economies in developing countries that the local financial system cannot cope, monetary policy is undermined, the exchange rate gets out of line, and an asset boom results. In the extreme, foreign flows can participate in, if not trigger, a financial crisis. There has been extensive debate in the Mexican case, for example, about the respective role of foreign versus domestic investors in capital flight, but at a minimum foreign capital clearly participated.[25] Some countries have designed policies to counter portfolio volatility. The best known case is probably the Chilean controls on incoming flows, used to slow the surge in capital in the early 1990s but put in abeyance in the late 1990s when the surge subsided. These controls arose in the context of the FTA negotiations with the United States, when U.S.

Investment in Central America," Working Paper No. 58, Center for International Development, Harvard University, Cambridge, MA, 2000; Eduardo Alonso, "Trade and Investment Promotion: The Case of CINDE in Costa Rica," Inter-American Development Bank, Washington, DC, 2001.

[22] For a critical analysis, see Paus and Gallagher, "Missing Links."

[23] One distinction that may mark U.S. capital markets is greater innovation, but the most innovative products are not likely to be used in Latin America.

[24] Ricardo Ffrench-Davis and Stephany Griffith-Jones, eds., *From Capital Surges to Drought: Seeking Stability for Emerging Economies*, Palgrave, New York, 2003.

[25] See, for example, Graham and Wada, "Foreign Direct Investment in Mexico."

negotiators pushed for and got agreement to limit severely the Chileans' ability to use this instrument. Many experts thought that the U.S. position was inappropriate.[26]

Since the 1970s, the most important type of portfolio flow has been bank loans. These loans can be originated either in the home or host country, assuming the bank has a branch or subsidiary in the latter. Evidence suggests that banks with local presence in developing countries are more likely to make loans via both channels, so the recent spurt of foreign takeovers of Latin American banks becomes important. Of the major Latin American countries, over 80 percent of Mexico's banks are foreign owned, while Argentina, Chile, and Peru approach 50 percent; Brazil is the main exception with less than 30 percent.[27] With the important exception of Citigroup in Mexico and Chile, however, most of the new foreign ownership involves European (and especially Spanish) institutions.

Martinez-Diaz identifies four issues arising from the "de-nationalization" of Latin American banking systems.[28] First is, indeed, the question of volatility: does foreign ownership make a country more or less vulnerable to crisis, and do foreign banks operate in an anti-cyclical way in the midst of turbulence? Second is the issue of spillovers: does foreign entry force local banks to become more efficient? The third involves access to finance: will foreign banks lend only to the largest, most creditworthy lenders, or will they pioneer in new lending to groups that have been excluded? Finally, there is the question of capitalization: will foreign banks help to make local banking systems more solvent? Empirical evidence provides contradictory answers to all four sets of questions, and the role of foreign bank ownership remains controversial.[29]

Since Latin American regained access to the international capital markets in the 1970s, the tendency has been for sovereign borrowers and large corporations to tap those markets for their funding needs. In reality, there was little choice since local markets were too small and too weak, but doing so increased foreign exchange risk and the chance of heavy losses in the event of a devaluation of the local currency. In the last decade or so, Latin American capital markets have become much deeper, thus offering new alternative sources of finance for government deficits as well as private-sector investments. This is especially important for medium-sized firms that do not have access to international markets. At the same time, however, local and international markets are heavily interlinked, sometimes in negative ways. The stock markets offer the most dramatic examples. Many large Latin American companies, both public and private, have cross listed their shares on local stock markets and on international exchanges through American or Global Depository Receipts. Often this practice has resulted in negative externalities as more and more of the trading of large firms' shares takes place internationally and thus liquidity dries up on local exchanges and makes it more difficult for smaller firms to raise money there.[30]

Conclusions and Policy Implications

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[26] See, for example, Nancy Birdsall, "Chile FTA and Capital Flows: A Bad Precedent?" Center for Global Development, Washington, DC, January 2003.
[27] BIS, "Foreign Direct Investment in the Financial Sector of Emerging Market Economies," Committee on the Global Financial System, Bank for International Settlements, Basle, Switzerland, 2004. Data are for 2002.
[28] Leonardo Martinez-Diaz, "Banking Sector Opening: Policy Questions and Lessons for Developing Countries," Global Views Policy Brief 2007-02, Brookings Institution, Washington, DC, February 2007.
[29] For a review of the evidence, see Barbara Stallings with Rogerio Studart, *Finance for Development: Latin America in Comparative Perspective*, Brookings Institution Press, Washington, DC, 2006, chp. 3.
[30] Augusto de la Torre and Sergio L. Schmukler, *Emerging Capital Markets and Globalization: The Latin American Experience*, The World Bank and Stanford University Press, Washington, DC, 2007, chp. 2. See also Stallings with Studart, *Finance for Development*, chp. 5.

