

UNIVERSITY OF CALGARY

REGIONAL TRADE AGREEMENTS IN THE AMERICAS  
AND COUNTRY RISK:  
SOLVING THE FOREIGN DIRECT INVESTMENT PUZZLE

by

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Abstract

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by Annette Hester

Chairperson of the Supervisory Committee: Professor Eugene Beaulieu  
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This thesis examines the direct and indirect impacts of regional trade agreements in the Americas on the inflows of foreign direct investments (FDI) into the region from the perspective of the “eclectic theory” of international investment, and hence the advantages of foreign ownership, host country location, and internationalization. In theory, regional trade agreements may affect FDI inflows both directly, by creating a regional market, and indirectly by changing investors’ perceptions of the riskiness of signatory countries. Pooled cross-section and time series data for 22 Latin American countries over 1984-98 are used in a Two Stage Least Square simultaneous system estimation with control variables in the order to investigate these impacts. The results demonstrate that regional trade agreements in the Americas have no direct impact on the inflows of FDI and that the indirect effects are statistically significant. Regional trade agreements have an impact on the perceptions of country risk and, in turn, country risk impacts the inflows of FDI.

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## DEDICATION

To Brian, Illana, and Marc

For giving me the opportunity to embark on this voyage

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## LIST OF SYMBOLS, ABBREVIATIONS. NOMENCLATURE

Canada-United States Free Trade Agreement	CUSFTA
Caribbean Common Market	CARICOM
Caribbean Free Trade Association	CARIFTA
Central American Common Market	CACM
Common External Tariff	CET
Foreign Investment Protection Agreements	FIPAs
Free Trade Areas	FTA
FTA between Mexico, Venezuela and Colombia	GROUP of THREE
General Agreement on Tariffs and Trade	GATT
Latin America Free Trade Association	ALALC
Latin America Integration Association	LAIA/ALADI
Mercado Comun del Sur	Mercosur
North American Free Trade Agreement	NAFTA
Organization of American States	OAS
United Nations Conference on Trade and Development	UNCTAD
United Nations Economic Commission for Latin America	ECLAC/CEPAL
World Trade Organization	WTO

## **I n t r o d u c t i o n**

In the last thirty years the world trading scene has changed dramatically. Once dominated primarily by a single trade organization, the General Agreement of Tariffs and Trade (GATT), it is now fragmented into a large number of separate trading blocs which co-exist with the GATT and its successor the World Trade Organization (WTO). This fragmentation has become the norm, rather than the exception. According to Paul Krugman, "from 1945 until about 1980, regional trade agreements and the global trade negotiations under the GATT could reasonably be seen as complements rather than substitutes, . . . Since then, however, the two have moved in opposite directions." (Krugman, 1992 in King ed., 1995 p. 163).

The pattern of trade agreements in the Americas, particularly in Latin America, fits this trend. From the 1960's until the 1980's several schemes of economic integration of the Latin American region were attempted within the GATT framework. In the post 1980's period, economic integration goes a great deal beyond the scope of the GATT.

These new types of trade arrangements are part of a new development paradigm which includes export promotion, market liberalization, privatization, a shift in regulatory frameworks, democratization, and the aggressive pursuit of foreign direct investments (FDI). This is a very fluid and dynamic environment. Each of these government policies has a potential to impact the others. While in theory this seems obvious, in practice very little has been done in empirical analysis to establish precise relationships. This thesis examines the reach of regional trade agreements in the area of foreign direct investment inflows into Latin America and provides empirical support for the theory and its conclusions.

Historically, trade agreements in Latin America, regional and sub-regional, had the objective of contributing towards the region's development. This approach towards development followed closely the theories put forth by the United Nation's Economic Commission for Latin America and the Caribbean (ECLAC or better known by its Spanish acronym CEPAL) and the writings of the influential Latin American economist,

Raul Prebisch. The strategy consisted primarily of pursuing industrialization through "import substitution" and, in the long run, the achievement of economies of scale and the co-ordination of industrial policy through a progressive move towards the formation of a regional market (Macadar, 1992, p.72).<sup>1</sup> The Latin American Free Trade Association (Asociación Latinoamericana de Libre Comercio) (ALALC), its subsequent organization the Latin American Integration Association (LAIA/ALADI), and the Central American Common Market (CACM) serve as fitting examples. Although significant progress was achieved in the political and economic relations between the region's countries during the 1960s, 1970s and 1980s, the overall results of the majority of these trade agreements were disappointing. Several events, of both political and economic nature, contributed to the meagre results. For example, military coups experienced by several Latin American countries in the 1960s and the 1970s; the two 1970s oil crises (1973 and 1979), and the debt crisis of the 1980s, all had a tremendous adverse impact on the region.

By the mid-1980s, most Latin American countries had abandoned import substitution and had embraced a program of economic liberalization. A new integrationist effort emerged in the late 1980s following in the wake of the signing of the Canada-United States Free Trade Agreement (CUSFTA) in 1988 and the announcement of the Enterprise for the Americas Initiative (EAI) in June 1990. Interestingly, this new effort strongly favours export promotion and the expansion of international trade throughout most of the developing world (Edwards, 1994, p.34). This new era saw the formation of some important new blocs and the revival of old ones. Among the new blocs are the Common Market of the Southern Cone (Mercosur) and the extension of the CUSFTA to Mexico, forming the North American Free Trade Agreement (NAFTA). Another feature of this era has been the proliferation of bilateral agreements – particularly of Foreign Investment Protection Agreements (FIPAs).

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<sup>1</sup> Import Substitution- in order to promote domestic industrialization and conserve scarce foreign exchange, tariffs and quotas are used to limit or at times remove competing imports. The aim is to establish manufacturing industries that initially can be expanded to supply the domestic market, and later to develop an export trade. (adapted from *The Harper Collins Economics Dictionary*, 1991, pg.240)

One is left wondering what led to this regionalism/bilateralism movement within the context of globalization. In other words, if there was a global organization to which most of the world, including Latin American countries, belonged (see Table I.1), why create other bureaucracies? The answer to this question lies in the evolution of the GATT.

TABLE I.1

<i>Selected Latin American Countries and GATT Membership</i>	
Country	Membership Year
Brazil	1948
Chile	1949
Dominican Republic	1950
Nicaragua	1950
Peru	1951
Uruguay	1953
Jamaica	1963
Guyana	1966
Argentina	1967
Suriname	1978
Colombia	1981
Mexico	1986
Bolivia	1990
Costa Rica	1990
Venezuela	1990
El Salvador	1991
Guatemala	1991
Honduras	WTO – 1995*
Paraguay	WTO – 1995*
Ecuador	WTO -1996
Bahamas	Not a member
Panama	Not a member

\* denotes automatic membership into the WTO on January 1<sup>st</sup>, 1995.

source: [gopher://gopher.undp.org:70/00/unearth/organizations/gatt/mcountrye](http://gopher://gopher.undp.org:70/00/unearth/organizations/gatt/mcountrye)

In the wake of World War II an attempt to negotiate a comprehensive International Trade Organization was made. The motivation for the creation of such an organization was both philosophical and practical. Philosophical, because the framers of the "new world order" believed in trade liberalization, and practical because the high tariffs which had given rise to the tariff wars of the 1930s were still in place. Unfortunately, the political timing was wrong. The only agreements reached were on a limited subset of trade matters negotiated under the brand-new GATT. The larger, more ambitious International Trade Organization

was stillborn. The GATT, by default, became the principal world organization regulating trade (Kerr, 1995, p. 93).<sup>2</sup>

The GATT's principal objective was to liberalise international trade in goods and provide a secure environment under which trade could be conducted. After fifty years of existence one could claim that world trade has been liberalised a great deal. However, the pace and scope of these improvements were unsatisfactory in the eyes of many participants, who began to look for alternative arrangements.

There were three principle deficiencies in the GATT process. Negotiations took too long, were too complex and, the dispute settlement mechanism was flawed. Both the liberalization of trade and the ongoing development of rules for trade have been accomplished through successive rounds of negotiations: Annecy Round (1948), Torquay Round (1950-51), Dillon Round (1956; 1960-62), Kennedy Round (1964-67), Tokyo Round (1973-79) and the Uruguay Round (1986-1994) (Ibid. p.96). As one can observe, these rounds had been getting longer and longer, a reflection of the complexity of issues and divergence of interests of the GATT's over 100 member countries. A further complication was the fact that the GATT did not have supra-national legal authority; therefore it had to rely on voluntary compliance of its rules and rulings by the member countries. The dispute settlement mechanism had the major fault of requiring the agreement of the contending parties for a panel to be convened.

Some of the major principles introduced were flawed. In order to achieve its objective of liberalization, the GATT used a combination of tariff reduction with tariffication.<sup>3</sup> One of the GATT's major principles is that once a country agrees to lower its tariff rates they become "bound" (they cannot be raised). Another major principle is that of "non-discrimination" - which means that any tariff concessions given to any member must be

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<sup>2</sup> It is important to note that a number of countries, primarily the former communist countries, did not join the GATT

<sup>3</sup> Tariffication is the process whereby alternative trade restricting practices are converted into tariffs which provide an equivalent degree of protection (Kerr, 1995 p.97)

extended to all member countries.<sup>4</sup> The third principle was that of transparency - that any trade action taken by a country must be reported to all member countries. This left out a whole array of non-tariff barriers to trade such as voluntary export restraints, import quotas variable levies, and, health, sanitary and phytosanitary regulations.<sup>5</sup> Finally, the last important principle was that of retaliation - which specified that injured countries had the right to retaliate up to an amount of equivalent value without fear of second round retaliation (Ibid. p.98). Included in the retaliation mechanisms were the allowance of anti-dumping and countervailing duties.<sup>6</sup> This retaliation mechanism has often been misused by all signatories, but the United States and the European Union (EU) have been repeat offenders. The United States has gone even further. It has created legislation, such as Section 301 of the Trade and Tariff Act of 1974 and its subsequent amendments (Super 301 and Special 301), which, although written in compliance with GATT principles, completely violate them in the manner in which they were applied (Bhagwati, in King ed., p.85).<sup>7</sup> The gist of Super 301 is that it requires the United States representative, on schedule, to prepare an inventory of foreign trade barriers, establish a priority list of countries, and then set deadlines for their removal, and, should countries fail to comply, decide on U.S. retaliation. Special 301 is similar in its time-bound approach but is addressed especially to intellectual property rights. This continuous harassment led to a situation in which countries tried to secure easier access to markets (especially the United States' market) by alternative means (i.e. either bilateral or regional trade agreements).

Lastly, the GATT was unable to deal with the rapid pace of technological change, the development of the service sector, and the increase in direct and indirect international investment.

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<sup>4</sup> This treatment is commonly known as "Most Favoured Nation" rates. It is also important to note that a different rate of tariff reduction for countries belonging to a regional trade agreement is allowed.

<sup>5</sup> The GATT does mention that all import quotas should be changed into tariffs, which provides a similar degree of protection. However, the time period for the tariffication was extremely long and the rulings had no "teeth."

<sup>6</sup> Anti-dumping duty refers to a tax applied on imported goods judged to be priced below the cost of production and countervailing duty refers to a tax levied on imported products that have been subsidized by export incentives. (adapted from *The Harper Collins Economics Dictionary*, pgs.104 and 145)

<sup>7</sup> Brazil was one of the targeted countries. The others were India and Japan.

These and a multitude of other problems led to negotiations and an agreement in 1993 to form a World Trade Organization (WTO). The WTO has been operational since 1995. Membership in the WTO was extended to all GATT members. The WTO has addressed several of the problems mentioned previously. It is a permanent organization with a much better conflict resolution procedure. Added to the GATT (which is still responsible for trade in goods) were the GATS (General Agreement on Trade in Services) and the TRIPS (Agreement on Trade -Related Aspects of Intellectual Property). Since its creation, the WTO has been the forum for successful negotiations to open markets in telecommunications and in information technology equipment. Further, more than 150 trade disputes have been brought to the WTO for resolution. According to the information provided on the organization's website:

“ . . . Of the 150 cases, about 30 have been withdrawn following consultations between countries in dispute; over 100 are going through the procedure of consultation, panel adjudication or appeal; about 20 are in the final stage of implementing a solution; four have been settled and the solution implemented; seven have been closed without any need for action to be taken” (FAQs, 1999, p.2 of 5).

Many observers including the WTO itself boast of the organization's superior dispute settlement mechanism. However, judging from the statement above, it is not clear how effective the mechanism is. Note that of the 150 cases, 30 have been withdrawn, which leaves 120. Subtracting the 100 cases that are still going through the process only 20 remain. At this point the math gets complicated as the WTO claims 20 are in final implementation stages, while there are still 11 which have been settled or closed. However, it has to be recognized that solving disputes and negotiating with 131 countries is a complicated and lengthy proposition.<sup>8</sup> Moreover, the trade world is far different than it was at the beginning of the Uruguay Round in 1986. Countries that belong to some of

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<sup>8</sup> 131 countries are currently members of the WTO and 29 others have requested to join the organization. Their applications are currently being considered by accession working parties.

the regional trade arrangements negotiate at the WTO as a group; consequently, the bargaining process has been irrevocably changed.<sup>9</sup>

Nonetheless, a new round of negotiations may be launched in November, 1999. Although the original proposal was for negotiations to liberalize the services and agriculture sectors beyond what was accomplished during the Uruguay Round, the final agenda will be set at the November meeting.

Clearly, regional trade agreements have led to a change in the world-trading scenario. But, is this the only area regional trade agreements are affecting? In other words, are regional trade agreements in the Americas just about trade? This is the central question of this thesis.

The premise which will be developed is that regional trade agreements in the Americas impact several areas other than trade. Among these areas, and the one that will be discussed in this study, is the effect of these arrangements on the inflows of foreign direct investment.

Traditionally, the developed countries dominated the foreign investment stocks. According to the World Investment Report 1998: Trends and Determinants (WIR98), developed countries account for more than two-thirds of the world inward FDI stock and 90 per cent of the outward stock. However, their dominance is being eroded. In 1997, developing countries accounted for almost a third of the global inward stock. The figure in 1990 was one-fifth of the global inward stock. In terms of flows, they went from 17 per cent of global inflows in 1990 to 37 percent in 1997 (UNCTAD, 1998, p. xviii).

The distribution of foreign direct investment inflows into Latin America also experienced a major shift in 1997. Latin America and the Caribbean experienced a sharp increase of 43 per cent, reaching a share of 44 per cent of the total inflows of foreign direct

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<sup>9</sup> Any countries belonging to an arrangement constituted as a Customs Union or Common Market (the definitions for all types of trade arrangements are provided in chapter 1) negotiate at the WTO as a group.

investments, while the Asian developing economies maintained but did not improve their lead. They accounted for 53 percent of the total foreign direct investment inflows. Africa lost considerable ground (CEPAL, 1998, p.17).

It is interesting to observe the evolution of the inflows of foreign direct investments into the region. In the first half of the 1990s, privatization of State-owned assets was the main mechanism for attracting foreign direct investments. This initial wave was followed by a series of new investments in the private sector combined with investments in restructuring and modernization by already-established foreign companies and by the firms which had bought the state enterprises. In the late 1990s a new wave of privatizations took place as Brazil and Colombia's privatization programs went into full swing. In addition, a new type of privatization has started. It involves the transfer to the private sector – under concession – of activities previously reserved by the State such as, telecommunications (especially cellular telephony), mining, and oil and gas development. At least for the near future, inflows of foreign direct investment into the region should continue on the same levels as privatization programs are still under way and a new wave of construction of large infrastructure projects is just starting (Ibid., p. 19).

Several of the recent reports on the inflows of foreign direct investment into developing countries link these inflows to the presence of regional trade agreements. Included in these studies are the WIR98 and the CEPAL's Foreign Investment in Latin America and the Caribbean: 1998 Report. For example, the latter report states:

“ . . . In recent years, many foreign corporations have taken advantage of these opportunities to enter or expand their presence in the region. The process has been especially intense in Mexico – because of opportunities offered by the North American Free Trade Agreement (NAFTA) – and in Argentina and Brazil – as a way of creating and consolidating subregional production networks in the Southern Common Market (Mercosur).” (1998, p. 19).

