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Possible effects of *European Union widening* on Latin America

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Pending widening of the European Union to the East has revived concerns in Latin America that Europe may become more inward-looking. However, booming trade and foreign direct investment relations between current European Union members and Central and Eastern European countries are unlikely to harm Latin America. Trade patterns suggest that Latin America's exports to the European Union are complementary to the exports of the Central and Eastern European countries. Moreover, the recent surge in flows of foreign direct investment to various host countries, including several Latin American economies, indicates that new investment opportunities in the Central and Eastern European nations induce additional foreign direct investment, rather than causing its diversion. This picture is unlikely to change significantly once some of those nations become members of the European Union. The paper concludes that future economic relations between Latin America and the Union depend primarily on sustained economic policy reforms in Latin America and the European Union's role in multilateral trade negotiations, rather than on the Union's widening *per se*.

I

Introduction

The widening of the European Union (EU) to include the Central and Eastern European countries (CEECs) may involve a dilemma for Latin America. On the one hand, Latin America should be interested in the successful integration of the CEECs into the EU,¹ since Latin American exporters may find new buoyant markets in the CEECs if their economic transition and integration into the Union proceed smoothly. By contrast, if the widening of the European Union to the East were to fail, this would most likely result in economic and political destabilization of the CEECs, and the adverse repercussions of such a failure might well spread beyond Western Europe, with non-EU members becoming the victims of economic and political tension between the Union and the CEECs, because the EU would be a less reliable trade and investment partner for all non-members, including Latin America.

On the other hand, the pending widening of the EU has revived concerns that Europe may become more inward-looking. In many Latin American countries, the perception of being discriminated

vis-à-vis intra-EU suppliers and privileged trading partners of the Union is deeply rooted. Adverse effects of discrimination are indeed to be expected if the prospective EU members among the CEECs are direct competitors of Latin America in exporting to the EU and attracting foreign direct investment (FDI) from it. Concerns about trade and FDI diversion resulting from EU widening to the East are justified in principle. For various reasons, however, Latin America is rather unlikely to be affected by significant diversion effects. This proposition will be substantiated in the following sections, first by analysing recent trade patterns (section II), and second by discussing the issue of competition for the EU's foreign direct investment (section III). The evaluation takes into account the fact that recent trends may change once some CEECs become full EU members (section IV). The conclusion is that economic relations between Latin America and the EU are most likely to prosper if EU integration proceeds smoothly and Latin America sustains its economic policy reforms.

II

The pattern of EU imports: why trade preferences are not a sufficient explanation

1. Booming East-West trade: a case of trade diversion?

The CEECs have benefited from an unprecedented shift in the EU's trade policy stance. In the socialist era, CEECs were seriously restricted in terms of market access to the EU. They faced high tariffs, quantitative restrictions and a wide range of contingent

protection measures. At that time, the CEECs ranked at the bottom of the pyramid of trade preferences granted by the EU to various groups of countries (Hiemenz, Gundlach, Langhammer and Nunnenkamp, 1994, pp. 18 et seq.). The liberalization of East-West trade began in 1988 (when the EU concluded a trade and cooperation agreement with Hungary), but the really big change came in 1991, when the so-called "Europe Agreements" promoted the former Czechoslovakia, Hungary and Poland to the top of the pyramid of trade preferences.

The shift from discriminatory to preferential treatment has certainly favoured the boom of EU im-

¹ For a similar line of reasoning, see Langhammer and Nunnenkamp (1993).

ports from CEECs. Such imports from a group of seven CEECs² increased fivefold between 1986 and 1995 (OECD, *Foreign Trade by Commodities. Series C*, several issues). Though it is true that they started from a higher level, EU imports from Latin America only doubled during the same period. In 1995, imports from the seven CEECs exceeded imports from all the Latin American economies. It is not unreasonable to assume that the trend of considerably faster growth of EU imports from CEECs will continue, considering that some of them will join the EU soon.

Nevertheless, it is open to question whether booming EU imports from CEECs were (or will be) at the expense of other trading partners in general, and Latin America in particular. Likewise, it is debatable to what extent the boom in these imports was due to preferential access of the CEECs to EU markets. Historical trade patterns of the inter-war period, as well as the simulation of "normal" trade patterns,³ suggest that the CEECs would normally direct the largest share of their exports to Western Europe in any case. There are two reasons why the exports of CEECs to the EU fell short of the "normal" pattern until the early 1990s: apart from the aforementioned trade restrictions imposed by the EU, those countries suffered from a deterioration in their supply capacity under conditions of central planning. In other words, the economic transformation of the CEECs would most likely have resulted in rising exports to the EU even if preferential market access had not been granted by the latter.

This implies that the increase in EU imports from CEECs may reflect trade creation, rather than preference-induced trade diversion.⁴ It is almost impossible to empirically assess the relative importance of trade creation and trade diversion. However, the following evaluation suggests that the EU's trade policies towards the CEECs are of minor importance in explaining Latin America's competitive position on EU goods markets.

2. CEECs and Latin America: competing suppliers on EU markets?

Trade diversion to the detriment of Latin America would be most likely if substitution elasticities between (preferred) CEEC suppliers and (non-preferred) Latin American suppliers in EU markets were high. As substitution elasticities are difficult to measure, trade overlap indices are often used as proxies (Langhammer, 1994). Comparing the commodity structure of EU imports from CEECs and Latin America as a whole reveals a surprisingly low degree of overlapping. Most strikingly, perhaps, manufactured goods accounted for 70% of total EU imports from CEECs in 1994, while the share of manufactures in EU imports from Latin America was only 20% (see table 1).

It might be suspected that the significant increase in the share of manufactures in EU imports from CEECs since 1989 has hindered Latin America from reducing the strong bias in favour of non-manufactures (such as food products, crude materials and other commodities) in its exports to the EU. It is indeed striking that, in contrast to EU imports from Latin America, imports by the United States from the latter region shifted considerably towards manufactures in the early 1990s.⁵ However, several observations conflict with the above suspicion. For Latin America as a whole, the stylised facts are as follows:

- The share of manufactures in Latin America's exports was about 50% lower in the EU market than in the United States market even before the CEECs were granted privileged status by the EU (United Nations, 1996).
- At the level of particular manufacturing industries, there is little evidence that shifts in the structure of EU imports from the CEECs were related to shifts in the structure of EU imports from Latin America.⁶ The shares of chemicals, machinery and transport equipment, and textiles, clothing and leather in manufactured EU imports

² Albania, Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovak Republic.