What conclusions can be drawn from this analysis? Despite the often contradictory evidence, there are a number of things that we do know with some degree of certainty. We know something about the prerequisites for attracting foreign capital to developing countries, including Latin America, in this new age of more open economies. Political and economic stability, economic growth, economic openness including substantial export capacity, and a strong human capital base are important factors that will appeal to foreign investors. These factors were found to attract FDI, and they are likely to be important for portfolio investment as well. Signing a free trade agreement with a capital exporting country is helpful, although bilateral investment treaties appear to be less so. Insofar as competition from other regions is relevant, it should serve as a wake-up call to Latin American countries to search for ways to increase their competitive position.

With respect to the impact of foreign capital, we found less of a consensus. Indeed, the bottom line may well be that there is no single answer to this question, but rather it depends on the context into which foreign capital arrives. More analysis is available for FDI, where an important point is that this type of capital is likely to be more beneficial in an open economy than in a closed one where little competition exists. A crucial issue is the existence (or not) of positive externalities. These were reported in the case of productivity increases and export activity beyond the foreign firms themselves, but not with reference to increasing wages. In case studies of Mexico, Brazil, and Costa Rica, substantial benefits were reported, but some analysts argue that the state must provide more guidance for full potential benefits to be realized.

For portfolio investment, the situation is even more difficult to analyze. A central issue about portfolio flows is their volatility and whether governments can devise and implement policies to dampen it. The increasing role of foreign banks may be a way to help deal with volatility; there is some evidence that they may also play a positive role in increasing access to finance, raising capitalization, and making their local competitors more efficient. But, at the same time, there is evidence to the contrary about foreign banks as well as indications that the internationalization of finance may undermine local financial institutions by attracting the best clients and stimulating herd behavior. This is an area in particular need of further research.

While we know some things that Latin American governments can do to attract U.S. financial flows, we are primarily concerned in this memo with what U.S. policy makers can do and what the two can do together. The research that has been cited provides a number of suggestions with respect to both direct and portfolio investment. I conclude by mentioning some of them after starting with a more general point. All begin with the premise that foreign capital is useful for Latin American countries, but that the measures suggested could increase its value.

If there is a single thing that the United States could do to provide more investment funds to Latin America and other developing countries, it would be to stop living beyond its means and thus stop absorbing such a large share of the world's available savings. The capital inflows into the United States to finance the current account deficits, created in turn by government deficits and deficient private savings, are depriving poorer countries of funds that could help them expand their economies and provide more opportunities for their populations. While a smaller U.S. current account deficit might imply fewer export possibilities for developing countries, this topic is a complex one and beyond the scope of this brief paper.

With respect to FDI in particular, one policy issue is related to the previous point. If the United States were to stop protecting firms and industries that are no longer competitive – while providing support for workers to find new employment – more of these firms would relocate to developing countries where the factor endowments are more in line with the industries in question. At the same time, it is important to help prevent a "race to the bottom" provoked by Latin American and other developing countries providing huge incentives to attract subsidiaries of foreign firms. Moran, Graham, and Blomstrom suggest that a renewed multilateral attempt to restrict this kind of activity, and thus deal with the free rider problem, would increase the quality of investment flows and thus their results. Excessive tax breaks can attract industries that cannot survive without protection, and neither the United States nor Latin America has an interest in this outcome.[31]

Turning to portfolio investment, the issue of how to stimulate more flows also arises. Ffrench-Davis and Griffith-Jones advocate consideration of several mechanisms in industrial countries to stimulate larger flows to developing countries: tax incentives, guarantees for some kinds of flows, changes in the rules on the percentage of developing country paper that institutional investors can hold, and clauses in bond issues to make debt work-outs easier if and when problems arise.[32] Dealing with volatility is at least as important as increasing the volume of flows. The financial industry could innovate in terms of risk models that "see through the cycle" rather than focusing on quarterly results, especially for long-term investors. Equally important is that the U.S. and other industrial-country governments should avoid exacerbating volatility problems. For example, the attempt to eliminate use of controls meant to reduce volatility should be avoided.[33] It is also important to take care with new regulations (e.g., the new international banking regulations known as Basle II), which many experts say are pro-cyclical and penalize developing country borrowers.[34] New regulations are likely to be placed on credit rating agencies, given their role in the current credit crisis, and these may create additional impediments for developing countries if their perspective is not taken into account. The United States should also help Latin American governments in their attempts to strengthen local or regional capital markets. Technical assistance for supervisory agencies would be very important as would be studies on the relationship between local and international markets. Finally, the U.S. government could provide greater assistance to their Latin American counterparts when the latter are seeking information on capital flight of the illegal sort.

In summary, foreign capital from the United States can be a valuable resource for Latin American countries that are trying to develop their own economies. Existing research provides a number of suggestions, but also raises a number of unanswered questions, about how both sides can work separately and together to increase the quantity but especially the quality of those flows. Doing so will be an important task for the incoming U.S. government as it tries to play a positive role in the hemisphere.

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[31] Moran, Graham, and Blomstrom, *Does Foreign Direct Investment Promote Development*, chp. 14.
[32] Ffrench-Davis and Griffith-Jones, *From Capital Surges to Drought*, chp. 1.
[33] Birdsall, "Chile FTA and Capital Flows."
[34] Ffrench-Davis and Griffith-Jones, *From Capital Surges to Drought*, chp. 10.