However, statements such as the one above are being made with very little empirical evidence to support it. The report mentions in one page that privatization led to a wave of

foreign direct investments into the region and on the next page attributes these inflows to regional trade agreements. The link between regional trade agreements and foreign direct investment inflows is also made in the article, "Sour Mercosur" recently published in the respected magazine, *The Economist*. In the opening paragraph the following statement is made, "Foreign investment has poured in, attracted by the potential of a market of over 230m people, with a combined GDP of \$1.2 trillion in 1998" (The Economist, 1999, p. 13). Again, no empirical evidence to support this statement is provided. A closer look at the difference in foreign direct investment inflows into the region pre and post-signing of the these regional agreements, suggests that the story might be more complex than the one told above suggests. Table I.2 shows the differences in question.

TABLE I.2

<i>Foreign Direct Investment Inflows into Latin America in millions of US Dollars</i>							
Year	Latin America	Latin America minus Mercosur	Latin America minus Mercosur and Mexico	Mercosur	Argentina	Brazil	Mexico
1986	4463	3506	1470	956	574	345	2036
1991	12456	8806	4064	3650	2439	1103	4742
1997	61518	34870	22039	26647	6643	19652	12831
<b>Difference (percent)</b>							
1986-1991	179	151	176	281	324	219	132
1991-1997	394	296	442	630	172	1682	171
<b>Difference i Differences</b>							
	215	145	266	349	-152	1463	39

For instance, note that the change in foreign direct investments for Argentina and Brazil after the signing of Mercosur in 1991 is exactly the opposite. While inflows into Brazil increased by a staggering 1463 over this period, Argentina's decreased by 152 percent. Certainly, the Argentine privatization program started by the Alfonsin government (1984-1989) and completed by his successor, Carlos Menem, impacted the inflows of foreign direct investment into Argentina more than the signing of the Mercosur agreement. One could also question the impact of the Mercosur on the inflows of foreign direct investment

into Brazil. The large increase in FDI coincides with the beginning of a massive privatization program. Finally, the modest difference in percentage increase pre and post-NAFTA experienced by Mexico could be attributed to several factors. First, NAFTA was signed in December 1992 and ratified in 1993. Consequently, the time period covered in Table I.2 is not conducive to pre and post-NAFTA analysis. Second, Mexico already had relatively large inflows of foreign direct investments prior to NAFTA. Thus, although there is still a considerable increase of 39 per cent, this increase looks small compared to the ones experienced by the rest of the region which started from a much smaller base. Last, note that Mexico accounted for almost half of all of the inflows of foreign direct investments into the region in 1986, while in 1997 it represented only one-fifth of the total.

Have trade agreements affected the foreign direct inflows to Latin America and, if so, through which mechanisms? These are essentially empirical questions. As the subsequent chapters will show, although there is an increasingly large body of literature on the theory of international investments, including some discussion on the impact of regional trade agreements on the inflows of foreign direct investment into developing countries, unanswered questions remain. Moreover, the empirical work on this subject is almost non-existent.

Hopefully, the search for answers to these questions will not only contribute to the field of empirical studies, but also, to an understanding of how regionalism will melt - or not melt - into the globalization of the world. Moreover, it will answer the question: are trade agreements in the Americas just about trade?

The remainder of this thesis is organized as follows. Chapter 1 describes the regional trade agreements covered in this study while chapter 2 provides a literature review. Chapter 3 analyses and estimates the impacts of the agreements discussed in chapter 1 on the inflows of foreign direct investments into selected countries in Latin America. Final remarks and comments are offered in the concluding chapter.

## Chapter 1

### TRADE AGREEMENTS IN THE AMERICAS

Regional integration, an unsuccessful strategy in the Latin America of the 1960s, is making a strong reappearance in this era of globalization. This time every Latin American country is busy forging alliances with its neighbours: Mexico looking north, Brazil looking south, and Bolivia looking all around. However, although the alliances are clearly regional, the motivations are very different.

Mexico's new partnership in NAFTA has given it access to one of the most coveted markets in the world. Perhaps Mexico's strategy is to use this access to become the link between the rest of Latin America and North America. Brazil, on the other hand, has chosen to pursue a connection with North America from a strictly South American position, through the Mercosur. Chile's tactics are to gain access to as many regions as possible. Among its most important alliances are the associate membership in the Mercosur and the Free Trade Agreement with Canada, both achieved in 1996.

Certainly, trade agreements are being used as a means to gain access to markets. But, is this all they are doing? Are regional trade agreements in the Americas just about trade? A first step in answering this question is to gain an understanding of the regional trade agreements in the region. This is the focus of this chapter.

The remainder of this chapter is organized as follows: section 1.1 explains the different types of agreements. Section 1.2 is divided into two sub-sections. The first sub-section provides a historical overview of the agreements in the region while the second part discusses the Latin American Integration Association (LAIA). The regional trade agreements pertinent to this study will be presented in the six sub-sections of section 1.3. Conclusions are given in section 1.4.

## 1.1 - THE STRUCTURE OF ECONOMIC BLOCS<sup>10</sup>

Economists have classified trading blocs into four major types:

1) Free Trade Areas (FTA) - In this type of arrangement trade restrictions between signatory countries are reduced to zero (or placed on a reduction schedule), for either all or a set of goods agreed upon by the member countries. Each country is allowed to maintain its own trade and commercial policy towards the rest of the world (i.e. countries that do not belong to the FTA). Rules of origin are used in order to prevent trade deflection schemes by which outsiders use the member country with the lowest trade barriers to transship products to the more protected market. A conflict resolution mechanism exists to resolve and possibly defuse potential conflicts among member countries.

2) Customs Unions - As in the FTA, members trade freely with each other. However, they adopt a common external tariff against non-member countries. In this case, rules of origin are not as important and can be interpreted as equivalent to domestic content requirements. In trade negotiations with international organizations, such as the WTO, member countries are required to co-ordinate their approach and policies.

3) Common Markets - They are Customs Unions with the addition of free movement of capital and labour. In order for this type of arrangement to be successful a large degree of co-ordination in several areas is necessary. For instance, taxes and commercial policies must be harmonized in order to create a level playing field. The existence of a central body which arbitrates and co-ordinates policies is extremely important.

4) Full Economic Union - This type of arrangement includes all of the aspects of a Common Market plus a total harmonization of government spending and taxation and operations of central banks. It also includes the elimination of national preference in

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<sup>10</sup> This section's information has been derived from the following books: Kerr, W.A. and Nicholas Perdakis, *The Economics of International Business*, Chapman & Hall, London, 1995; Sodersten, Bo and Geoffrey Reed, *International Economics*, Macmillan, London, 1994; and my own class notes from several courses.

government procurements. Although a single currency is not a required element, it might be a desirable one. It is important to note that as countries become integrated in this form, they give up some of their economic sovereignty. In other words, there is a trade-off between national sovereignty and that of the union.

Another way to describe trading blocs is to define them as "open" or "closed." According to Lustig and Primo Braga,

“For a bloc to be defined as "open", at least two conditions must be met: first, trade and investment barriers to nonmembers must not be raised; and second, new members who are prepared to abide by the same rules as the existing members should be easily accepted.” (in Weintraub ed., 1994 p.24).

These are the criteria which have been used to set the foundations for the analysis of the regional trade agreements in this study.

## 1.2 - REGIONAL INTEGRATION IN THE AMERICAS

### 1.2.1 A Historical Overview

Between 1960 and the late 1970s there were several attempts at economic integration in Latin America. Most notably the Latin American Free Trade Association (Asociación Latinoamericana de Libre Comercio - ALALC) was signed originally by Argentina, Brazil, Chile, Mexico, Paraguay, Peru, and Uruguay. Also, the Central American Common Market (CACM), signed in December of 1960 between Guatemala, Honduras, El Salvador and Nicaragua.<sup>11</sup> This integration wave also touched the Caribbean, where in 1965 Antigua, Barbados and Guyana formed the Caribbean Free Trade Association (CARIFTA), which was augmented by eight other countries in 1968, and renamed the Caribbean Common Market (CARICOM) in 1973. Some countries that belonged to the ALALC decided to form a common market in order to speed up the integration process.

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<sup>11</sup> In 1961 Colombia and Ecuador joined ALALC while, Venezuela and Bolivia did so in 1966 and 1967 respectively.

This effort resulted in the formation of the Andean Pact (Pacto Andino) in 1969. The original signatory countries were Chile, Colombia, Ecuador and, Peru.<sup>12</sup> Unfortunately, for reasons explained in the introduction, the results of these agreements were very disappointing.

Currently, the majority of the countries in the Latin American and Caribbean region belong to one of four regional integration arrangements whose stated objective is to develop a common market. The CACM, CARICOM and the Pacto Andino have been revived, and Brazil, Argentina, Uruguay and Paraguay have formed the Mercosur. As mentioned above, Mexico and Chile have taken a different path. Mexico has decided to formalize its economic integration with its northern neighbours, the United States and Canada, by signing the North American Free Trade Agreement (NAFTA). Although Chile is probably the most likely candidate to join in NAFTA, difficulties in negotiations with the United States have prevented the process from occurring in an expeditious fashion.<sup>13</sup> Chile has also signed bilateral free trade agreements with Colombia, Mexico, Venezuela, and Canada, and a preferential trade agreement with the Mercosur. Table 1.1 presents an outline of these various regional trading arrangements in the Americas

TABLE 1.1

<i>Regional Agreements in the Americas</i>			
Multilateral	Regional Integration	Regional Customs Unions	Regional Free Trade Areas
WTO/GATT	LAIA/ALADI	ANDEAN COMMUNITY	NAFTA
		MERCOSUR	GROUP OF THREE
		CARICOM	
		CACM	

<sup>12</sup> In 1973 Venezuela became a member and in 1976 Chile withdrew.

<sup>13</sup> The Brazilian newspaper Jornal do Brasil of August 8<sup>th</sup> 1999 announced that Chile had "given up" pursuing negotiations to enter NAFTA. Instead, the article claimed, Chile was beginning a free trade agreement negotiations directly with the United States. (<http://www.jb.com.br>)

Apart from the regional agreements outlined above, many bilateral agreements have also been signed. In fact, so many trading arrangements have been formed or revitalized since 1990, that one is left with the impression that several of them must be redundant, such as the FTA signed by El Salvador, Guatemala, and Honduras; or contradictory, such as the bilateral FTAs signed by Colombia and Venezuela with Chile. Yet in practice, although the duplication and complication of bureaucracy is far from ideal, these agreements serve a useful purpose. They often are used as an instrument of pressure to goad a slow-moving member of the original agreement to speed up the pace of change. (Lustig, Nora and C.A. Primo Braga in Weintraub ed., 1994 p.25).

Moreover, Latin American countries, like the rest of the world, are signing Bilateral Foreign Investment Protection Agreements (FIPAs) at warp speed.<sup>14</sup> According to the United Nations Conference on Trade and Development (UNCTAD), of the 1500-plus FIPAs in existence at the end of 1997, more than three-quarters date from the 1990s (UNCTAD, 1998, p.117). The figures for Latin America are even more staggering: three FIPAs were signed in the 1980s and fifty-three in the 1990s (up to the end of 1998).

In essence, FIPAs are designed to promote foreign investment through the granting of national treatment and the elimination of most restrictions on capital and profit remittances. They also allow countries to accept international arbitration as a means of solving disputes that might arise between the host country and foreign investors. The acceptance of international arbitration marks a departure from tradition for most Latin American countries, which historically required that all disputes be resolved in national courts. According to the Organization of American State's (OAS) analysis, "this new approach to foreign investment has eliminated a major impediment hampering the negotiations and signature of bilateral investment treaties between Latin American countries and capital exporting countries" (OAS, 1997, p. 2).

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<sup>14</sup> FIPAs are also known as Bilateral Investment Treaties (BITs)

The proliferation of trading and investment arrangements can also be interpreted as a "race" to be included in blocs. In the early 1990s some economists believed that Latin American countries were only using the sub-regional agreements as a stepping stone towards ascension into NAFTA, as they perceived the United States to be more willing to negotiate with a group rather than with individual countries ((Lustig, Nora and C.A. Primo Braga in Weintraub ed., 1994 p.24). Other authors however, believed that this desire to become a member of NAFTA was only a reflection of "small, though influential, groups now in government in different countries." (Naim, Moises. in Weintraub ed., 1994 p.48). The debate now, in the late 1990s, has evolved considerably.

Joining NAFTA is seen as a lost cause even by the most willing countries, as in the case of Chile. This is probably a consequence of the lack of fast-track authority of the Clinton administration combined with the realization, by most Latin American countries, that the changes necessary to meet the conditions required for NAFTA membership might not be compatible with their own objectives.<sup>15</sup> As it was, the successful signing of NAFTA was due to a particular set of circumstances. Mexico and Canada already had a high level of economic integration with the U.S., Mexico has a large constituency in the U.S. which the Mexican government was capable of mobilizing, and finally, the Mexican government, because of the unique executive grip it has over the legislature, the unions, the communications and the private sector, was able to overcome domestic opposition. It is unlikely that other Latin American governments can deliver the same type of concessions without facing a great deal of opposition at home. The solution to the issues mentioned above was found by reviving the Enterprise for the Americas initiative, now the Free Trade Agreement of the Americas (FTAA). These negotiations, which are expected to be completed in 2005, involve all of the countries in the Americas, with the exception of Cuba.

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<sup>15</sup> Fast track legislation refers to the American congressional approval of any negotiated agreement in full. That is, any agreement negotiated by the US administration must have Congressional approval to be ratified. However, without fast track legislation in place, the Congress has the right to approve parts of the agreement while rejecting others.

In addition, the Mercosur has become considerably more powerful in the last five years. Among several initiatives, it is presently negotiating an agreement with the European Union in conjunction with its active participation in the FTAA proceedings.

The scenario gets even more complicated. As mentioned in the introduction, all of the WTO member countries are preparing for the organization's 3<sup>rd</sup> Ministerial Conference, scheduled to be held at the end of November, 1999 in Seattle, Washington. This conference may launch the next major world trade negotiations – the Millennium Round. (WTO, 1999, website).

The increasing regionalism within globalization highlights the importance of the classification of "open" or "closed" blocs, alluded to earlier. In principle, none of the regional trading arrangements is raising its barriers to non-members. Therefore, they fulfil the first condition for definition as open blocs. As for the second condition, new members who are prepared to abide by the same rules as the existing members should be easily accepted into the bloc. Some of these arrangements, particularly NAFTA, appear to be closed. Although Mercosur is definitely more open than NAFTA, it is not completely open either. Bolivia and Chile were accepted as associate partners in 1996; however, the accession process is full of twists and turns – possibly the equivalent to non-tariff barriers to trade. This fact adds to the uncertainty of the future direction of the region. To understand this regionalism within a movement towards globalization it is necessary to look at some of the specific arrangements in closer detail.

### 1.2.2 – The ALALC/LAIA

This agreement, signed in February of 1960, was the first integrational scheme among undeveloped countries (Macadar, 1992, p. 143).<sup>16</sup> The eleven signatory countries were Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela. The agreement, per se, was a simplified type of integration via free trade. The long-term objective was to create a Latin American Common Market, which would

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<sup>16</sup> In the decade of the 1960s seven other integration movements were noted in Asia, Africa, and Latin America

be achieved by first creating a Free Trade zone by 1973. This integrational proposition followed closely the CEPAL's ideas. However, changes to this original concept doomed this treaty. The original idea had been to achieve a Free Trade zone in a gradual and flexible manner (i.e. a preferential trade zone initially) whereas, in the actual agreement, this flexibility was lost (Ibid., p.140). The instruments used were: market integration through tariff reduction in specific products, monetary and financial policy co-operation, co-ordination of the industrial development policies and, special treatment for countries with a lesser degree of development.