³ This was done by using gravity models which consider economic size and distance as major determinants of the direction of trade; see, for example, Piazzolo (1997).

⁴ Piazzolo (1997) concluded from a comparison of revealed comparative advantage of CEECs *vis-à-vis* the EU on the one hand, and *vis-à-vis* all trading partners on the other hand, that regional integration benefitting intra-European trade is unlikely to lead to substantial distortions.

⁵ The share of manufactures in United States imports from Latin America almost doubled from 31% in 1990 to 60% in 1994 (United Nations, 1996).

⁶ Table 1 includes three prototype manufacturing industries: the chemical industry, which is relatively physical capital intensive; machinery and transport equipment, where production technologies tend to be relatively skill-intensive; and textiles, clothing and leather, the production of which is relatively (unskilled) labour-intensive.

TABLE 1

**European Union: Commodity structure of imports
from CEECs and Latin America, 1989 and 1994**
(Percentages)

		Manufactured goods ^a (total imports = 100)	Chemicals ^b	Selected industries (manufactured imports = 100) Machinery and transport equipment ^c	Textiles, clothing and leather ^d
CEECs ^e	1989	49.4	16.4	22.4	30.4
	1994	70.3	9.3	29.7	30.0
Latin America	1989	19.4	17.6	37.5	24.3
	1994	20.4	16.5	34.7	23.3
Argentina	1989	14.7	34.9	13.6	39.6
	1994	14.1	21.4	22.1	39.9
Brazil	1989	29.3	12.9	41.3	24.3
	1994	27.4	12.2	33.0	24.4
Chile	1989	3.5	71.6	4.5	5.0
	1994	7.3	61.6	7.6	7.2
Mexico	1989	28.5	19.3	58.2	10.2
	1994	47.0	16.4	57.4	7.2

Source: OECD, *Foreign Trade by Commodities. Series C*, several issues.

^a SITC sections 5-8, minus divisions 67 and 68.

^b SITC section 5.

^c SITC section 7.

^d SITC divisions 61, 65, 84 and 85.

^e Excluding the Community of Independent States.

from Latin America all declined slightly, irrespective of the direction of change in the share of these items in manufactured EU imports from CEECs (see table 1).

- Finally, for the bulk of manufactures, access to EU markets is largely unrestricted for Latin American suppliers. To put this a different way, preference margins favouring CEECs play only a marginal role in large areas of manufacturing. This is also because about 60% of Latin American exports of processed and semi-processed goods to the EU actually enter EU markets duty-free or with reduced duties under the Generalized System of Preferences (European Union, EUROSTAT, 1995).

Obviously, average figures for Latin America as a whole disguise significant differences at the country level. Considering four major Latin American economies, the share of manufactures in EU imports in 1994 ranged from 7% for Chile to 47% for Mexico (see table 1). Nevertheless, country-specific evidence tends to support the view that trade diversion played

a minor role. For instance, Mexico and, to a lesser extent, Chile succeeded in raising the share of manufactures in their total exports to the EU, although EU imports from CEECs shifted towards manufactures at the same time. Moreover, trade diversion cannot reasonably be blamed for the slightly declining share of manufactures in Argentina's and Brazil's exports to the EU. Changes in the share of particular industries in manufactured EU imports from Argentina were exactly in line with changes in the share of these industries in EU imports from CEECs. In the case of Brazil, the share of machinery and transport equipment declined considerably. Although EU imports from CEECs shifted towards this industrial sector, Brazil is unlikely to have suffered from trade diversion. Rather, this decline in its share seems to be due to country-specific factors that impaired Brazil's international competitiveness in this sector. Otherwise, it would be difficult to explain why the share of the same industrial sector increased in the cases of Argentina and Chile, and remained outstandingly high in Mexico.

A closer look at trade overlaps may be required in so-called sensitive areas. Notably in the cases of steel, textiles and agricultural products, EU imports have traditionally been quota-restricted. It is primarily in these areas that CEECs were granted preferential treatment by the EU, which may have caused trade diversion. However, empirical analyses revealed rather small overlaps in the supply of CEECs and Latin America in quota-restricted EU markets (Langhammer, 1994).

As regards steel, trade overlaps in the late 1980s and early 1990s were basically due to competition between Brazil and the former USSR in special steel products. However, Brazil's declining market shares in this period cannot be explained by preference margins, but must be attributed to price underbidding by the successor States of the USSR. Trade diversion caused in this way has diminished since 1992-1993: the EU enforced "orderly marketing behaviour", imposed quantitative restrictions on steel imports from the republics of the Community of Independent States, and subjected steel imports from the Czech and Slovak Republics to tariff quotas (WTO, 1995, p. 59). Both Latin America and the CEECs became subject to a "managed trade" strategy of the EU, designed to protect domestic steel producers and traditional trading partners against allegedly dumped steel imports. As a matter of fact, the share of iron and steel in total exports to the EU declined for both Latin America and the CEECs.⁷

Likewise, Latin America does not appear to have suffered from considerable trade diversion with respect to textiles and clothing. True, Latin America's share in EU imports of textiles and clothing (SITC divisions 65 and 84) from all non-OECD sources declined from 2.9% in 1989 to 1.7% in 1994, while the share of the CEECs more than doubled to 16.2% (OECD, *Foreign Trade by Commodities. Series C, several issues*).⁸ However, the decline in Latin America's

market share was even more pronounced in the 1980s:⁹ i.e., before the CEECs became the most favoured trading partner of the EU. Moreover, in 1989-1994 Latin America experienced a similar decline in its share in EU imports of all manufactures (from 7.1% to 4.5%; see table 2). Country-specific data presented in table 1 reveal that it was only for Mexico that textiles, clothing and leather accounted for a declining share in manufactured exports to the EU. All this implies that preferential treatment of imports of textiles and clothing from CEECs does not provide a sufficient explanation of Latin America's poor performance. Moreover, the preferences granted to CEECs were less significant than might be suggested by the expression "removal of quantitative restrictions". As in the case of steel, preference-induced trade diversion in favour of imports of textiles and clothing from CEECs was contained by persistent trade monitoring by the EU. The remaining preferences will be further reduced once international trade in textiles and clothing becomes subject to WTO discipline, as agreed in the Uruguay Round.