This agreement only succeeded in a very limited way. Although tariff reduction was achieved on an individual basis (i.e. countries reducing tariffs unilaterally), not one of the attempts to achieve a common tariff reduction list was successful. In regards to monetary and financial co-operation the treaty did succeed in creating an "agreement of payment and credit" through the member countries' central banks. It is not surprising that, given the economic and developmental heterogeneity of the countries in the region, aggravated by the enormous geographical distances and the cultural-political diversity, the co-ordination of industrial policy and any special treatment for other countries was a complete failure.

In 1980, a new treaty was signed establishing the Latin American Integration Association (LAIA/ALADI). Its objectives were much more limited and, more flexible in scope. Although this agreement kept the original long-term goal of forming a Latin American Common Market, no specific time or quantitative measures were imposed. A specific mention is made of the allowance for the creation of other types of bilateral and sub-regional trading arrangements with the only condition that these agreements must allow the incorporation of new members (i.e. a convergence clause). Furthermore, LAIA members have made political compromises in order to maintain the viability of the organization. For instance, in June 1994, the Council of Ministers approved the Interpretative Protocol of Article 44 ( LAIA's Most Favored Nation (MFN) clause) in order to accommodate Mexico's entry into NAFTA. This new interpretation allows

members who have granted preferences to third countries the right not to have to apply the MFN clause and to extend these preferences to the other LAIA members, provided negotiations are launched to compensate LAIA members. Mexico invoked this clause in September 1994 to safeguard the concessions made to NAFTA partners from having to be extended to all of the LAIA members (OAS, 1998, p.9). In addition, in 1998 the LAIA Council of Ministers approved Cuba's membership request. The full participation of this country is awaiting ratification from the Cuban parliament.

In the global context, ALALC was a necessary tool for Latin American countries who were GATT members. In 1960 the formation of free trade zones and custom unions was governed by GATT's Article 24. This article did not allow the formation of a limited preferential tariff area. As a result, ALALC was created. The possibility of forming limited preferential zones, such as ALADI, only occurred with the "enabling clause" of the Tokyo Round (1973-79). This clause allows developing countries to form trade zones which are less ambitious than a full free trade area, and consequently, avoid the MFN clause of the old GATT (Almeida, 1999). ALADI's future seems assured. Hearsay is that should a South American Free Trade Area come into existence, it would be defined as a limited free trade area and registered in the ALADI. This procedure would avoid the creation of another bureaucracy and would ensure the viability of ALADI, which would administer the agreement and register it with the WTO.

Thus, although ALADI might seem superfluous, it is not. It allows the countries of the region to enter into arrangements of limited reach, often more in line with their needs, while still being a members of the WTO. In that sense, it has been a successful agreement, even if its most important function is that of a regional "registrar."

### 1.3 THE REGIONAL TRADE AGREEMENTS

Six regional trade agreements will be detailed in this section: Andean Pact, Mercosur, NAFTA, CARICOM, CACM, and Group of Three (Free Trade Agreement between Mexico, Venezuela, and Colombia). Although, given the geographical distances, the last

arrangement is not a regional agreement, it is included for comparison purposes on the final model on this study.

### 1.3.1 – Andean Pact

The limitations and the conflict of interests within ALALC led some member countries to look for other avenues for integration. The Andean countries, which had more of a need to increase their market size than other larger countries in the region, decided in 1969 to implement a more extensive and faster type of integration.<sup>17</sup> This objective would be accomplished by the following instruments: a) creation of an institutional body with executive power, b) adoption of a timetable for commercial trade liberalization, c) the gradual establishment of a common external tariff, d) co-ordination of industrial policy with specified distribution of costs and benefits among member countries, e) special treatment for the two less developed countries in the group, Bolivia and Ecuador, and finally e) the harmonization of policy in regards to foreign investment. These countries judged that they would be able to implement goals that were a great deal beyond those of the ALALC because they were more homogeneous in size, location and development than those countries in the ALALC. Unfortunately, these goals proved to be far too difficult to achieve, and although all member countries were aware that changes in the treaty were needed, it took twenty years to reach a consensus (Macadar, 1992, p.165).<sup>18</sup>

Then, in November of 1990, the Acta de la Paz was signed by the presidents of Bolivia, Colombia, Ecuador, Peru and Venezuela. This treaty reactivated the Andean Pact and again, ambitious targets were established. These objectives were much like the ones established originally, such as: a) the implementation of a free trade zone in the region by 1992; b) an agreement on the level and structure of the Common External Tariff (CET) by December 1991; c) the implementation of the CET by December 1995; and d) the

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<sup>17</sup> The original signatory countries were: Bolivia, Colombia, Chile, Ecuador, and Peru. Venezuela joined in 1974 while Chile withdrew in 1976.

<sup>18</sup> In May, 1987 the Quito Protocol was signed establishing some changes. In May 1989 the "Manifiesto de Cartagena de las Indias" was written specifying the desire to resume the integration process. Finally, in December 1989, in the second meeting of the presidents of the member countries, the strategic design of the Andean Pact was approved

facilitation of foreign investment and capital mobility within the Andean Group. There was also a new objective: to liberalize air and maritime transportation (Edwards, 1994, p. 37). In this case again, the differences in economic structure as well as macroeconomic policy between the countries in the group has led to several difficulties. An agreement on the level and structure of CET was established in 1992, by the Act of Barahona (an act within the Andean Group but not including Peru and Ecuador). The CET had four levels and an extremely cumbersome mechanism. The whole process was flawed by contradictions and exceptions, and there were no clear rules of origin legislation. On the positive side, a free trade area - with no goods exempted – went into effect in 1993 between Bolivia, Colombia, Ecuador, and Venezuela. Note that Peru was not part of this free trade area.

In May 1992, Peru suspended the preferential treatment granted to imports from within the pact and President Fujimori closed the Peruvian congress. As a consequence, the governments of Colombia and Venezuela suspended negotiations with Peru. The level of political-diplomatic tension in the region was further aggravated by border conflicts between Peru and Ecuador (Edwards, 1995, p.155). In 1996 it appeared that the Andean Pact was at a standstill and its future uncertain. Nonetheless, member countries did not stand still. Colombia and Venezuela signed a free trade agreement with Mexico (the Group of Three) and Bolivia became an associate member of the Mercosur.

However, instead of fading, the Andean Group metamorphosed into the Andean Community in June, 1997. Among the several institutional changes that took place were the creation of a Presidential Council, a Council of Foreign Ministers which had a critical role in the decision making process, and the consolidation of all its institutions and mechanisms under a new umbrella, the Andean Integration System. The practical changes that occurred in 1997 were also numerous. For instance, Peru re-joined the group and agreed to gradually join the Andean free trade area by completing its trade liberalization process vis-à-vis the other countries by the year 2000 for most tariff lines, and by 2005 for a few remaining sensitive products (Mendonza, 1998, p.6). Other changes include the

new common investment and patent rights regimes, and the enactment of new copyright protection legislation. As far as the common investment regime is concerned, the new Decision 291, which replaced the old, restrictive Decision 24, grants national treatment to foreign investors and eliminates all restrictions on capital and profit remittances

Regarding Andean Community relations with the international community, a landmark accord was reached with the Mercosur in 1998. This agreement aims at the creation of a free trade area between the two blocs to be implemented by January 2000. It appears that the Andean Community has been putting negotiations with the Mercosur at the top of its priorities, a decision which, according to Mendoza (1998), has been questioned by several scholars on the basis of existing trade and trading patterns. The author remarks that these criticisms fail to account for the new direction of regional trade agreements.

“ . . . Trade agreements are not made to lock in past patterns of comparative advantage, nor should they restrict their effects to the trade field. If the experience of the Latin American countries with the recent trade arrangements is any guide, greater economic integration between the Andean Community and Mercosur should lead to an important expansion of trade and investment flows.” (1998, p.6)

### 1.3.2 - Mercosur

In 1991, Argentina, Brazil, Paraguay, and Uruguay signed the Treaty of Asuncion, forming a common market to be phased in by 1995. This treaty formed the basis for a geographic trading region which is now known as the Mercosur. Originally, the goals of this agreement were the free movement of goods, services, capital, and labour between member countries, a common external tariff by 1995, and co-ordinated macroeconomics and exchange rate policies (Almeida, 1993, p.15). A transition period, in effect until December 31, 1994, was established. An interesting change from other agreements in the region was that the program of gradual trade liberalization consisted of the elimination of restrictions to intra-regional trade which followed a gradual, linear, and automatic schedule. This automaticity permitted the accord to progress on schedule in spite of

difficulties. Another difference consisted in the creation of an administration and implementation body, which then formed eleven subordinate negotiating sub-groups. This structure allowed for independence in sectorial trade negotiation, and a very efficient mechanism for reaching consensus. A common parliamentary commission was also formed. This action also implied that, during the transitional period, there would be no plans for the formation of supra-national councils (Hester, 1996, p.5).

Most of the treaty's original goals were achieved. In the end of 1994 the "Ouro Preto Protocol" was signed giving the accord an international legal identity. At the same time, a new administrative structure was created including: the Common Market Council, the Common Market Group, the Mercosur Business Commission, the Joint Parliamentary Commission, the Economic and Social Consultative Forum, and the Mercosur Administrative Secretariat. The Council's decisions, the Group's resolutions, and the Commission's directives constitute juridical norms and, their implementation, are mandatory for all member States. This new structure served to solidify the Mercosur as a "de facto" entity. (Almeida, 1998)

The common external tariffs (CET) implementation calendar, negotiated in 1993-1994, is being followed. The structural and developmental differences between countries in the accord led to an agreement of a "convergence phase" (from 2001 to 2006) for national exclusion lists. For instance, capital goods' adherence to the CET is scheduled for 2001 while the introduction of computer products (software and hardware) and telecommunication is slated for 2006.

Within the Mercosur, progress is being made in the development of a free trade area, not without some setbacks. In 1994, when the custom unions regime was established, two important sectors were excluded: automotive and sugar. By the end of 1998 a resolution had been reached regarding the automotive sector but not for the sugar sector. The recent devaluation of the Brazilian currency – November 1998 – and the upcoming Argentine presidential elections are causing some delays and disagreements. As 1999 draws to a close, Argentina and Brazil are trying to resolve disputes in sectors or commodities such

as footwear, rice, and automotive. These disputes are not unique to the Mercosur; they are part and parcel of any agreement that involves a high volume of transactions.

In terms of investment provisions, the Mercosur has enacted two Protocols – the Colonia (January, 1994) is applicable for member countries while the Buenos Aires (August, 1994) refers to non-member countries. To itemize the differences between these two documents would require a detailed analysis that is beyond the scope of this study. However, in general terms, the Colonia Protocol has all of the MFN clauses and elimination of performance clauses and restriction of remittances commonly found in FIPAs. The Buenos Aires Protocol, on the other hand, requires that “Parties shall not grant to investments of investors of third countries more favorable treatment than the one established in this Protocol.” (OAS, 1997, p.2). Nonetheless, the treatment of investments under this document is in line with traditional promotion and protection investment treaties.

It is interesting to note that the Mercosur is also emerging as a “political” entity. The rationale for this statement is the adoption, by the member states and the associate member states – Bolivia and Chile – of the “democratic clause.” This clause makes the existence of a democratically elected government a mandatory condition for participation in the bloc. This clause was legalized by its inclusion into the “Ushuaia Protocol” of 1997.

Last, as mentioned the Mercosur is actively pursuing agreements with other regional blocs. It started negotiations for the eventual creation of a free trade area with the European Union in 1995, it is a participant of the FTAA negotiations, it is completing final arrangements with the Andean Community, and it is preparing for full participation in the WTO’s Millennium Round.

### 1.3.3 - NAFTA

In June 1990, Mexican president Carlos Salinas de Gortari and United States president George Bush declared that the two countries were committed to negotiate a comprehensive bilateral trade agreement (Winham, G.R. and Heather A. Grant in Barry, ed. 1995 p.16). Canada reacted defensively. The same authors explain " . . . the Mulroney government had narrowly survived a divisive national election in 1988 over CUSFTA , and was wary of entering what appeared to be a controversial negotiation for Canada. . . (it did so, in the end, because it). . . wanted to ensure that the gains it had made under the CUSFTA were not diluted as a result of a bilateral deal between the U.S. and Mexico." (Winham, G.R. and Heather A. Grant in Barry, ed. 1995 p.17). Therefore, in February of 1991, Canada, Mexico and the United States decided to start negotiating NAFTA, and later that year the U.S. Congress approved the "fast track" treatment for the agreement. In December, 1992 the final agreement was signed, and approved by the U.S. Congress a year later (Edwards, 1994, p.40).

An important point about this agreement should be emphasized. Just like the CUSFTA, NAFTA is more than a free trade agreement: it is an accord over investment rules, and it creates a dispute settlement mechanism (Krugman, 1992 in King ed., 1995 p. 180). The scope of this agreement is wide. It covers areas such as: tariffs and non-tariff barriers, rules of origin, agriculture (through three separate bilateral agreements), energy, auto industry, textile and apparel, services, government procurement, financial services, intellectual property, dispute settlement, and investment. NAFTA also addresses the area of labour and environment protection in separate side agreements.

Although this agreement has been in effect for over five years, some provisions – particularly tariff reductions – have not been fully implemented. This follows from the fact that NAFTA was designed to have a gradual impact on the North American economy; thus, some tariff reductions have a phase-in schedule of five to ten years for implementation.

Opinions on the overall effects of the agreement vary greatly; however most critics do not dispute the fact that NAFTA has helped increase trade among member countries. A 1997

report details that “trade between Canada, United States, and Mexico has increased by 43 percent since NAFTA took effect. For the United States, trade with Mexico and Canada comprises nearly one third of U.S. trade in goods with the world.” (Bannister, 1997, p.5). It is important to note that these results were achieved despite the fact that in 1995 Mexico experienced a severe economic recession, and stand out in contrast to the Mexican crisis of 1982. Following the 1982 financial crisis, Mexico raised tariffs by 100 percent, causing American exports to fall by half. That recovery took seven years. In 1995, Mexico continued implementing its NAFTA obligations even as it raised tariffs on imports from other countries. This time, the recovery of U.S. exports to Mexico took less than two years (OAS, 1997, p.3).

The dispute resolution mechanism appears to be functioning well. The agreement stipulates that antidumping and countervailing duties disputes are to be resolved under Chapter 19, while violations of provisions of the agreement are addressed under Chapter 20. Up to the middle of 1997, according to Bannister, two cases had been brought forward under Chapter 20 and some 29 under Chapter 19 (1997, p. 3). This number might even be considered low when the magnitude of trade volumes covered under NAFTA is taken into account.

As with any “living” agreement, there are glitches and problems to be resolved. In the 1997 U.S. International Trade Commission’s report on NAFTA, problem areas in each of the three countries are cited. Among those are: for Mexico, the unpredictable administration of tariff-rate quotas on agricultural products<sup>19</sup> and the difficulties with testing procedures and technical standards for telecommunications terminals; for the United States, the failure to comply with NAFTA’s timetable on trucking safety certification and access, and implementation of sugar quotas and the sugar re-export program; and for Canada, the protection of cultural industries, and the subsidies for

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<sup>19</sup> Tariff rate quotas were set allowing a set amount – a quota – of goods into the country under reduced or no tariffs, with a tariff rate imposed when the quota is exceeded.

lumber and wheat (Ibid, p. 10). One suspects that if each government made its own problems list, there would be a great deal of overlap.

In sum, NAFTA is a landmark agreement in the Americas. It is the first agreement between developed and developing countries to cover areas such as services, investment, government procurement, intellectual property rights, etc.. Notwithstanding, its potential, NAFTA's future growth is doubtful, due to the lack of fast track powers of the current U.S. administration and other issues mentioned earlier. It will probably remain an agreement between three partners.

#### 1.3.4 CARICOM

The integrationist movement in the Caribbean dates back to 1965 when Antigua, Barbados, and British Guiana signed the Caribbean Free Trade Association (CARIFTA)<sup>20</sup> By 1968, eight other countries: Dominica, Grenada, Jamaica, Montserrat, St. Kitts-Nevis-Anguilla, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago ratified the agreement. Belize joined in 1971.

The agreement aimed at immediately freeing trade among its member countries and establishing a five year schedule for the phasing out of tariffs on the few import substituting products which were exempt from the first list. No attempts were made to create a common external tariff. According to Edwards, gains were achieved from this integration, although they were strongly biased in favour of the more industrial members of the arrangement (1995, p.157). As expected, the least favoured members exerted pressure for a different design that would benefit countries more equitably.

As a result, the Caribbean Community (CARICOM) was established in 1973.<sup>21</sup> Its objectives surpassed those of CARIFTA by acknowledging the different stages of

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<sup>20</sup> By 1968 British Guiana had become Guyana

<sup>21</sup> Antigua was the only original member who did not join the new association. In 1994 Suriname joined and in 1999 Haiti was accepted as a member.. Note that the Bahamas is a member of the Community but not of the Common Market.

development of its members and including the coordination of foreign policies, the creation of planning agencies for agricultural and industrial development, and the adoption of a common external tariff. However, the timing for implementation of the common external tariff was poor, as the region was dealing with the impact of the oil shock. The deterioration of the region's terms of trade led several countries to impose protectionist measures which provoked severe antagonism among member countries and led to the disintegration of the group.

In 1991 the CARICOM heads of State decided to revive the association. Among their new initiatives was the reduction of the common external tariff band to 0-45 percent. In 1992 this band was further reduced to 5-20 percent within a period of four to five years (Ibid, p. 158). Since then, CARICOM has been moving towards an approach more in line with the other Latin American regional agreements. A Single Market and Economy Initiative, signed in 1998, is expected to be implemented by the end of 1999. This initiative includes measures such as the enactment of legislation relating to the free movement of skilled CARICOM Nationals, the introduction of Double Taxation Agreements throughout the region, the removal of all remaining unauthorized barriers to intra-regional trade, and the completion of a fourth phase of reduction of the common external tariffs.

In the words of the Hon. Owen Arthur, Prime Minister of Barbados, on the occasion of the Twentieth Meeting of the Conference of Heads of Government of the Caribbean Community, which took place in Port of Spain, Trinidad on July 4<sup>th</sup>, 1999

“ . . . For our Caribbean of today is, and our world of tomorrow will be remarkably different from those envisioned by the founding fathers of CARICOM just 25 years ago. . . They conceived a CARICOM in an era of inward-looking, import substituting development paradigms. . . Where they were inward looking, it now falls to this generation of Caribbean leadership to reorient our

focus outward. For our immediate purposes, however, where our founding fathers found it impossible to look beyond a limited concept of a Common Market, we dare now to conceive of the Caribbean constituted as a single market and a single economy.”

### 1.3.5 – Central American Common Market (CACM)

In 1960 Costa Rica, Guatemala, Honduras, El Salvador, and Nicaragua set out to create the first custom union in Latin America. However, given the political volatility of the region and ambition of this project, its failure was not unexpected.

According to Bulmer-Thomas, “the architects of CACM hoped to use the custom union to reduce dependence on the external sector, improve the net barter terms of trade and achieve industrialization at one and the same time.” (1998, p. 314). The industrialization objective was pursued through the freeing of trade within the custom union subject to a common external tariff on third countries. Freeing of trade was targeted to industrial products, of which 94 percent were traded intra-regionally free of tariffs by 1966 (Hansen, 1967 cited in Bulmer-Thomas, 1998, p. 314). The harmonization of tariffs necessary for the implementation of a common external tariff resulted in large increases in average tariffs for consumer goods which were not offset by the small decline in average tariffs on all other goods. Consequently, it was not surprising that, although initially intra-regional manufactured goods’ exports surged, many problems began to surface in the next decade. For instance, trade creation was limited to a very small manufacturing base – remember that trade liberalization did not include agricultural products –while trade diversion meant that locally made products from newly established industries replaced cheaper and higher quality imports. Another big problem was the fall in revenues as consequence of the reduction in tariffs. These revenues traditionally had constituted a large part of the Central American countries’ budgets. Lastly, the total population of Central America in the 1960s numbered 11 million people, of which a large portion were excluded from the

market by poverty. As a result, the market demand did not support economies of scale necessary for optimal production needed in most manufactured goods.

These problems, in combination with the fact that the few gains made were unevenly distributed, led to the withdrawal of Honduras at the end of 1970. Moreover, the movement lost momentum in the 1970s and sporadic efforts made to revive it never commanded the highest priority among the political elites. Political turmoil accompanied this deterioration with the Somoza regime being replaced by the Sandinistas in Nicaragua and the left making gains in El Salvador. However, the real turning point arrived in the 1980s with the onset of the debt crisis. Most countries in the region responded to the crisis by imposing massive non-tariff barriers. In 1986, the CACM received a fatal blow when the Central American payment clearing mechanism collapsed (Edwards, 1995, p.156).

Only in 1990 would talk of integration return to the region. A first step towards reconstruction was taken during the summit of Central American Presidents held in June 1990. The new CACM would have Honduras return as a full member, a new common external tariff at much lower levels than before, elimination of non-tariff barriers, and trade liberalization would include agricultural products. The next year saw the creation of a new legal and institutional framework through the new “System of Centro American Integration” which was housed in El Salvador in 1993. In addition, in 1994, the Central American Presidents adopted the “Alliance for Sustainable Development” – a program to promote sustainable development in the region.

Although the revival of the CACM has an export-promoting framework as opposed to the original import substituting, it still suffers from excessive optimism. The region tends to embark on a series of commitments that are far beyond what it can realistically accomplish. For example, the original plans of “sweeping away non-tariff barriers” were imposed with no thought of how this would be accomplished. Adequate funding was never provided to the sustainable development program; consequently, it has gone nowhere. Finally, not all countries in the region, particularly Costa Rica, seemed

interested in implementing a common external tariff so that while three different common external tariff proposals have been made, none have been implemented fully.

All in all, success has been very modest. Perhaps this experience will lead to a new sense of realism in any future plans

#### 1.3.6 – Free Trade Agreement between Mexico, Venezuela and Colombia

##### Group of Three

This agreement does not constitute a regional integration arrangement. It is only one of the many bilateral or trilateral arrangements among several in the Americas. However, its inclusion in this study is justified for purposes of comparison in the final model presented in chapter three. The rationale for this decision is that as the NAFTA member countries are concerned, only Mexico is included in this study. Including the U.S. causes problems in the empirical analysis and modeling as the size of the American economy is so large that it dwarfs all other economies in the rest of the hemisphere. Therefore, including a different arrangement in which Mexico is a participant provides a basis for comparison between the effects of NAFTA and the effects of another integration scheme on Mexico.

The Group of Three arrangement is classified as a free trade area. Although it was negotiated in 1993, the signing date of January 1<sup>st</sup>, 1994 was postponed because of the Chiapas rebellion in Mexico. The actual signing date was the 13<sup>th</sup> of June, 1994. The original provisions of the agreement provide for an immediate zero tariff for some items and a ten-year transition for others. Mexico agreed to cut tariffs faster than the other two partners and Colombia and Venezuela do not exchange any obligations between themselves with respect to the following sectors: national treatment and market access for goods, automotive sector, agricultural sector, rules of origin, state enterprises, intellectual property, and trade remedies.

There is an extensive section on investments that includes the same articles expected in FIPAs including most favoured nation treatment, and international arbitration.

This agreement is one of the many signed by Mexico after the signing of NAFTA. As was suggested earlier, perhaps Mexico is pursuing a strategy of making itself the link between Latin America and the United States.

#### 1.4 - CONCLUSION

This chapter has sketched a Latin American trade arrangements map that would confuse even people familiar with it. However, clearly, these arrangements are about a lot more than just trade. Embedded into each regional agreement are the aspirations of development and global positioning of each member country.

The multiple layering in the present scenario shows that Latin American countries have embraced trade liberalization and openness with the same gusto as they once embraced policies of import substitution. Although the implementation of this new position has not occurred evenly across countries, all are using trade agreements to entrench these changes. Although one should always be cautious in making definitive statements, especially in regards to Latin America, it appears that this liberalization process is irreversible.

This process is also changing the “market” landscape of the region. The talk is not only of Argentina, and Brazil but of Mercosur, not just of Mexico, but of NAFTA. It appears that this is fertile terrain for the growth of additional linkages beyond the traditional trade – comparative advantage paradigm.

One of the possible new links is the influence trade agreements are having on Latin American countries’ ability to attract foreign direct investments. This issue will be explored in the subsequent chapters.

## Chapter 2

### LITERATURE REVIEW

One of the ways regional trade agreements could affect areas other than just trade is through their possible impact on the inflows of FDI into member countries. Regional trade agreements constitute a government policy that may have both direct and indirect effects on companies' decisions to locate in a particular country. The direct effect may take several forms, but basically, trade agreements may enhance the participating countries' relative position as a host for foreign direct investment. The indirect effect is that a trade agreement possibly impacts the risk of investing in the host country and thereby, affects foreign direct investment flows into that country, i.e. lower risk increases the desirability of the location for foreign direct investments. Establishing these links is an important step in finding an answer to the central question of this thesis: are regional trade agreements in the Americas just about trade? This chapter addresses this issue by reviewing the literature to date, on the determinants of inflows of FDI and on the assessment of political risk.

Signing a trade agreement constitutes a government policy. The discussion in this chapter will show that the eclectic theory of foreign investment provides a solid foundation for the analysis of the impact of host countries' policies on the inflows of foreign direct investment. However, this is primarily an empirical question and, as the review of recent empirical works will demonstrate, one which has not been fully addressed.

The remainder of this chapter is organized as follows: section 2.1 presents a survey of the theoretical literature on the determinants of FDI inflows and then comments on the literature on the impact of regional trade agreements on FDI. Section 2.2 reviews the empirical literature on the subject. Section 2.3 comments on the evolution of political risk assessment. Last, conclusions are presented in section 2.4.

## 2.1 THE DETERMINANTS OF FDI INFLOWS

### 2.1.1 Theory Review

In 1980, when Agarwal published the seminal paper “Determinants of Foreign Direct Investment: A Survey,” he classified the currents of thought in four groups: (1) Hypotheses assuming perfect competition; (2) Hypotheses based on market imperfections; (3) Hypotheses on the propensity to undertake FDI; and (4) Hypotheses on the propensity of countries to attract FDI. Although only the fourth group is strictly related to this thesis’ query, a discussion of some of the hypotheses included in groups one and two is essential, as they became the foundation for both current thought and empirical work. The third group gets at the issue from a companies’ decision perspective and is beyond the scope of this study.

From group one (perfect market assumption), the output and market size hypotheses are singled out as “practically two sides of the same coin” (Agarwal, 1980 p. 746). The output is applied at the micro level while the market size concerns the macro level. In the latter case, FDI is a function of output or sales and is approximated by the size of the market. Generally GDP or GNP, as well as market growth, are used as proxies for market size in empirical analysis. Although this hypothesis has been confirmed in several empirical studies, Agarwal comments:

“The studies on the market size hypothesis are, however, in most cases not very explicit about the assumptions and the objective function of their theoretical models . . . . Many of the studies on market size hypothesis are more concerned with establishing an association between FDI and the market size of the host countries than with the theoretical basis of this association” (1980, p.746).

Among the criticisms offered by the author are: first, this hypothesis is based on neoclassical theories of domestic investment which are “surrounded with a good deal of unrealism” (Agarwal, 1980, p. 748); second, the size and growth of the host countries are likely to influence FDI undertaken for the production of goods for the local market and

not the FDI aimed at export markets; and third, little discussion is offered on the structural relationship of GDP growth and FDI. Finally, he comments on the shortcoming of this hypothesis in differentiating between the initial FDI decision and expansionary FDI, which are likely guided by different considerations.

The origins of most of the theories which assume imperfect markets (group two) is attributed to the contributions made by Charles Kindleberger in 1969 and to Stephen Hymer's doctoral dissertation which was written in 1960. The gist of their argument was that foreign firms must have some advantages over local firms which will more than compensate them for the cost disadvantages they have when operating in a foreign market. The disadvantages of a foreign firm are related to their lack of knowledge of local customs and customers, legal system, institutional framework, etc. while the advantages may come from having cheaper sources of financing, brand name, patented or nonmarketable technology, managerial skills, etc.

Agarwal points to the fact that the authors fall short of explaining why a firm with these type of advantages would not serve this market via exports or by licensing, renting, or selling technology or marketing skills. He concludes by stating that "any one or more of the market imperfections or oligopolistic advantages are a necessary but not sufficient condition for foreign operations of a firm" (Agarwal, 1980, p. 749).

Regarding the hypotheses on the propensity of countries to attract FDI, Agarwal argues that, especially concerning the developing countries' ability to attract FDI, no solid theoretical framework exists. Furthermore, he mentions that from all the hypothesis discussed in the first three groups only the market size argument can be used in this case. He goes on to suggest that several variables have been used to inductively examine this question and singles out three for discussion. They are political instability, incentives for foreign investors, and supply of cheap labour. In each of these three cases, he finds evidence both supporting and negating their impact on the inflows of FDI into developing countries (Agarwal 1980, p. 763)

In his concluding remarks, Agarwal shows that he is aware that the theoretical framework is about to change. He states:

“...on the theoretical side a major breakthrough seems to be in the offing. The credit for that goes to Dunning [1977; 1979]. With his eclectic approach he has made a promising start towards the development of a general theory of FDI.”, (p.763).

One wonders if he realized that Dunning's eclectic theory of foreign investment, which appears to be based on Hymer–Kindleberger's work, would consolidate several of the existing hypotheses, and provide one framework within which to understand both companies' investment decisions and the ways by which host governments' policies impact the inflows of FDI.

The criticisms offered by Agarwal on Hymer-Kindleberger's work were shared by Dunning and others. In the essay “The Influence of Hymer's Dissertation on the Theory of Foreign Direct Investment,” written by Dunning and Alan Rugman (1985), the authors remark that Hymer's dissertation “is remarkably prescient in its identification of structural market failure, but that it somewhat overlooks the transaction cost side of the literature” (Dunning, J., and Alan Rugman, 1985, p. 228). That is, the theory provides an answer to the question of how foreign firms can compete with local firms but leaves the question of why through FDI instead of licensing or any other mechanism unanswered.

This second question is best answered using the internalization of transactions theory. According to the literature, firms choose FDI when transaction costs make trade and licensing uneconomic alternatives. Some transaction costs exist independent of government policies, such as the pricing of technology transfers or the negotiation of long term supply contracts; while others are a direct consequence of government policies. Among the latter costs are government imposed trade barriers and lax enforcement of licensing agreements (Brewer, 1993, p.104).

Dunning (1981a), (1981b) expanded on previous work by suggesting an eclectic approach to the theory of foreign investment. He postulates that three conditions must be met for FDI to occur.

First, a firm must be able to compete with local firms despite the disadvantages of being foreign. This “ownership” advantage is derived from the usage of its brand name, patent or knowledge of technology or marketing. In addition, oligopolistic firms are able to exercise market power.

Second, a “bundled” FDI approach must be preferred to “unbundled” product licensing, capital lending, or technical assistance. This will be the case whenever market imperfections create additional transaction costs associated with trade and licensing. Thus, these costs make the “unbundled” option less efficient than the internalized transactions made possible by FDI. According to Dunning, protectionist trade policies create market imperfections for arms-length trading relations. Foreign direct investment provides a mechanism around these imperfections and therefore increased protectionism is associated with increased foreign direct investment.

Third, the location advantages of a particular host country make FDI flows into it preferable to FDI into other potential host countries and to domestic investment in the home country. This advantage may be derived from the host country’s comparative advantage, its transaction costs advantage, or from government policies that act as determinants of the relative attractiveness of some host country over others including the home country.