Arguably, the value of trade preferences granted to the CEECs was particularly high for products covered by the Common Agricultural Policy (CAP). Nevertheless, the degree of trade diversion affecting Latin America does not appear to be as substantial as is widely believed (Langhammer, 1994):¹⁰ first, CAP products exported by CEECs in 1992 amounted to less than one-third of CAP products exported by Latin America;¹¹ second, trade overlaps in food supply on EU markets by the CEECs on the one hand and Latin America on the other hand were even smaller than for steel and textiles, and third, as in the case of textiles, preference margins in favour of the CEECs

⁷ In 1989, iron and steel accounted for 7% of total EU imports from CEECs and 3.2% of total EU imports from Latin America; the respective shares declined to 5.5% and 1.4% in 1994 (OECD, *Foreign Trade by Commodities. Series C, several issues*).

⁸ Soaring EU imports of textiles and clothing from CEECs appear to be largely due to outward processing (maquila) activities of EU companies in CEECs (Nunnenkamp, Gundlach and Agarwal, 1994, p. 76). By contrast, outward processing trade does not play a significant role in Latin America's exports to the EU. This implies that trade patterns in textiles and clothing are biased in favour of the CEECs, considering that processed re-exports to the EU are inflated by imports of unprocessed inputs from the Union.

⁹ In 1980, Latin America accounted for 5.8% of EU imports of textiles and clothing from all non-OECD sources (OECD, *Foreign Trade by Commodities. Series C, several issues*).

¹⁰ Koester (1996) analyses in detail the impact of the EU's agricultural policy towards the CEECs on developing countries. He finds that "LDCs will certainly be somewhat negatively affected by the increase in preferential exports of the CEECs to the EU ... Yet this effect is most likely to be ... marginal, as LDCs sell a set of products which only compete indirectly through cross-price effects with products supplied from the CEECs" (Koester, 1996, p. 174).

¹¹ EU imports of food, beverages and tobacco suggest that Latin America has remained a more important supplier than the CEECs. In 1994, the latter countries (including the former USSR) exported about US\$ 3 billion of these items to the EU, compared with Latin American exports of US\$ 13.5 billion (United Nations, 1996).

TABLE 2

**European Union: Regional structure of imports
from non-OECD countries, ^a 1989 and 1994
(Percentages)**

		Total	Manufactured goods ^b	Chemicals ^c	Machinery and transport equipment ^d	Textiles, clothing and leather ^e
Africa ^f	1989	9.1	3.7	5.3	0.9	2.7
	1994	6.6	2.3	1.4	0.6	2.2
Asia ^g	1989	30.4	60.6	20.3	68.9	63.1
	1994	38.7	62.0	28.0	72.0	60.2
Central and Eastern Europe ^h	1989	6.6	8.0	14.3	6.0	7.4
	1994	13.1	16.7	20.9	14.3	16.2
Maghreb and Mashrek ⁱ	1989	7.5	4.3	8.0	1.7	8.4
	1994	6.9	4.4	6.4	1.7	10.2
Latin America	1989	14.9	7.1	13.6	9.0	5.3
	1994	12.2	4.5	10.1	4.6	3.4
Argentina	1989	1.52	0.55	2.09	0.25	0.66
	1994	1.57	0.40	1.16	0.26	0.52
Brazil	1989	5.66	4.05	5.70	5.63	3.01
	1994	4.42	2.21	3.60	2.09	1.74
Chile	1989	1.39	0.12	0.92	0.02	0.02
	1994	0.99	0.13	1.08	0.03	0.03
Mexico	1989	1.49	1.04	2.19	2.03	0.32
	1994	1.06	0.91	2.00	1.50	0.21

Source: OECD, *Foreign Trade by Commodities. Series C*, several issues.

^a Including Mexico.

^b SITC sections 5-8, minus divisions 67 and 68.

^c SITC section 5.

^d SITC section 7.

^e SITC divisions 61, 65, 84 and 85.

^f Excluding Algeria, Egypt, Libya, Morocco, Tunisia and the Republic of South Africa.

^g Excluding the Middle East.

^h Excluding the Community of Independent States.

ⁱ Excluding Lebanon.

will be reduced once the Uruguay Round agreements on agriculture are implemented completely.

The experience of Argentina is particularly revealing for assessing trade diversion in agriculture. About 60% of Argentina's exports to the EU consist of food items (SITC category 0),¹² and this share remained virtually constant from 1989 to 1994 (OECD, *Foreign Trade by Commodities. Series C*, several issues). It might be suspected that, due to its high dependence on food exports, Argentina would be the first to suffer from trade diversion in agriculture. Yet,

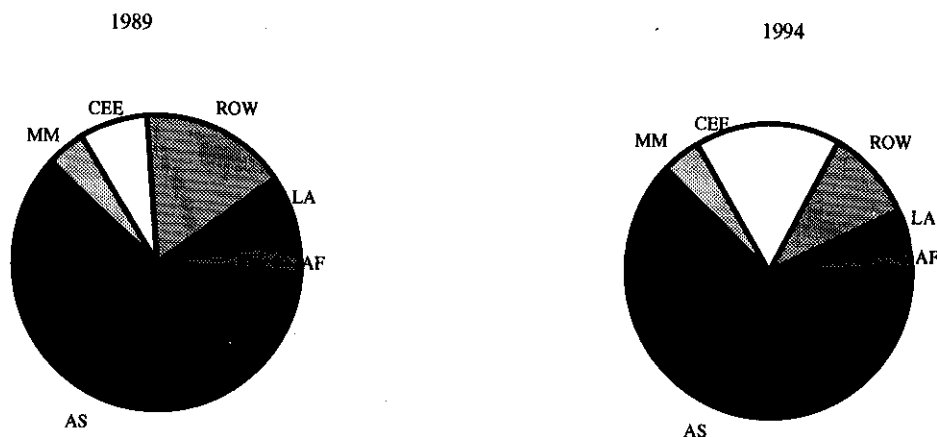
among the four Latin American economies under consideration, it performed best on EU markets, for only Argentina reported a (modest) increase in its overall market share in the EU (see table 2). In 1989-1994, Argentina's exports to the EU increased by a factor of 1.4, compared with a factor of 1.1 for Latin America as a whole. Even more strikingly, it was non-manufactured exports which were largely responsible for this favourable performance.¹³ In 1994, EU imports of food items from Argentina were 40% higher than in 1989 (OECD, *Foreign Trade by Commodities. Series C*, several issues).