These three conditions became the tenets of the eclectic theory of foreign investments. Some authors, such as Rivoli and Salorio (1996) refer to them as the ownership-location-internalization (OLI) advantages.

While the first of these conditions depends strictly on the characteristics of the firm, government policies and host country institutions can influence the other two conditions.

Dunning argues that some of these policies act as sources of market imperfections and that these imperfections make FDI preferable to other strategies. For instance, a country with poorly developed licensing system and primitive or corrupt legal system generates transaction costs that lead firms to choose FDI over licensing. In terms of location advantages, the host government's policies towards areas such as tariffs and non-tariff barriers to trade, foreign affairs, infrastructure development, exchange rate regime, education, health and a host of others are enormously influential.

Brewer (1993) expands Dunning's work on the effects of host governments' policies on FDI inflows. He begins by questioning Dunning's premise that government policies' induced market imperfections always have a positive effect on foreign direct investment. In essence, Dunning saw a simple relationship. Brewer, on the other hand, thought this interaction was, potentially, a great deal more complex. Although he acknowledged that some policies created market imperfections, he suggested that others have the converse effect. In other words, some government policies instead of increasing, decrease market imperfections and in turn, may decrease FDI. Further, he mentions that FDI flows can be "... increased and/or decreased by a given government policy; in fact, it is possible for a single given government policy simultaneously to increase and decrease FDI" (Brewer, 1993, p. 110). The case of government procurement practices that discriminate against foreign firms provides an example. If all foreign firms are discriminated against no matter where they are located, FDI is less likely to occur than in the case where there is no discrimination against domestic firms that are foreign-owned. Another example, which will be discussed in length in Chapter 3, is the possible impact of regional integration arrangements.

Brewer also calls attention to the fact that the effects of government policies on FDI may vary according to the strategic nature of FDI projects. He cites three strategic objectives that are associated with different FDI ventures: market-seeking, production cost-minimizing, and raw material-seeking. One of the examples given is the difference between government subsidies for inbound FDI projects that export much of their output

and government restrictions on FDI projects that import much of their inputs (Brewer, 1993, p. 105).

Rivoli and Salorio (1996) address another shortcoming of the eclectic paradigm: although the theory offers rich explanations of the “why,” “where,” and “who” of FDI it leaves the “when” mostly unexamined. Although for different reasons, they make an argument similar to the one advanced by Brewer. They put forth the “counterintuitive proposition that in some cases the ownership-location-internalization (OLI) advantages will be negatively rather than positively related to FDI” (Rivoli and Salorio, 1996, p. 335). They draw this proposition from the studies of investment under uncertainty. Essentially, they believe that high levels of OLI advantages, while creating a rationale for FDI, also generate more uncertainty. Consequently, FDI would be more delayable or less reversible and therefore less likely to occur.<sup>22</sup>

In all, despite criticisms, Dunning’s eclectic theory has become one of the most widely used theories of international investment. Gastanaga et al (1998) provide a fitting comment:

“The fact that the theory is compatible with any theory of comparative advantage, be it of the Heckscher-Ohlin, classical or product cycle variants, as well as with any transaction cost explanation, makes it unusually flexible. Another advantage is that it can be applied at either the micro or macro levels. At the micro level, it allows one to relate individual firm, industry, and home and host country characteristics to one another. At the macro level, the eclectic theory can be used to explain the relative importance of various FDI-sending and/or receiving countries” (p.1301).

The macro level explanation links government policies to locational and internalization advantages.

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<sup>22</sup> The theory of investment under uncertainty, also known as option value investment theory, was postulated by Avinash Dixit and Robert Pindyck (1994). Although its findings and propositions help explain several interesting

### 2.1.2 Regional Trade Agreements

Only recently has the issue of the impact of regional trade agreements on the inflows and outflows of FDI in the integrating region started to command attention from economic theoreticians. Blomström and Kokko (1997) provide an interesting conceptual framework while the World Investment Report: Trends and Determinants 1998 (UNCTAD) delivers a comprehensive study of the subject.

Blomström and Kokko start by following the eclectic theory to analyze the effects of trade liberalization on the intra-regional FDI flows. They suggest that although there are expectations of a decrease in tariff jumping FDI (trade liberalization makes exports from home country relatively more attractive), these policies would not affect investments that were primarily undertaken as an internalization mechanisms. In addition, they claim that “the reduction of regional trade barriers could instead stimulate overall FDI flows among the relevant partners by enabling MNCs to operate efficiently across international borders” (Blomström and Kokko, 1997, p. 4). Inter-regional FDI flows are expected to increase as a reaction to increased average tariff level to “outsiders” and to the increase in locational advantage, i.e the regional market. Citing Kindleberger’s work the authors suggest that investment creation is a likely response to the trade diversion brought about by regional trade agreements. However, the flows of FDI are not necessarily distributed evenly among the members of the block.

Special investment provisions in the agreements are also expected to impact the FDI flows. Particularly if these measures include “national treatment,” a dispute settlement mechanism, the elimination of trade-related investment measures (TRIMS). These measures are seen as “lock in” mechanism for economic reforms in the participating countries. In this respect, they create a more predictable environment for foreign investors and should have an impact on the their perceptions of the participating countries’ risk factor.

Blomström and Kokko also mention that the establishment of regional trade agreements generates various dynamic effects that affect FDI flows. Among these effects, they mention economic growth, exploitation of economies of scope and scale, and greater geographical concentration of individual economic activities likely driven by inter and intra-regional FDI (Blomström and Kokko, 1997, p. 8).

In the conclusion, attention is brought to the fact that the impacts of regional trade agreements on FDI depend on three factors: the depth of the agreement and the degree of change brought about by its implementation, the locational advantages of the participating countries, and the industries covered by the agreement.

As mentioned before, the World Investment Report: Trends and Determinants 1998 (UNCTAD) delivers a comprehensive discussion of the host country determinants of FDI. It also addresses the impact of various bilateral and regional agreements on these inflows. Not surprisingly, it discusses several points that have already been made in this chapter. In light of this fact, only the propositions that are unique to this report will be mentioned here.

Although Blomström and Kokko mention that the impact of regional trade agreements on the flows of FDI will depend on the degree of integration resulting from the arrangement, the WIR goes further. It states that the more integrated a region is through a “regional integration framework” the more sectors will be influenced by this arrangement. Further, as regulatory FDI policies become more harmonized within a region, more importance is attached to economic determinants of foreign direct investment and, to a lesser extent, to business facilitation measures.<sup>23</sup>

An interesting point is made regarding investors’ perceptions of these arrangements. “The credibility of regional integration frameworks, manifested in the extent of which their

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empirical studies.

<sup>23</sup> Economic determinants of foreign direct investment are classified as: resource seeking, market seeking and efficiency seeking. While business facilitation measures are: promotion efforts, incentives for FDI, and reducing the “hassle costs.”

provisions are actually implemented, is another factor determining the impact of regional integration frameworks on FDI determinants” (UNCTAD, 1998, p. 118). In addition, these arrangements may also influence the speed of FDI and trade policy liberalization. Although the report does not mention any investors’ perceptions of risk directly, an inference can be drawn from these statements. Following Blomström and Kokko’s line of thought, any increase in predictability contributes to investors’ perceptions of a lessening of risk factor.

Finally, although the subject of FIPAs is not the focus of this thesis, a short comment on them is valuable.<sup>24</sup> The report claims that FIPAs exert some influence on the policy framework for FDI by contributing to the improvement in the investment climate. However, in a recent statistical study, they have been found relatively insignificant as a determinant of FDI inflows (UNCTAD, 1998, p. 117).<sup>25</sup>,

## 2.2 EMPIRICAL STUDIES

This section reviews some of the recent empirical studies examining the determinants of FDI. The choice of studies, with few exceptions, was based on their inclusion of a risk variable in the model.

Schneider and Frey (1985) attempt to correct what they see as a void in the empirical literature of foreign direct investments in developing countries. They include both economic and political variables in their model and estimate it for three separate years (1976, 1979, 1980), for 54 developing countries. They compare the quality of the estimates and the ex-post forecast of the comprehensive model (which includes both economic and political variables) with the estimations of two alternative models: one with only political variables model<sup>26</sup> and the other with only economic variables. They find

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<sup>24</sup> Given the bilateral nature of FIPAs, the incorporation of all existing FIPAs in the Americas is beyond the scope of this study.

<sup>25</sup> This study was conducted by UNCTAD and is forthcoming.

<sup>26</sup> This model includes GNP per capita and political instability (measured by the number of political strikes and riots average over two periods: 1972-75, and 1975-1977)

that the comprehensive model performs better on both goodness of fit and ex-post forecast. The most important determinants of foreign direct investment were: real per capita GNP (positive); the balance of payments (negative); the amount of bilateral aid coming from Western countries (positive) and political instability (negative).

Studies following this approach were published in the 1990s. For instance, Loree and Guisenger (1995) studied the effects of policy and non-policy variables on the location of new U.S. direct investment abroad for 1977 and 1982 in developed and developing countries. The independent variables used were: Political Risk (measured by the International Country Risk Guide (ICRG) Composite Index), Cultural Distance, Telecommunications Infrastructure, Transportation Infrastructure, GDP per Capita, Average Affiliate Wage Rate, Effective tax rate, and a Dummy for developed country. In general terms, they found that investment incentives (positive), performance requirements (negative), and host country effective tax rates (negative) are statistically significant determinants of U.S. direct investment abroad. They also found differences between developed and developing countries and time periods. For instance, the investment incentives variable was statistically significant only for developed countries. In addition, they point out that political risk is a significant factor in the foreign investment decisions of U.S. companies in 1982 but not in 1977. The explanation offered is that foreign investment behavior became more conservative with respect to country stability during the early 1980s when a recessionary period set in and the dimensions of the developing world debt problem became apparent.

Wang and Swain (1995) tried a different approach. Instead of looking at the determinants of the investors' decision using cross section analysis, they studied the determinants of foreign direct investment from the host country perspective using time series data.<sup>27</sup>

They investigated, separately, the determinants of FDI inflows into Hungary and China for the period of 1978 – 1992. Although they included a dummy variable for political

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<sup>27</sup> Cross section analysis refers to comparisons across countries rather than over time

instability the model's theoretical basis is rather weak. They fail to cite the eclectic investment theory and use several different theoretical constructs such as, the market size theory and investment theory as the basis for the model. The variables of the model follow traditional lines. They include GDP, growth, cost of capital, labour costs, tariff barriers, exchange rates, imports and exports volumes, and political stability. The authors mention that the results generally support the hypotheses that FDI is determined by the size of the host country market, cost of capital, and political stability.

Although both studies discussed above use different methodologies, cross section and time series respectively, they have something in common. They are only able to capture part of the picture. The cross sectional analysis limits the results to an investors' behaviour in a specific year while the time series analysis does not offer a comparison between countries. Two recent studies, Ferris et al (1997) and Gastanaga et al (1998), deal with these shortcomings by using a combination of cross section and time series data.

Ferris et al (1997) provide an analysis of FDI in Latin America with the intent of drawing some recommendations for the Guyanese economy. The model includes 11 Latin American countries viewed over the period of 1963 to 1985 in their model.

Unfortunately, their analysis suffers the same theoretical weakness found in Wang and Swain (1995). In addition, they do not provide details on their methodology.

Consequently, although it is clear that they used panel data<sup>28</sup>, the estimation method used is unclear. A particular concern is whether the estimation regression accounted for the usage of panel data because, if not, the results may be biased. Keeping this shortcoming in mind, the model includes GDP, imports, exports, the number of vehicles (a proxy for infrastructure), and a risk variable – GASTIL Freedom Index, published by Freedom House. They find that imports (positive), exports (negative), GDP (positive) and the number of vehicles (positive) are a significant determinant of FDI inflows into Latin America. Note that political risk was found to be statistically insignificant.

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<sup>28</sup> Panel Data or pooled data refers to comparisons across countries over time, i.e. a combination of cross section and time series.

Gastanaga et al (1998) examined the effects of various host countries' policies on FDI inflows for 49 developing countries over 1970 to 1995. It is worth mentioning that both the theoretical basis and the methodology are excellent. The authors constructed a model which includes "economic variables" such as past inflows of FDI, and growth and "policy" variables such as corruption, bureaucratic delays, contract enforcement, nationalization risks, etc. They account for the size of the economy by using FDI divided by GDP as the dependent variable. The estimation methodology includes pooled Ordinary Least Squares (OLS), and Pooled Fixed and Random Effects Estimators. The mixed result lead the authors to conclude that although there are collinearity problems and availability constraints regarding some of the variables used, "the results demonstrate the relevance and importance for FDI flows of many of the policy/institutional variables under study" (Gastanaga et al, 1998, p. 1299).

Finally, although there have been studies that include regional integration agreements as a determinant of FDI inflows, for the most part they only address developed countries. Among those, Bajo-Rubio and Sosvilla-Rivero (1994), present a novel methodology. They use cointegration analysis to examine the inflows of FDI in Spain over 1964 to 1989 from the perspective of the investment decision of a multinational corporation. Among their findings, the dummy variable representing the European Economic Union is found to be a significant determinant of FDI inflows into Spain. Regarding models that focus on developing countries only one was found - Torrisi (1985). Comments on this study are offered in the next chapter.

### 2.3 POLITICAL RISK ASSESSMENT

This section provides a brief discussion on the evolution of political risk assessment.

The increase in international transactions – trade, direct and portfolio investments – observed world wide in the last three decades has had an impact on the information needs of both corporations and investors. The political environment faced by these agents has become a particularly critical factor in corporate strategy formulation.

Since 1971, when Stefan H. Robock's ground-breaking paper on political risk was published, a number of researchers have tried to gather systematic assessments of these risks. In addition, a number of political and economic studies have attempted to link political risks and, international portfolio and direct investments. Chase (1988) agrees with the findings of Schneider and Frey (1985) discussed in section 2.2. He mentions, "these studies overall failed to establish a relationship between political risk and the flow of foreign direct investment." (1988, 32). His conclusions are that these studies reaffirm the postulates of investment theory where flows are linked to investment risks and returns. Researchers attribute the weakness of these results to the lack of reliable, time series data on political risk.

As the collection and generation of political risk data became more systematic and structured, the results of studies linking this variable to all types of investment started to improve. Publications as early as Burton and Inoue's (1987) found that political risk variables are significant in predicting foreign asset expropriation in developing countries. By the mid 1990s, several scholars, such as Claude et al (1996), Diamonte et al (1996), Bohn and Deacon (1997), Ferris et al (1997), Bergara et al (1998), and Ramcharran (1999) were finding that measures of political risk are significant in models forecasting international investments.

The evolution of measures of political risk can be briefly described as follows.<sup>29</sup> In the late 1970s and early 1980s several papers concentrated on the definition and measuring of political risk (Haendel, 1979, Brewer, 1981; Kobrin, 1981; Shapiro, 1981). Included in several works of this era is the analysis of the effectiveness of the available commercial political risk indices referred to earlier. Studies by Rummel and Heenan (1978), The Futures Group (1980), and Howard Johnson (1980) of Arthur D. Little, cited in Kobrin (1981) are termed "the first generation of attempts at quantitative modeling of political risk" (Kobrin, 1981, p. 259). The BERI index from BERI LTD produced the

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<sup>29</sup> Please note this is not meant to be an all inclusive list of all available political risk indices but a brief overview of the subject.

first formalized qualitative index of political risk. It started producing an index in the early 1970s that by 1980 had evolved into a quarterly report on 45 countries. Today, its Business Risk Services unit publishes a qualitative report on political risk for 50 countries three times a year. Another landmark on political risk assessment was the development of in-house generated systems by international corporations. The leader was the ASPRO/SPAIR methodology developed by Shell Corporation, which was adapted by other oil firms and extended to a broader range of industries by Risk Insights Inc (Ibid p. 263). Presently there are several providers of political risk indices, among them, the Institutional Investor, Euromoney, The Economist Intelligence Unit, and Political Risk Services. The industry focus, methodology, and availability of historical data vary with the service provider.

## 2.4 CONCLUSION

The study of international direct investments, both theoretical and applied, has made great strides in the last two decades.

First, John H. Dunning provided a major breakthrough in the theory of international investments. The eclectic theory provides a foundation for the understanding of the determinants of foreign direct investment flows from the perspectives of both investors and recipients. This understanding has allowed scholars to expand the research into new areas. The impact of host countries' policies on the inflows of foreign direct investments is one of them.

Second, the improvement in the understanding of political risk by political scientists led to the increase in reliability and availability of risk indices. In turn, researchers and entrepreneurs have come together to make these indices available commercially.

Third, the advances in the field of econometric modeling and data gathering are providing new research opportunities. Issues that were very difficult to study before can now be revisited with greater potential for insights.

In conclusion, the analysis provided in this chapter provides ample theoretical evidence that host countries' policies, such as signing a regional trade agreement, could have an impact on the inflows of foreign direct investments. The empirical evidence regarding this matter, however, is still scant. The next chapter will attempt to find this empirical evidence.

## **Chapter 3**

### **THE EFFECT OF TRADE AGREEMENTS ON FOREIGN DIRECT INVESTMENT IN LATIN AMERICA**

The purpose of this thesis is to shed light on the question: are regional trade agreements in the Americas just about trade? The previous chapters have established that trade agreements are about more than trade and that, theoretically, they affect the foreign direct investment inflows. This chapter's objectives are: to examine, empirically, whether trade agreements have affected the FDI inflows to Latin America and, if so, to investigate the affecting mechanisms. The focus is on building a model with control variables to account for the main determinants of FDI inflows and deterministic variables to account for the direct and indirect impact of trade agreements. The analysis covers twenty-two Latin American countries from 1984 to 1998.

The remainder of the chapter is organized as follows: Section 3.1 explains the issue at hand and discusses the model used as a foundation for this study. Sections 3.2 and 3.3 outline the theory and data employed. Section 3.4, is divided into three sub-sections. In two of those sub-sections models are estimated and discussed while the remaining part offers a critical comparison of different estimation methodologies. The robustness of the estimates is addressed in section 3.5. Conclusions are presented in the last section.

#### **3.1 DETERMINANTS OF FDI FOUNDATION CASE STUDY**

As mentioned in the previous chapter, several empirical studies have examined the determinants of FDI. Some, like the Schneider and Frey (1985) estimate these determinants using cross section data; some, like Wang and Swain (1995) and Loree and Guisenger (1995) use time series analysis, while others such as Gastanaga et al (1998) and Lucas (1993) use a combination of either cross section or time series and pooled data. This study follows the latter strategy. Cross section data estimation will be used as a benchmark for comparison with the results obtained from the panel data estimation.

The foundation model used in this study is the one presented in the Annex to Chapter IV of the World Investment Report 1998 – Trends and Determinants (UNCTAD, 1998, pp. 135-140). I should note that although the report does not assign authors to different chapters and annexes I have confirmed with the UNCTAD's Geneva office and with Dr. Robert Lipsey himself that he is the author of the mentioned Annex.<sup>30</sup>

The focus of Lipsey's study was to survey 142 countries in order to determine which host country's attributes act as determinants of FDI inflows. It is important to note that developing countries are only a subset of the countries Lipsey analyses. Although Lipsey estimated equations for developing countries separately, he does not mention the number of countries included in this subset. Despite this shortcoming, the comments that follow refer to the estimations formulated with the developing country data subset, as this is the relevant model for this thesis.

Lipsey's cross section study covers four separate years, 1980, 1985, 1990, and 1995. The variables used to test the determinants of inward FDI are: the host country's market size, measured by the nominal GDP; the rate of growth of the host country averaged over the previous five years, which expresses investor's expectations of future market size; and real GDP per capita, a measure of the country's residents' purchasing power, as a proxy for effective demand. The study postulates that determinants other than the ones included in the regressions would be included in the error term.

The only variable that was found significant in all four years is the proxy for market size, nominal GDP. This variable is significant at the 1% level for all four years. Except for real GDP per capita, which was significant at 10% in 1990, all other variables are insignificant. Lipsey comments that the explanatory power of the equations is considerably weaker than the ones found for the estimations including all 142 countries. A political stability variable was added in an attempt to further define the estimation and improve the explanatory power. However, the results of this estimation present only a

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<sup>30</sup> Dr. Robert Lipsey's current position is Research Associate and Director, New York Office, National Bureau of Economic Research

slight improvement. Again, GDP is the only significant variable for all years and it is significant at the 1% for all four years. This time, the only other significant variable is political stability at the 5% level in 1985 and at the 10% level in 1990. The equations' explanatory powers only show improvements in 1985 and 1990.

Lipsev attempts to deal with the weaknesses of the model in several different ways however, not one specific model emerges from this exercise. Consequently, he concludes that;

“national market variables do explain much of the variation in inward FDI attractiveness among countries, but the size and importance of the residuals and their predictive power is a challenge for further investigation. . . A conclusion to be drawn from the econometric analysis is that host country market-size variables remain the dominant influence on inward FDI . . . However, for the world as a whole, the institutional variables included in this exercise are not the explanation. A candidate for further explanation, not tested here, would be existing membership in or recent adherence to a regional arrangement, for example the European Union or NAFTA.” (Ibid. p.140).

The statement above highlights the void in the empirical research related to determinants of FDI inflows mentioned in chapter 2. Also, as mentioned, although there have been several studies on the subject which include political stability or different measures of country risk, few have addressed the impact of regional trade agreements. Among these few, Torrisi's (1985) paper estimates the determinants of FDI in Colombia using a time series approach and includes the Andean Common Market as a variable in his regressions. He finds this variable insignificant.

One of the reasons for this void has been the lack of availability of reliable long time-series data for developing countries covering a long enough period of time. However, although the present availability of data for developing countries is still more limited than for developed countries, progress has been made. Further, the ability of combining cross-section with time-series in panel data allows analysis to be conducted with a much

smaller time-series. Notwithstanding the recent advances in data availability and econometric techniques, this issue has not been revisited. In this void lies the motivation for this thesis.

In sum, it is suggested that both country risk and regional trade agreements might have an impact on the inflows of FDI. Although studies have attempted to address the impact of country risk they have neither included regional trade agreements nor the mechanism by which they would impact the inflows of FDI. This is what this study does.

### 3.2 THEORY

This section will discuss the theory underlying the following hypothesis: regional trade agreements are believed to impact inflows of FDI through two main mechanisms: direct and indirect.

The direct mechanisms will be addressed first. According to Dunning's (1981) eclectic theory discussed in chapter two, trade agreements increase market imperfections by creating different tariffs for members and non-members. Consequently, member countries would have a locational advantage over non-members and there would be a FDI inflow from non-member countries' investors.

However, according to Brewer's (1993) contribution to this theory, regional trade arrangements could potentially decrease or increase FDI. Brewer mentions that such schemes can lead to increased FDI among member countries while discouraging inflows from outside the trade agreement region (Brewer, 1993, p. 110). This is similar to the trade creating versus trade diverting argument in that investments are created within the region and, diverted by the loss of potential investments from/to non-members. Note, however, that regarding this data set, it is not possible to define the origins of the inflows. Nonetheless, Brewer mentions that "free trade zones that decrease trade-related market imperfections can increase both FDI and trade" (Ibid., p. 111).

Considering that the recent trade agreements in the Americas have been accompanied by a general lowering of tariffs to all countries and a concerted effort to attract FDI, it is believed that these arrangements impact FDI inflows positively. The rationale for this assertion is that the general liberalization environment in Latin America combined with the regional trade agreements would act as in the case mentioned above, where “free trade zones that decrease trade-related market imperfections can increase both FDI and trade.” Nevertheless, this hypothesis is made cautiously. Although market imperfections have been created by these regional arrangements, they may be relatively less of an imperfection than the previous import substitution regime. Consequently, if one follows Dunning’s theory, less market imperfections would cause a decline on the inflows of foreign direct investments.

In addition, based on the “location advantage”, regional trade agreements are thought to have a direct positive impact on FDI inflows. The rationale is that these agreements enlarge the host country’s market which, from then on, is thought of as a market as large as the “regional” market created by the agreement.

In sum, regional trade agreements’ direct impact on the inflows of FDI could be either positive or negative. This is an empirical question.

The indirect mechanism through which regional trade agreements may affect FDI inflows is an extension of the “political instability” determinant as defined by Argawal (1980, p.760) and commented on by Blomström and Kokko (1997). The hypothesis is that regional trade agreements contribute to investors’ perceptions of a decline in the risk factors as follows. First, the political risk factor is reduced in two ways: by democratization clauses and by political pressures. Second, although economic and financial risks may in fact increase with integration, investors may have the opposite perception.

As far as the political risk factor is concerned, some agreements, like the Mercosur, have an explicit “democratization clause.” These clauses have proven to be a great political

risk stabilizer. The events that took place in Paraguay recently serve as a good example.<sup>31</sup> In addition, membership in a regional trade agreement opens the door to political pressures by other member countries. The “democratization” of Mexico can be easily linked to its NAFTA membership. For instance, in the introduction to the edited book *Nafta in Transition*, Randall and Konrad point out that although the Salinas<sup>32</sup> agenda was not derailed by the Zapatista Army of National Liberation insurgency, the media attention it commanded, combined with an “increased scrutiny by the NAFTA partners,” resulted in electoral reforms (Randall and Konrad, 1995, p.3).

The same philosophy applies to financial and economic risks. Although these risks could potentially become higher with integration, the international community is more responsive to crisis involving countries belonging to a major regional trade group. The rationale for the statement that financial and economic risks can increase with integration follows from the fact that countries become more susceptible to shocks caused by troubles in partner economies. The latest Brazilian crisis provides a fitting illustration. All countries in the region were affected by the devaluation of the Brazilian currency in late 1998, but the impact on the Mercosur countries was more pronounced.

As mentioned above, in the event of a crisis the international community intervenes much faster if the country belongs to a major trading block. For instance, it is argued that the fact that Mexico is signatory to NAFTA contributed to the prompt action by the United States and the International Monetary Fund (IMF) in averting a potentially much bigger crisis in 1994, when the Mexican government was forced to devalue its currency. Gerber (1999) provides an insightful discussion of this issue. He mentions that the 1982 peso crisis caused a long recession in the Mexican economy. According to his calculations, the inflation adjusted per capita GDP fell by about 15 percent between 1982

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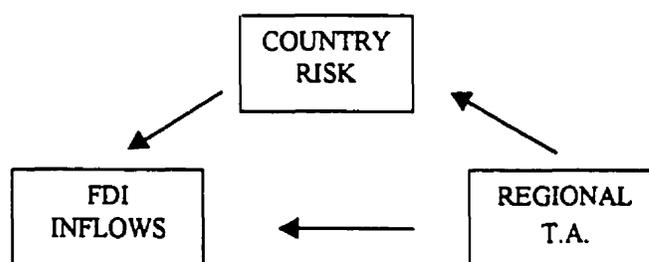
<sup>31</sup> Earlier this year the president of Paraguay was linked to the assassination of the vice-president. In other times the assassination of the vice-president could have easily led to great political instability and even a coup. However, Paraguay has signed the “Ushuaia Protocol” which institutionalized the Mercosur’s “democratic clause.” Consequently, it risked jeopardizing its membership in the event of a coup. A crisis was averted with the help of the Brazilian and Argentine presidents.

<sup>32</sup> Carlos Salinas was the president of Mexico who negotiated the NAFTA agreement.

and 1986. Compare this long adjustment to the one following the 1994 peso crisis when GDP resumed growing within one year (Gerber, 1999, p.286). The inflows of FDI into Mexico tell the same story. It took ten years for FDI inflows to return to their pre-1982 crisis' level while by 1997 – three years after the post-NAFTA peso crisis – these inflows had surpassed the pre 1994 crisis' levels. Another example is the already discussed Brazilian devaluation crisis. Although, it can be argued that the size of Brazil, in itself, warranted the international rescue package provided during the “devaluation crisis,” the country's importance as a regional player can not be discounted. This regional dimension has been achieved through the creation and participation in the Mercosur.

Clearly, these arrangements directly impact country risk and, through this mechanism, potentially impact FDI inflows. In other words, if investors perceive a country to be a lower risk, the required risk premium is lowered and, all else being equal, more investments are realized. In conclusion, first, regional trade agreements are expected to lower country risk; and second, lower country risk is expected to increase the inflows of FDI. Figure 3.1 illustrates this concept.

FIGURE 3.1



The assumptions mentioned above are, in essence, the deterministic variables of this study's model. They are country risk (CR) and a dummy variable for each of the six trade agreements included in this study. The trade agreement dummy variable identifies

country and date of membership.<sup>33</sup> In other words,  $D_{it} = 0$  if the  $i$ th country is not a member of the trade agreement at time  $t$  and  $D_{it} = 1$  if country  $i$  is a signed member of the trade agreement at time  $t$ . Table 3.1 describes the trade agreements' dummy variables. Column three states the year each agreement was signed. Note that the dummy variable for each agreement is equal to 1 starting from the year after signing a trade agreement. This time lapse reflects investors' "wait and see" attitudes towards Latin America. After all, as mentioned in chapter one, there have been several unsuccessful attempts at integration in the region. This time lapse introduces a small element of the "when" issue alluded to in chapter two.

TABLE 3.1

<i>Dummy Variables Summary</i>		
Variable	Countries (in the sample)	Year (signed)
Andean Pact (ANDEAN)	Bolivia, Colombia, Ecuador Peru, and Venezuela	1969 Peru withdrew (1992-97)
Caricom Caribbean Community	Bahamas, Guyana, and Jamaica, and Suriname	Signed in 1973 and revived in 1991
CACM Central American Common Market	Costa Rica, Guatemala, Honduras, El Salvador, and Nicaragua	Signed in 1960 and revived in 1991
Mercosur Southern Common Market (MERC)	Argentina, Brazil, Paraguay and Uruguay	1991
NAFTA North American Free Trade Agreement	Mexico	1992
Group of Three (GRUPO3)	Colombia, Mexico and Venezuela	1994
MERCO Mercosur's Associates	Chile, and Bolivia	1996

Note. The corresponding dummy variable is entered the year following the signing of the agreement.

<sup>33</sup> Although six agreements are included (Mercosur, NAFTA, Group of Three, Andean Pact, Caricom, CACM) an

The choice of control variables for this model follows Lipsey's approach discussed in section 3.1. As mentioned, there is an assumption that variables not included in the model are included in the error term, and in addition that they are not correlated to the independent variables used. This model attempts to refine Lipsey's model by introducing another control variable: lagged FDI.

The control variables used are: the host country's market size, measured by the nominal GDP (GDP); the rate of growth of the host country's real GDP lagged one period, which expresses investor's expectations of future market size (GROWTHLG); real GDP per capita, as a proxy for effective demand (RGDPCAP); and FDI inflows lagged one period, expressing the assumption that not only are previous inflows a predictor of present inflows, but also that investors tend to cluster into markets (FDILG). As mentioned in the introduction, this has been the foreign direct investment pattern in Latin America (CEPAL, 1998).

### 3.3 DATA

FDI inflows are expressed in millions of nominal US dollars and have been obtained from the International Monetary Fund's International Financial Statistics (IFS) – CD ROM Version. FDI represents flows that include equity capital, reinvested earnings, and other capital associated with the various inter-company transactions between affiliated enterprises. Excluded are flows of direct investment capital into the reporting economy for exceptional financing, such as debt-for-equity swaps (IFS, p.xxii). This data set was complemented by information from the Inter-American Development Bank (IADB), the United Nations Conference on Trade and Development (UNCTAD), and the United Nations Economic Commission for Latin America and the Caribbean (CEPAL). Figure 3.2 shows the inflows of FDI for each country.<sup>34</sup>

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additional dummy variable was included for the Mercosur associates – Bolivia and Chile.