¹² This compares with about 35% for Brazil, 28% for Chile and 6% for Mexico in 1994 (OECD, *Foreign Trade by Commodities. Series C*, several issues).

¹³ It may be noted that Argentina's share in manufactured EU imports declined between 1989 and 1994 (see table 2).

FIGURE 1

**European Union: Regional structure of imports
of manufactured goods from non-OECD countries
(Percentages)**



Source: See table 2.

AF = Africa (excluding Algeria, Egypt, Libya, Morocco, Tunisia and the Republic of South Africa).

AS = Asia (excluding the Middle East).

CEE = Central and Eastern Europe (excluding the Community of Independent States).

LA = Latin America.

MM = Maghreb and Mashrek countries (excluding Lebanon).

ROW = Rest of non-OECD countries.

3. Latin America's position on EU markets: who is to blame?

The changes observed in the regional structure of EU imports from all non-OECD countries support the view that Latin America's relatively poor performance on EU markets cannot be attributed to closer institutional ties with, and trade preferences for CEECs. If discriminatory trade policies by the EU had been the major factor shaping changes in market shares, Asian suppliers should have been the first to suffer from trade diversion, because Asian countries – notably the newly industrializing economies – were a major target of discriminatory trade policy instruments applied by the EU (such as export restraint agreements and anti-dumping measures) (Hiemenz, Gundlach, Langhammer and Nunnenkamp, 1994, pp. 65-67).¹⁴

Nonetheless, Asia further strengthened its dominant position among non-OECD suppliers of manufactured goods on EU markets in 1989-1994 (see figure 1; for details, see table 2).¹⁵

Asia gained market shares in capital- and skill-intensive industries such as chemicals and machinery and transport equipment, while its market share declined somewhat with respect to labour-intensive EU imports of textiles, clothing and leather.

In sharp contrast to Asia, Latin America's competitive position on EU markets deteriorated in 1989-1994, in terms of both total trade and trade in manufactures. Furthermore, Latin America's market share declined in various manufacturing industries (see table 2).

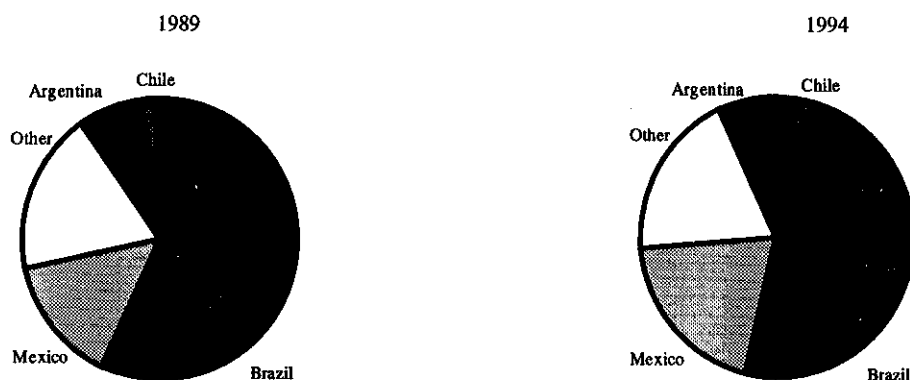
EU trade policies in general, and preferential treatment of CEECs in particular, cannot explain the contrasting performances of non-favoured trading

¹⁴ Recent anti-dumping investigations concerned various Asian suppliers, including India, Indonesia, Malaysia and Thailand (WTO, 1995).

¹⁵ For a detailed analysis, see Agarwal, Langhammer, Lücke and Nunnenkamp (1995).

FIGURE 2

**European Union: Country structure of imports
of manufactured goods from Latin America
(Percentages)**



Source: see table 2.

partners in penetrating EU markets. Latin America lost market shares to other trading partners of the EU, irrespective of whether those partners had privileged access to EU markets (CEECs) or, on the contrary, were subject to discriminatory treatment by the EU (Asian countries). It therefore follows that the blame for Latin America's poor performance on EU markets must be placed primarily on domestic supply constraints, especially in manufacturing, which may be the legacy of prolonged import substitution policies that impaired the international competitiveness of Latin American manufacturers.

The effectiveness of trade policy reforms in overcoming this problem may have been slow in manifesting itself. Yet, country-specific data indicate that the earliest reformers in Latin America performed relatively favourably on EU markets for manufactured goods. Thus, for example, only Chile avoided a decline in its share of manufactured EU imports from all non-OECD countries in 1989-1994 (table 2). At the other extreme is Brazil, whose eco-

nomie reforms were delayed until recently. Brazil's share in EU imports of manufactures from non-OECD countries was cut by half, standing at only 2.2% in 1994. Argentina and Mexico rank between these extremes. Industry-specific trends are consistent with the view that the market position of latecomers in the reform process deteriorated most seriously. For instance, Brazil's share in EU imports of machinery and transport equipment from non-OECD countries dwindled from 5.6% in 1989 to 2.1% in 1994, whereas the corresponding loss by Mexico was quite modest (see table 2). Figure 2 underscores the link between domestic policy reforms and export performance. Brazil accounted for a drastically reduced share of Latin America's manufactured exports to the EU in 1994. The shift mainly benefitted Mexico, but non-traditional exporters of manufactures such as Chile gained in relative importance as well. The crucial role of domestic economic policy is also evident when it comes to explaining FDI patterns, to which we turn next.