<sup>34</sup> For easier comparison between countries, each country graph was attributed its own scale.

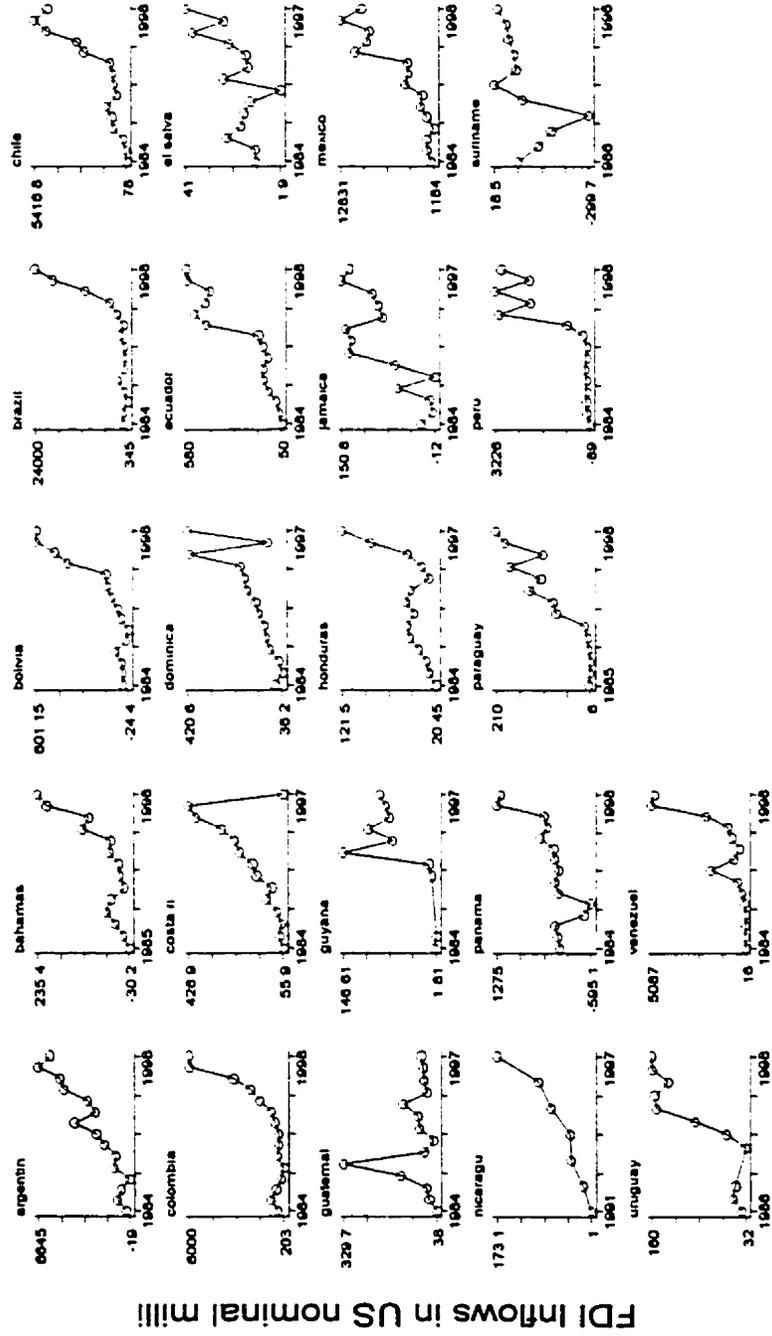
From Figure 3.2 it can be observed that in general, growth of FDI inflows remained almost stagnant through the 1980s and only started to increase in the early 1990s. For the most part, this increase can be traced to the success of stabilization programs in each country. Note that Argentina's FDI inflows increase started much before Brazil's. Also, the fact that Chile does not show dramatic increases until the mid 1990s is a function of the graph's scale. That is, FDI inflow increases in Chile started, albeit slowly, in the late 1980s. More precisely, foreign direct investment into Chile amounted to US\$78 million in 1984, US\$1283 million in 1989, and US\$54168 million in 1997. Last, the dramatic decrease of FDI inflows into Costa Rica in 1997 can not be explained. Although there was an election that year, it was not a "traumatic" event. It is possible that there was a mistake in the IFS' own data entry.<sup>35</sup>

Time series data on nominal and real GDP (1990 base year) are both expressed in millions of US dollars and are taken from the IADB website. Population census information is provided by the IFS. Finally, growth rates have been calculated from real GDP according to the formula:  $\text{LnRGDP} - \text{LnRGDP}_{-1}$ . Figure 3.3 shows the growth variable for each country separately. This Figure (3.3) shows that, in general, the growth in real GDP has been erratic. It is difficult to discern any regional pattern from this variable, other than the difficulties encountered by almost all of the countries in the region in the 1980s and early 1990s.

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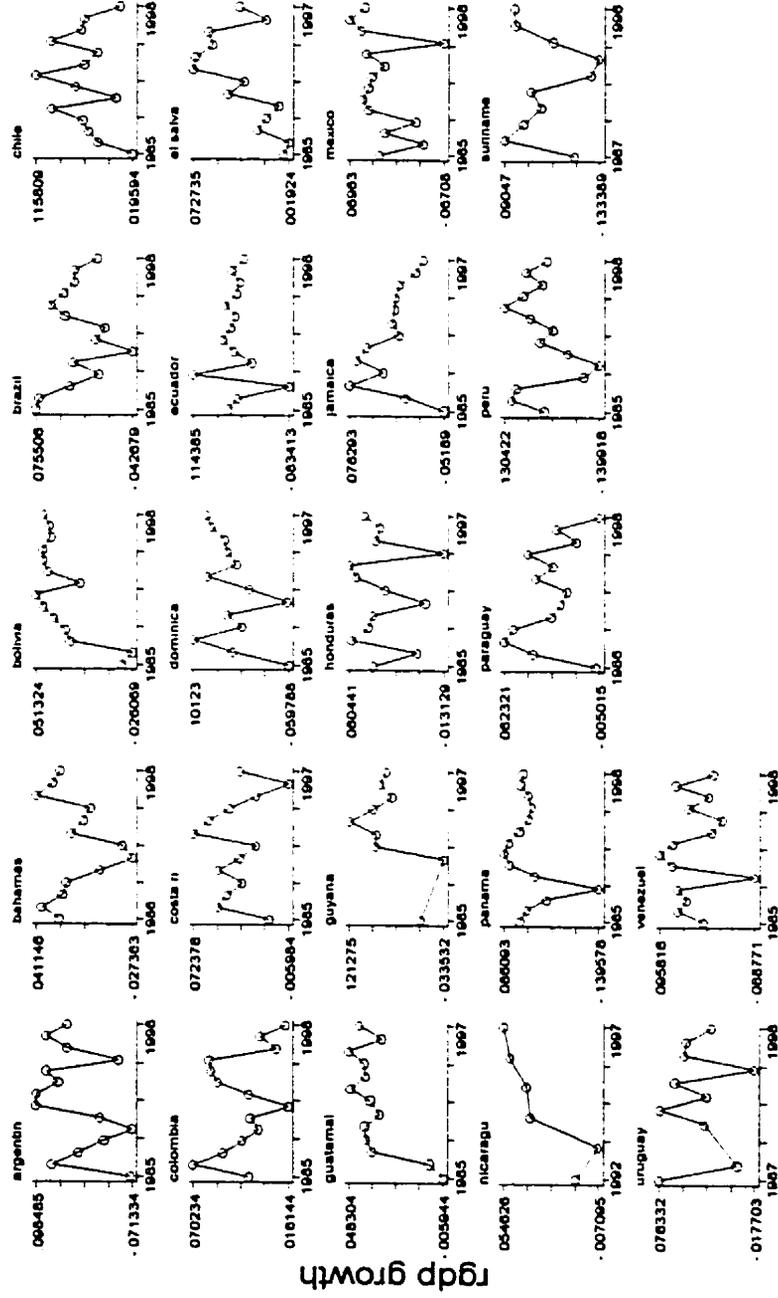
<sup>35</sup> Although I have communicated this possibility to the IFS data management team through email until now (August 20th, 1999) they have not replied.

FIGURE 3.2  
FDI INFLOWS BY COUNTRY



1984-1998  
Graphs by country

FIGURE 3.3  
REAL GDP GROWTH BY COUNTRY



1984-1998  
Graphs by country

The choice of the index “International Country Risk Guide (ICRG)” produced by Political Risk Systems (PRS) as a source for the country risk variable was deliberate. The rationale for this decision is that this is one of the primary commercial risk indices available to corporations. Consequently, it is often used as a risk indicator in corporate foreign investment decisions. The indices are published monthly and have been converted to yearly averages. The CR variable used is the ICRG’s composite risk index, which is calculated by combining the political (PR), financial (FR), and economic risk (ER) ratings according to the following formula:  $CR = 0.5(PR+FR+ER)$ .<sup>36</sup> Table 3.2 describes the individual components of each of the three ratings. The maximum possible rating for Country Risk is 100 points. Further, for all indices, the highest overall rating (100 points for political risk, 50 points for economic risk and 50 points for financial risk) indicates the lowest risk. Conversely, the lowest rating (0) indicates the highest risk. Twenty- two countries are included in the analysis. A complete list is presented in Table 3.3.

Descriptive Statistics for all variables are presented in Table 3.4. Note first that the FDI flows reported are gross flows (i.e. they do not account for the FDI flows from the host country). Negative gross flows, as in the minimum reported, occur when a foreign firm’s assets are sold. Panama experienced two years – 1987 and 1988 – when the FDI “inflows” were –447.9 and –595.1 respectively. These outflows accompanied the deterioration of the Noriega regime and preceded the 1989 American invasion of that country. Second, note the change in FDI once this variable is lagged. The maximum reported decreases substantially and so does the mean and standard deviation. This is a consequence of the fact that the largest FDI observation is Brazil in 1998, possibly a result of both the large privatization program and the construction of large infrastructure projects.<sup>37</sup> Note that when the series is lagged, observations for 1998 foreign direct investment are not included in the sample. Third, the growth variable indicates the

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<sup>36</sup> Note: The maximum score for each index is as follows: PR=100, ER=50 and FR=50. Consequently, given the formula presented, the maximum CR rating is 100 points. Effectively, this formula gives PR twice the weight given to ER and FR.

<sup>37</sup> Lagged FDI ends with actual 1997 FDI inflows.

economic turmoil that the region faced during the late 1980s and early 1990s. The minimum -14 percent reported for Panama in 1989 is consistent with a relationship between FDI inflows and growth. That is, the FDI outflows from Panama in 1987 and 1988 preceded the negative growth in 1989. Consequently, in order to deal with this potential endogeneity the growth variable is entered into the model lagged one period.

TABLE 3.2

<i>Political, Financial and Economic Individual Risk Components</i>	
<b>Political Risk</b>	
Economic expectations vs. reality	12 points
Economic planning failures	12 points
Political leadership	12 points
External conflict	10 points
Corruption in government	6 points
Military in politics	6 points
Organized religion in politics	6 points
Law and order tensions	6 points
Political terrorism	6 points
Civil war	6 points
Political party development	6 points
Quality of the bureaucracy	6 points
<b>Maximum Possible rating</b>	<b>100 points</b>
<b>Financial Risk</b>	
Loan default or unfavorable loan restructuring	10 points
Delayed payment of suppliers' credits	10 points
Repudiation of contracts of government	10 points
Losses from exchange controls	10 points
Expropriation of private investments	10 points
<b>Maximum Possible rating</b>	<b>50 points</b>
<b>Economic Risk</b>	
Inflation	10 points
Debt service as a percent of exports of goods and services	10 points
International liquidity ratios	5 points
Foreign trade collection experience	5 points
Current account balance as a percent of goods and services	15 points
Parallel foreign exchange rate market indicators	5 points
<b>Maximum Possible rating</b>	<b>50 points</b>

TABLE 3.3

<i>Summary of Countries</i>		
COUNTRY	TIME PERIOD	DATA ON FDI
Argentina	1984-1998	15
Bahamas	1985-1998	14
Bolivia	1984-1998	15
Brazil	1984-1998	15
Chile	1984-1998	15
Colombia	1984-1998	15
Costa Rica	1984-1997	14
Dominican Republic	1984-1997	14
Ecuador	1984-1998	15
El Salvador	1984-1997	14
Guatemala	1984-1997	14
Guyana	1984, 1985, 1990-1997	10
Honduras	1984-1997	14
Jamaica	1984-1997	14
Mexico	1984-1998	15
Nicaragua	1991-1997	7
Panama	1984-1998	15
Paraguay	1985-1997	14
Peru	1984-1998	15
Suriname	1986-1996	11
Uruguay	1986-1988, 1991-1998	11
Venezuela	1984-1998	15
22 Countries	1984-1998	301 Observations

Last, although the descriptive statistics for the risk variables indicate a wide range of risk, it does not show that all of the countries in the region have become less risky with time. This fact is best described by the box and whiskers plot presented in Figure 3.4.

The box-and whiskers plot shows the median value of the variable plotted, in this case country risk, as a line in the centre of the box. Remember that in this case the representation is for each year across countries. The top of the box records the 75<sup>th</sup> percentile while the bottom the 25<sup>th</sup> percentile. The height of the box, which is the difference between the 75<sup>th</sup> and 25<sup>th</sup> percentile, is called the interquartile range (IQR). The lines, called whiskers, extent to the upper and lower adjacent values which are calculated as top observation of the 75<sup>th</sup> percentile + 1.5 x IQR and lower observation of the 25<sup>th</sup> percentile – 1.5 x IQR. Any points more extreme than the adjacent values are plotted separately and constitute outliers.

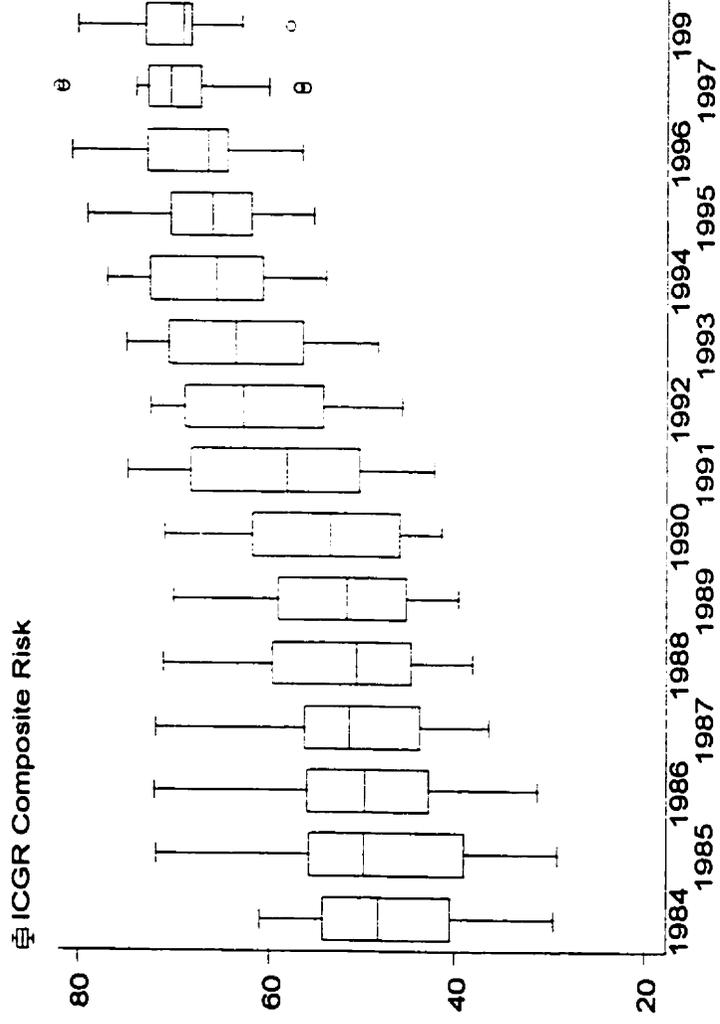
This figure provides a very revealing illustration of the distribution of the CR variable over time. The median score increased over time. Half the countries had scored less than 50 in 1984 and by the 1990s seventy five percent had risk ratings above 50. Moreover, the interquartile range narrowed. In other words, risk ratings for L.A. countries moved closer together. The increase in the median of the country risk variable over time implies a high correlation between country risk and the possible inclusion of a trend variable in this analysis. Last, note that 1997 and 1998 are the only years with outliers. This result shows that, in 1997, although most of the region slowly continued to decrease their risk, a few countries performed much better than most of the countries, while a few others did much worse. In 1998, with the exception on Colombia, the riskiest country in the region, all others had returned to their previous pattern. In 1997 Chile and the Bahamas are the least risky of all the countries in the sample while Colombia and Honduras are the riskiest.<sup>38</sup>

TABLE 3.4

<i>Summary Statistics</i>					
Variable	Observation	Mean	Std. Dev.	Min.	Max
FDI	301	1007.30	2559.43	-595.10	24000
FDI lag	279	894.98	2193.28	-595.10	19652
GDP	301	61869.68	130608.70	202.80	793042
RGDP	301	59406.02	114761.40	257.80	529988
RGDPcap	301	2423.40	2423.35	412.11	12631
GROWTH	279	0.03	0.04	-0.13	0.13
GROWTH lag	257	0.03	0.04	-0.1399	0.13
PR	301	57.96	11.67	29.50	81.10
FR	301	29.47	8.29	6.50	43.00
ER	301	29.72	5.73	11.90	41.00
CR	301	58.65	11.21	29.10	82.10

<sup>38</sup> Note that Figure 3.4 only includes CR ratings for countries for which foreign direct investment data is available in any given year. Nonetheless, these results are consistent with the ones obtained using the complete CR rating data set.