III

Outward FDI by the European Union: why a zero-sum game is unlikely

1. The Central and Eastern European countries as new competitors for FDI: a threat to Latin America?

Latin America has traditionally been the dominant host region for FDI from the EU in the non-OECD area. About 45% of the FDI stocks of the four main EU investor countries (France, Germany, the Netherlands and the United Kingdom) in all non-OECD countries were located in Latin America in 1985 and 1990 (see figure 3), and about 60% of the FDI flows from six EU countries¹⁶ to the non-OECD area were channelled to Latin America in 1985-1987 (OECD, 1996).

The CEECs were practically non-existent as competitors for FDI until the demise of socialism. In 1985-1987, six EU countries invested a meagre annual average of US\$ 20 million in Central and Eastern Europe, compared with US\$ 2.5 billion in Latin America (OECD, 1996). Figure 3 shows that European Union FDI stocks in those countries were exceptionally low until recently.

However, the CEECs have experienced a boom of inward FDI since they started to transform themselves into market economies. FDI inflows from six EU countries soared thirteenfold to ECU 2.7 billion in 1994 (see figure 4). In contrast, FDI flows from the EU to Latin America remained considerably below the 1990 inflows in the three subsequent years, increasing substantially only in 1994.

The prospective EU members among the CEECs, in particular, may be expected to become even more attractive hosts for FDI in the future. Moves towards closer integration into the European Union have boosted FDI in several EU member countries in the past. Spain, for example, emerged as a major host

country of FDI after it joined the EU in 1986.¹⁷ For the EU as a whole, the Internal Market programme provided a major stimulus to intra-regional FDI flows (Agarwal, Hiemenz and Nunnenkamp, 1995).¹⁸

All this would apparently suggest that Latin America has much to lose as a host of FDI. As in the case of trade, however, the region's attractiveness for FDI has little to do with EU integration and the emergence of prospective EU members as new competitors for FDI. This assertion is supported by a closer inspection of recent FDI patterns in the next section. Moreover, the subsequent discussion of investors' motivations underlying different types of FDI reveals that FDI diversion is likely to remain small in the future.¹⁹

2. FDI inflows to Latin America: how can we explain the region's impaired attractiveness?

Various empirical observations run counter to the idea that Latin America has been affected significantly by FDI diversion resulting from EU integration and closer ties between the EU and CEECs. First, if FDI diversion had been a major factor, all non-OECD hosts should have suffered from the improved attractiveness of the CEECs. In particular, developing Asia should not have fared better as a host region of FDI than Latin America. Yet, the most dramatic shift in the regional distribution of FDI in all non-OECD countries occurred exactly between these two regions (Gundlach and Nunnenkamp, 1996, figure 1): East Asia's

¹⁶ Flow data are also available for Denmark and Spain. OECD data for the remaining EU countries are either incomplete, inconsistent or completely lacking (OECD, 1996).

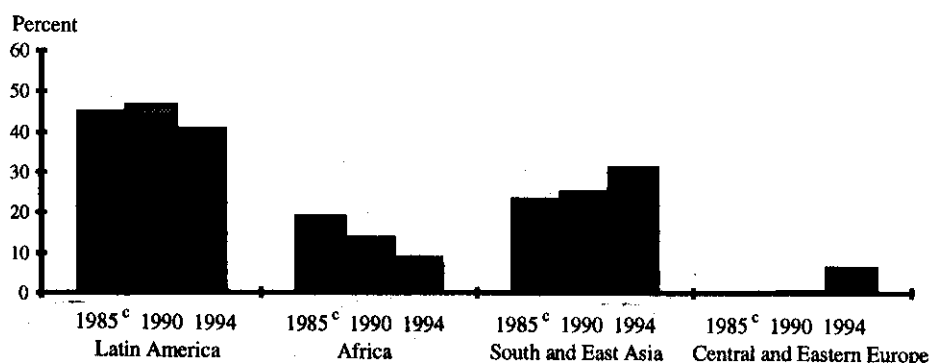
¹⁷ FDI flows from all sources to Spain soared from ECU 2.6 billion in 1985-1986 to ECU 5.6 billion in 1987-1988 and to ECU 11.8 billion in 1989-1990 (annual averages). The increase was particularly pronounced for FDI flows from other EU members to Spain, which increased more than sixfold to ECU 7.3 billion in 1989-1990 (OECD, 1996).

¹⁸ The intra-EU share of total FDI outflows of EU countries doubled from 31% in 1985-1987 to 63% in 1990-1992.

¹⁹ In contrast to trade diversion, the notion of FDI diversion lacks analytical foundation. We use this term as a catchword covering the possible effects of fiercer competition for FDI on traditional recipients of FDI.

FIGURE 3

European Union: Regional distribution of FDI stocks of four EU countries^a in non-OECD countries^b, 1985-1994
(Percentages)



Source: OECD (1996).

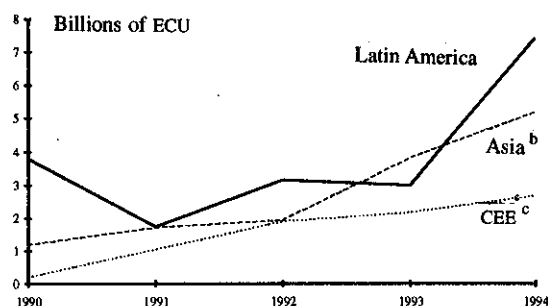
^a France, Germany, the Netherlands and the United Kingdom.

^b Including Mexico.

^c 1987 for France and the United Kingdom.

FIGURE 4

European Union: FDI flows from six EU countries^a to selected regions, 1990-1994



Source: OECD (1996).

^a Denmark, France, Germany, the Netherlands, Spain and the United Kingdom.

^b Excluding the Middle East.

^c Central and Eastern Europe, including the former USSR.

share of global FDI flows has nearly quadrupled since 1980, whereas Latin America's share has declined significantly. This pattern also holds for outward FDI by the EU. Although EU investors have traditionally been under-represented in Asia, the shift from Latin America to Asia is evident from figures 3 and 4.²⁰

²⁰ FDI flows from six EU countries to Asia amounted to less than one-third of the corresponding flows to Latin America in 1990, but this proportion increased to almost 90% when comparing average annual FDI flows in 1993-1994 (see figure 4). For a more detailed analysis, see European Commission/UNCTAD (1996).

Second, Latin America's loss of attractiveness for FDI occurred mainly in the 1980s: i.e., before FDI diversion in favour of CEECs could have played any role. The region's share in global FDI flows collapsed from 12.6% in 1979-1982 to less than 4% in 1990 (IMF, *Balance of Payments Statistics Yearbook*, several issues). Even more strikingly, Latin America's share in global FDI flows recovered precisely when the CEECs entered the scene as new competitors for FDI. Latin America's share remained persistently lower in 1991-1995 than in 1979-1982, but on average it was double the 1990 level.

Third, the recent increase in overall FDI flows to Latin America is mainly because of booming FDI from the United States (IDB/IRELA, 1996, table 11). Recently, however, EU investors too have expanded their commitments in the region (see figure 4). The relatively modest increase in FDI flows from Europe²¹ is unlikely to reflect FDI diversion, unless it is argued that this increase would have been more pronounced if the CEECs had not attracted rising FDI from the EU (which cannot be proven). Rather, United States FDI in Latin America generally appears to be more volatile than EU FDI in this region: the boom of FDI from the United States started from a depressed level in 1985-1989, whereas European FDI flows to Latin

²¹ According to data provided by IDB/IRELA (1996, table 11), European FDI flows to Latin America throughout the period 1990-1994 were 65% higher than in the second half of the 1980s. In comparison, FDI from the United States increased sevenfold.

America were even somewhat higher in 1985-1989 than in 1980-1984.

Finally, the performance of Latin America in attracting FDI differed remarkably between individual host countries:²²

- Traditionally by far the most important recipient of FDI inflows in the region, Brazil reported a steeply declining share of FDI flows from all sources to Latin America.
- Mexico, and recently also Argentina, surpassed Brazil in terms of total FDI inflows.
- Chile and Argentina proved to be most attractive with respect to average annual FDI inflows per capita in 1991-1995.

Brazil continued to be the most important recipient of FDI flows from the European Union (see table 3), but FDI flows from the EU displayed a remarkable shift towards other Latin American host countries. As in the case of global FDI flows, Argentina and Mexico (in the 1990s) and Chile (since the early 1980s) were the main beneficiaries of higher FDI flows from the EU.²³ This shift seems to be closely related to the economic policies pursued by the respective governments (Nunnenkamp, 1997a). As noted before, Chile is the front-runner with respect to economic reforms in Latin America, but the link between the timing of reforms and improved attractiveness for FDI is also evident in the cases of Argentina and Mexico.

It follows that Brazil's particularly poor performance in attracting FDI is the consequence of its serious delay in adopting reforms.²⁴

To sum up, FDI diversion resulting from European integration appears to have been only a minor factor in shaping recent FDI patterns. Both global and European FDI has been far from being a zero-sum game. Various Latin American economies recovered their attractiveness for FDI precisely when the CEECs emerged as new competitors for FDI. Countries in both regions benefitted from additional FDI at the same time, after they had implemented stabilization and structural adjustment programmes. Recent shifts

²² For a detailed analysis and data sources, see Nunnenkamp (1997a).

²³ The increasing share of the remaining part of Latin America suggests that EU investors strengthened their engagement in various smaller economies within the region, too. Examples include Jamaica, Peru and Trinidad and Tobago (IDB/IRELA, 1996, Statistical Annex, table 23).

²⁴ For a detailed analysis of the case of Brazil, see Nunnenkamp (1997b).

TABLE 3

Share of four major Latin American economies in European Union FDI Flows to the region, ^a 1980-1994
(Percentages)

	1980-1984	1985-1989	1990-1994
Argentina	16.7	14.4	18.2
Brazil	50.3	51.1	29.0
Chile	5.8	9.2	8.9
Mexico	12.1	8.9	14.9
Others	15.1	16.4	29.0

Source: IDB/IRELA, 1996, table 23.

^a Annual average. FDI flows to offshore financial centres excluded.

in the distribution of FDI across regions and among Latin American economies seem to have a close correlation with the timing and consistency of economic reforms.

3. Motivations of European Union investors: biased against Latin America?

The next question is whether closer EU integration in the future is likely to cause FDI diversion to the detriment of Latin America. An assessment of FDI in different sectors and the underlying motivations of foreign investors may offer some valuable insights in this respect,²⁵ since the potential FDI diversion can reasonably be assumed to differ widely between various types of investment (Agarwal, 1994).

There are three basic underlying motives for FDI: i) to draw on raw materials and natural resources available in the host country, ii) to serve the domestic markets of host countries or regions, and iii) to use overseas locations as platforms for global sourcing and marketing. The following discussion will show that FDI diversion is hardly a relevant issue in the first two areas. It may be a threat in the third area, but whether it will actually occur largely depends on Latin America itself.

As regards resource-based FDI, Latin America is highly unlikely to suffer from such diversion in favour of prospective EU members among the CEECs. With few exceptions, these countries do not offer promising investment opportunities in the mineral sector. Rather, most of them are heavily dependent

²⁵ For a comprehensive analysis of investors' motivations and possible FDI diversion effects, see Michalet (1997).

on imports of minerals and other raw materials. From an endowment point of view, the situation is different in agriculture, where investment opportunities may exist. Nevertheless, the available evidence suggests that the primary sector as a whole continued to be a negligible target for FDI in prospective EU member countries in the early 1990s (Agarwal, 1994, table 4). This is unlikely to change unless the restrictive Common Agricultural Policy is reformed fundamentally.

In contrast to prospective EU members among the CEECs, various successor States of the USSR do offer vast investment opportunities in the primary sector because of their favourable endowment of natural resources. This may induce a larger degree of FDI diversion if the EU strengthens its ties with these countries. Even so, Latin America is unlikely to be affected significantly. First, for the time being FDI conditions in the successor States of the USSR remain clouded by economic and political uncertainty. Second, various Latin American host countries have little to lose. In Brazil and Mexico, for example, the primary sector as a whole accounted for only about 2% of total FDI stocks in 1994 (IDB/RELA, 1996, table 8). Third, FDI diversion may be a minor concern even in Latin American countries where the primary sector figures prominently in total FDI stocks,²⁶ because resource-based FDI tends to be highly location-specific. This means that FDI diversion is conceivable only among countries offering the same quality of a particular commodity.

FDI for serving the domestic markets of host countries (in UNCTAD's jargon, market-seeking FDI) seems to account for the bulk of FDI in Latin America (Nunnenkamp, 1997a). This is a plausible assumption, although the available data do not allow for a clear distinction between market-seeking FDI and FDI undertaken in the context of global sourcing and marketing (efficiency-seeking FDI):

- The services sector, in which the production of non-tradeables is clearly dominant, accounts for a significant share of total FDI in major Latin American host countries.²⁷
- Surveys of enterprises and regression analyses reveal that the size and growth of host country markets have been major stimuli for FDI in manufacturing. This applies especially to Latin America, where lasting import substitution strategies provided a disincentive to efficiency-seeking FDI in the past. The low share of manufactured goods in Latin American exports to the EU (see section II.2 above) underscores the fact that European Union FDI in manufacturing has primarily been market-seeking in this region.

The sectoral distribution of FDI in several CEECs suggests that, as in Latin America, market-seeking FDI was dominant in the early 1990s (Agarwal, 1994, p. 12). This is corroborated by recent survey results (OECD, 1993; Michalet, 1997). Most probably, this similarity between Latin America and the CEECs will greatly reduce the scope for FDI diversion. It is hardly conceivable that EU investors will give up important markets in Latin America simply because of new market opportunities in CEECs. Rather, one can expect additional FDI if different regions all offer favourable market prospects.²⁸ This view is supported by the recent boom of FDI in the services sector of various countries in Latin America, Central and Eastern Europe and other regions, after these countries had joined the world-wide trend towards privatization and deregulation of services.

It follows that, as far as market-seeking FDI is concerned, the continuation of the recent recovery in FDI flows to the region will depend on the economic prospects of Latin American countries, rather than on the future course of EU integration. This is not to ignore the fact that the prominence of market-seeking FDI involves certain risks for Latin America. Indi-

²⁶ Examples are: Bolivia (76%), Chile (59%), Colombia (61%) and Ecuador (51%). The degree to which EU investors are engaged in the primary sector of these countries cannot be identified from the available data.

²⁷ The share of the services sector in total FDI stocks in 1994 was around 40% in Argentina, Brazil and Mexico, while it was about 25% in Chile (IDB/RELA, 1996, table 8). Moreover, recent FDI flows to various Latin American countries were heavily concentrated in services, largely because of privatization programmes (Nunnenkamp, 1997a).

²⁸ Additional FDI may be associated with relatively lower domestic investment in EU countries. In contrast to FDI diversion, this might be called "FDI creation" (by analogy to trade creation).

rectly, it may put Latin American economies at a disadvantage in competing for the third type of FDI, i.e., efficiency-seeking investments.

In the era of globalization, efficiency-seeking FDI is considered to be the hallmark of the response of multinational corporations to the changing international environment (UNCTAD, 1996, p. 97). The size of host country markets, as one of the most important traditional FDI determinants, is expected to decrease in relative importance. Under such conditions, Latin America may be handicapped *vis-à-vis* other regions.

Globalization may shift the FDI balance further towards Asia. Various Asian countries are well-known for their world market orientation which puts them in a favourable position to compete for efficiency-seeking FDI. In contrast, Latin American countries may still be suffering from insufficient international competitiveness of manufacturing industries that were established under conditions of import substitution. At the same time, the recent move towards trade liberalization in Latin America tends to weaken the incentive for foreign investors to undertake market-seeking FDI in this region in order to jump over protectionist fences.

It may also prove more difficult for Latin America than for CEECs to attract efficiency-seeking FDI. The recent surge of market-seeking FDI in CEECs occurred when these host countries liberalized their foreign trade regimes substantially. Hence, the existing FDI stock in the CEECs is probably more in line

with these countries' comparative advantages than in the case of Latin American countries. This could render it relatively easy for CEECs to switch from market-seeking to efficiency-seeking FDI. CEECs have two additional advantages in attracting efficiency-seeking FDI: their geographical proximity, which helps them in competing for this type of FDI from EU countries, as distance typically involves higher transaction costs, and their preferential access to EU markets.

It is in the area of efficiency-seeking FDI that the largest potential for FDI diversion exists. Under conditions of globalization, overall FDI prospects seem to depend increasingly on the attractiveness of a given location for efficiency-seeking FDI. If this is so, the Latin American economies have little choice but to prepare themselves for fiercer world-wide competition for this type of investment. Important steps have already been taken by various Latin American countries to reduce the risk of FDI diversion. Comprehensive reform programmes with regard to macro-economic stabilization and structural adjustment were instrumental in the recent recovery of FDI flows to Latin America (Nunnenkamp, 1997a). The close link between reform-mindedness and FDI inflows supports the view that the future prospects of Latin America in attracting efficiency-seeking FDI depend primarily on the economic policies followed in this region, rather than on the deepening and widening of EU integration.

IV

Future prospects

1. Towards more significant trade diversion?

Recent trade and FDI patterns suggest that EU widening to the East has only limited effects on Latin America. As regards trade, the CEECs and the Latin American countries have targeted different markets for their exports to the EU. The resulting surprisingly small trade overlaps mean that there is likely to be relatively little trade diversion due to EU integration which negatively affects Latin America. This picture may change somewhat when several CEECs become full members of the EU. However, the picture should not be dramatically different in the future, consider-

ing that possible changes work in opposite directions, so that their effects on trade diversion may cancel each other out:

– On the one hand, the potential for trade diversion will further decrease once the Uruguay Round agreements are fully implemented. Preference margins for CEECs will then be reduced, limiting trade diversion in “sensitive” areas such as textiles and clothing. Furthermore, trade overlaps may become even smaller in the future, if the CEECs succeed in making better use of their relatively favourable endowment of human capital and skilled labour. With continued investment to replace the obsolete capital stock inherited from

the socialist past, the comparative advantages of the CEECs will shift towards skill-intensive lines of production. Rising wages in the CEECs during the process of economic transformation and EU integration will reinforce structural change towards more sophisticated manufacturing industries. The supply by the CEECs on EU markets may then become increasingly complementary to Latin American supply, rather than taking its place.

– On the other hand, full EU membership of some CEECs may induce more trade diversion. Remaining trade barriers between these CEECs and current EU members will be removed, but at the same time the CEECs will be required to reduce their (relatively high) protection against non-EU members to the (relatively low) level of external protection of the current EU. Taken together, the free trade area requirement and the customs union requirement may give rise to considerable structural adjustment needs in the new CEEC members of the European Union. Against this backdrop, these countries will probably appeal to the EU to consider their demands for higher protection when it comes to trade negotiations with non-members. An extended EU may thus slow down the process of external trade liberalization, especially during the period of structural adjustment by the CEECs to the import pressures from both current EU members and non-EU countries (Langhammer and Nunnenkamp, 1993).

It is almost impossible to draw up a balance between these opposing influences, let alone assess the net impact on particular external trading partners of the EU such as Latin American economies. Even if trade diversion becomes more likely, new opportunities for trade will emerge simultaneously. Latin America may be adversely affected if the EU becomes more reluctant to liberalize extra-EU trade, but at the same time Latin American suppliers will benefit from better access to still highly protected markets of CEECs, once the latter are members of the customs union, and this may help increase the extremely low share of Central and Eastern Europe in total Latin American exports (1994: 0.3%, excluding the former USSR (United Nations, 1996)).

2. Towards stronger complementarity between trade and FDI?

As in the case of trade, there are certain risks that Latin America will be affected by FDI diversion. For

several reasons, however, such risks should not be overrated. World-wide FDI flows have never been –and are most unlikely to become– a zero-sum game. The recent surge of FDI flows to various host countries and regions, including many Latin American economies, indicates that new investment opportunities induce additional FDI, rather than leading to FDI diversion. Fears of such diversion tend to be exaggerated, failing to take into account the fact that overall FDI is far from being a uniform phenomenon. Different motivations underlie resource-based FDI, market-seeking FDI and efficiency-seeking FDI. The threat of FDI diversion is essentially restricted to efficiency-seeking FDI, but it may be expected that this type of investment will become increasingly important in the era of globalization.

The current trend towards globalized production and marketing may have important implications for the nexus between trade and FDI (see also UNCTAD, 1996, chapter IV). To a certain extent, and under specific conditions, FDI can still be a substitute for trade. For instance, FDI may follow trade once a certain market share has been achieved through exports, or FDI may be used to surmount import barriers. Brazil, for example, appears to have been the largest recipient of market-seeking FDI among developing countries prior to the foreign debt crisis, mainly because its import substitution policies hindered trade. However, the more traditional sense of substitutability of FDI for trade is challenged by the trend towards globalization. It would appear that multinational enterprises increasingly view trade and FDI as complementary modalities of serving markets and organizing production. Geographically dispersed manufacturing and the combination of markets and resources through FDI and trade are becoming an important part of the world economy:

- By means of FDI, multinational enterprises slice up the value chain and capitalize on international cost differences, locating production processes where the relevant comparative advantages are highest.
- At the same time, multinational enterprises account for about two-thirds of world exports of goods and non-factor services (UNCTAD, 1995, p. 193). About half the exports of multinational enterprises are intra-firm exports. Moreover, the share of intra-firm trade in the total trade of multinational enterprises appears to be on the rise.

Empirical analyses reveal a positive correlation between trade flows and FDI flows, which indicates

that complementarities between trade and FDI have predominated over substitution effects (Nunnenkamp, Gundlach and Agarwal, 1994, pp. 81 et seq.). FDI is positively correlated not only with exports of the investors' home countries to host countries, but also with exports of host countries to the home countries. Hence, rather than replacing trade with developing countries, the recent boom of FDI is likely to be accompanied by intensified trade relations.

3. How can we achieve closer economic relations?

The complementarity between trade and FDI not only helps developing countries in getting access to resources for strengthening their production capabilities, but also in penetrating world markets with products where they enjoy comparative advantages. They must meet various requirements, however, in order to become involved in globalized production and thereby improve their prospects of attracting FDI and penetrating world markets. Cross-country analyses suggest that the following factors should be of priority concern: sustained macroeconomic stability, openness to world markets, and accumulation of physical and human capital (Sachs and Warner, 1995; Gundlach and Nunnenkamp, 1996; Nunnenkamp, 1996).

This means that the question of whether Latin American countries' economic relations with the EU will prosper depends primarily on the economic policies pursued by them. Various countries of the region are in the process of restoring their international competitiveness and attractiveness for FDI, but major challenges remain. While the bulk of FDI has tradi-

tionally been market-seeking in Latin America, the region can no longer rely on local or regional market size as a sufficient incentive for FDI inflows. In order to benefit from complementarities between trade and FDI, Latin America must improve its attractiveness for efficiency-seeking FDI. A critical question is whether manufacturing industries which foreign investors helped to establish under conditions of import substitution can become competitive by international standards. Transport equipment and electronics are cases in point, since intra-firm trade plays a particularly prominent role in these industries (UNCTAD, 1995, p. 197). In the short term, Latin America faces a dilemma: trade liberalization may have negative effects on traditional forms of FDI, as it weakens the incentive to make such investments in order to surmount import barriers, but in the longer run, liberalization of trade and deregulation of FDI are instrumental to Latin America's integration into globalized production, as they enhance specialization according to comparative advantages.

Sustained economic policy reforms may be regarded as the contribution that Latin America must make in order to foster better economic relations with the EU. The EU's most important contribution would be to ensure open markets for non-members, including the Latin American countries, and to play a constructive role in maintaining a liberal multilateral trading system. EU widening to the East does involve some risk for the Union's external trade liberalization, but the threat of more inward-looking policies of the EU may be still greater if EU integration does not proceed smoothly.

(Original: English)

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