FIGURE 3.4  
COUNTRY RISK BOX-AND-WHISKERS PLOT



### 3.4 ESTIMATION METHODOLOGY AND RESULTS

This section explains and evaluates the different models and estimation techniques used to answer this study's queries. Are regional trade agreements indeed having an impact on the FDI inflows into Latin America and, if so, through which mechanism is this impact being realized? This section is divided into three parts. The first part discusses the results of model's cross section estimates. These results provide a benchmark for comparison with the final model, which is presented in last part. The middle section provides a critical methodology comparison.

#### 3.4.1 Cross Section Estimation

Lipsev's study, discussed in section 3.1, provides a very useful framework for the estimation of the direct and indirect effects of trade agreements of the inflows of FDI into L.A. countries. A similar cross series analysis will be provided as a benchmark for the final model.

As expected, the redefined model includes the same variables as in the foundation model: nominal GDP, lagged Growth, real GDP per capita, and country risk. Lagged FDI is added for reasons already cited, namely that it expresses the assumption that, not only previous inflows are a predictor of present inflows, but also that investors tend to cluster into markets.

The model is expressed by the following equation:

$$FDI = \alpha_0 + \alpha_1 FDI_{lg} + \alpha_2 GDP + \alpha_3 GROWTH_{lg} + \alpha_4 RGDPcap + \alpha_5 CR + e_1$$

This model has been estimated separately for four years: 1987, 1990, 1995 and 1997. A few comments are offered before turning to the results that are presented in Table 3.5. First, the choice of years was primarily dictated by the data availability. Second, corrections for heteroschedasticity were required for 1990 and 1995. Consequently, the

standard errors reported for these two years have been computed using White's robust estimators. Further, note that Adjusted  $R^2$  estimates are not calculated in estimations using White's robust estimators.

TABLE 3.5

<i>Country Risk and Other Determinants for selected years 1987-1997</i>				
Regression of FDI on GDP, FDI Lagged one period, Growth Lagged one period, RGDPcap, and CR				
	1987	1990	1995	1997
Intercept	-424.045 (446.774)	276.775 (450.591)	-2055.473** (912.174)	2391.925 (2527.266)
GDP	0.003*** (0.001)	0.000 (0.000)	0.004*** (.000)	0.010*** (0.003)
FDI Lagged one period	0.261 (0.138)	0.902*** (0.132)	0.770*** (0.027)	0.977*** (0.192)
GROWTH Lagged one period	-1238.599 (2139.935)	-1663.731 (1293.490)	-485.129 (2955.974)	-4590.522 (9011.259)
RGDPcap	-0.037 (.0333)	0.017 (0.032)	-0.005 (0.052)	0.026 (0.111)
CR	11.104 (9.872)	-4.649 (8.991)	32.879** (15.352)	-32.971 (39.001)
N	18	20	22	21
$R^2$	0.676	0.902	0.981	0.973
Adjusted $R^2$	0.541			0.964
F Stat.	5.020	41.66	435.560	110.830

Note: 1990 and 1995 Standard Errors have been corrected for heteroschedasticity  
Standard Errors reported in parentheses.

\* Significant at 10% level \*\* Significant at 5% level \*\*\* Significant at 1% level

Analyzing these results brings out a few patterns. For the most part, market power and previous inflows of FDI are the important determinants of foreign direct investment. Lagged growth and real GDP per capita are not significant determinants in any year. Although lagged growth is not statistically different than zero, it is puzzling that it has, consistently, a negative sign. This result is consistent with the one found in several studies, such as Tsai (1994) and Wang and Swain (1995). Unfortunately, none of the authors of those studies offer a discussion of the subject.

On the positive side, the explanatory power of these estimates is far superior to the one obtained by Lipsey. Even the lowest fit, in the 1987 equation, is superior to the highest fit obtained in any of the estimations in his model. Note that the model fits the conditions of the 1990s much better than it fits the 1980s. As was mentioned in the introduction, and according to the CEPAL's (1998) analysis, the foreign direct investment inflows into Latin America in the 1990s were primarily due to privatizations and subsequent investments from the same companies that had participated in the privatization. Consequently, including lagged foreign direct models this scenario accurately.

With respect to country risk, this model is no further ahead. According to these results, the variable is a significant determinant only in 1995. Further, although statistically not different than zero, in 1990 and 1997 the coefficients' sign are negative. It is hard to explain how an increase in risk (decrease in risk rating) would cause an increase in FDI. Given all these considerations, in order to obtain a more defined answer, a different approach must be sought.

#### 3.4.2 Cross Section , Time Series, and Panel Data

It is clear from the discussion above that cross section estimates present severe limitations to the study of the impact of country risk on the inflows of FDI in developing countries. Although it is a useful comparison between countries, it is not able to capture the changes over time. Changes in policy which affect the measures of country risk happen over time. Consequently, it seems important to complement this study with time series data.

Although, as mentioned earlier, there have been improvements in the availability of data for developing countries, these improvements have been limited. This limitation is exacerbated by the need to use lagged variables. For instance, when a lagged growth variable is used, two observations are automatically eliminated: one from the first differencing to generate the growth variable and a second one when the growth variable is lagged. Gastanaga et al mention another difficulty “ . . .another problem with pure

time series analysis of FDI is that the variations over time may be rather volatile, reflecting many idiosyncratic influences particular to an individual country” (Gastanaga et al, 1998, p.1300). Consequently, the ability to undertake meaningful time series analysis for developing countries is severely curtailed.

In order to mitigate the problems arising from using either pure cross section or pure time series estimations, this study uses panel data. This data set is particularly suited for the problem at hand. Further, given the focus of this chapter - the direct and indirect impacts of regional trade agreements on the inflows of FDI into Latin America - a simultaneous equation model is adopted as suggested by Figure 3.1. The next section will explain and estimate the model.

#### 3.4.3 Simultaneous Equations on FDI and Country Risk

As was discussed, the model attempts to explain and test two hypotheses: the direct and indirect effects of regional trade agreements on the inflows of FDI. In order to achieve these objectives two separate equations are estimated simultaneously using panel data and a Two Stage Least Square Estimator.

The choice of a simultaneous equation estimation is justified by the fact that although country risk is considered an independent variable in the determination of inflows of FDI, it might be also influenced by the trade agreements. If this is the case, then country risk is an endogenous variable. This hypothesis was tested by using a Hausman endogeneity test. The null hypothesis that CR is an exogenous variable was rejected at the 10 per cent confidence level ( $F(1, 243) = 3.64$ ). This situation can be dealt with by computing the effects of trade agreements on country risk “at the same time” as the effects of both, country risk and the agreements on FDI. So, in effect, two equations are calculated. The first equation explains the inflows of FDI while the second explains the determinants of country risk.

The equations estimated are:

$$(1) \quad FDI = \alpha_0 + \alpha_1 FDI_{lg} + \alpha_2 GDP + \alpha_3 GROWTH_{lg} + \alpha_4 RGDPcap + \alpha_5 CR + \alpha_6 MERC + \alpha_7 MERC0 + \alpha_8 NAFTA + \alpha_9 GRUPO3 + \alpha_{10} CARICOM + \alpha_{11} CACM + e_1$$

$$(2) \quad CR = \alpha_0 + \alpha_1 ER_{lg} + \alpha_2 MERC + \alpha_3 MERC0 + \alpha_4 NAFTA + \alpha_5 GRUPO3 + \alpha_6 CARICOM + \alpha_7 CACM + e_2$$

The gist of the Two Stage Least Square (2SLS) procedure is that it estimates equation two first and calculates the predicted value of country risk given all its determinants. Then equation one is estimated and the determinants of FDI are estimated using the predicted values of country risk instead of the actual values. Thus this 2SLS approach is a form of an Instrumental Variables (IV) estimation where the endogenous variable (CR) is replaced in the FDI equation by an instrument. The instrument is exogenous so equation one can then, be estimated.

The control variables in the first equation follow the model estimated in section 3.4.1. However, the model has been redefined to make best use of the panel data. Although the control variables remained the same, the deterministic variables now include both country risk and a dummy variable for each trade agreement.

In the second equation - the determinants of country risk - the control variable is lagged economic risk. This decision was taken after economic risk was found the most significant among the risk variables in a series of estimation tests.

The results reported on Table 3.6 are revealing. Overall, the hypothesis that trade agreements have a direct effect is rejected while the hypothesis that they have an indirect effect through country risk can not be rejected.

Note that the results of the estimation of FDI inflows demonstrate that the only control variable that is not significant is lagged growth. Further, the direction of the impact of lagged FDI and GDP is consistent with the proposed theory.

However, the negative significant impact of real GDP per capita is counter-intuitive. Based on the estimation, an increase of per capita earning would imply a decrease of FDI. Two possible explanations can be offered. First, assume that this result is not a consequence of a correlation between a variable included in the error term and the variable in question. Then, one must remember that the effects of an increase in per capita income in economies with an even income distribution are also evenly distributed. However, this is not the case in Latin America. According to the latest calculations from the United Nations the region suffers from one of the most unequal income distributions in the world. Consequently, an increase in per capita income might be translated as a diminishing earning power for the middle class.

Second, this result could be the consequence of the assumption made above, i.e. that there is a variable in the error term that is having an effect on real GDP per capita. In addition, this correlation might be the cause of the negative sign on lagged GROWTH. However, note that the coefficient on real GDP per capita is statistically insignificant.

Third, the negative significant intercept makes sense. It means that if countries had no past FDI inflows, no market size, zero scores for country risk (complete risk), and no change in real GDP per capita, FDI would be leaving the country rapidly.

Last, as mentioned before, country risk does matter. This is a particularly interesting result and it stands in contrast to the result obtained using the same model but treating CR as an exogenous variable. In the latter case CR was found statistically insignificant.<sup>39</sup>

With respect to the direct impact of the trade agreements on the inflows of FDI, none of the coefficients on the trade agreement variables are statistically significant and the signs

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<sup>39</sup> However, as mentioned, the model that treats CR as exogenous was not properly specified.

for four of these coefficients are negative.<sup>40</sup> Furthermore, an F-test on the null hypothesis that the trade agreement coefficients are jointly equal to zero found that, at the 99% confidence, the null hypothesis can not be rejected. That is, the test does not reject the hypothesis that the trade agreements had no direct effect on foreign direct investments.

Several aspects of the results of the determinants of country risk deserve comment. First, the key result is that the regional trade agreements are jointly significant at the 99 per cent level. Also, the control variable, economic risk is statistically significant at the 99 per cent level. This result seems logical considering the components of economic risk. Country risk, for Latin America, is closely associated with among others, the past performance of inflation, debt servicing, current account balances, and “black market” exchange indicators.

Second, the only two regional arrangements found insignificant were the Andean Pact and Group of Three.

A simple reason can be given to the insignificance of the Group of Three. It is not a regional agreement in scope. Consequently, although it might benefit the individual countries regarding trade issues, it does not lend itself to influencing perceptions of country risk. Further, both Colombia and Venezuela have other factors determining country risk. Colombia has had problems with drug cartels and guerillas while Venezuela is the only OPEC member in Latin America and consequently, is subject to risks associated with OPEC's actions. The fact that Colombia's independent risk factors contribute to the Group of Three statistical insignificant is confirmed by the results obtained in the estimation that removed the series outliers.<sup>41</sup> Remember that Colombia's risk ratings were considered outliers in both 1997 and 1998. Once these observations are removed from the data set and the model is re-estimated, the only change is that the

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<sup>40</sup> Negative signs are found for the Mercosur, the Mercosur's Associates, Nafta, and CACM.

<sup>41</sup> The simultaneous equations were estimated for a data set that excluded all outliers. The results are not reported here.

Group of Three becomes statistically significant at the 1 per cent level. That is, the agreement does impact country risk.

TABLE 3.6

<i>Pooled Two Stage Least Square Estimation</i>		
<b>Simultaneous Equations on FDI, Country Risk, and their Determinants</b>		
Independent Variable	Dependent Variable	Dependent Variable
	FDI	CR
Intercept	-1481.90** (728.95)	24.78*** (2.59)
FDI Lagged one period	.9578*** (.1135)	
GDP	.0044*** (.0016)	
GROWTH Lagged one period	-1341.102 (1425.23)	
RGDPcap	-.0738** (.0364)	
CR	27.51*** (13.67)	
ER Lagged one period		1.08*** (.0840)
MERC	-119.83 (255.65)	10.36*** (1.21)
MERCO	-72.80 (408.94)	8.90*** (1.61)
NAFTA	-1071.99 (1353.22)	9.11*** (2.31)
GRUPO3	678.84 (437.74)	2.17 (1.68)
ANDEAN PACT	15.50 (104.46)	.9771 (1.33)
CARICOM	92.95 (107.53)	5.35*** (1.57)
CACM	-112.40 (96.19)	3.47** (1.39)
N	257	257
R <sup>2</sup>	.90	.53
F Stat.	41.64	55.85
F Stat.on Joint Null for all Trade Agreements =0	1.58	16.67***

Note: all errors where corrected for heteroskedasticity  
Standard Errors reported in parentheses.

\* Significant at 10% level \*\* Significant at 5% level \*\*\* Significant at 1% level

The reasons for the insignificant result for Andean Group are slightly more complicated. First, Colombia and Venezuela are part of this agreement, and as explained above, their participation in regional trade agreements is probably not the driving force behind their individual country risk rating. Second, as mentioned in chapter one, this regional block has encountered severe difficulties. For instance, two of its members, Peru and Ecuador, were practically at war for several of the years included in this study – 1995 to 1998. It is possible that this fact did not contribute to the credibility of the regional block. Note that the issue of the impact of a treaty's credibility on foreign direct investment inflows was singled out by the WIR98 and mentioned in chapter two (UNCTAD, 1998, p.118). This result might also be impacted by the fact that Peru's withdrawal from the agreement, from 1992 to 1997, had no impact on any of its risk ratings.

Third, the size of the coefficients in the equations helps order the importance of these agreements vis-à-vis their impact on country risk. A possible explanation of why the Mercosur has a larger impact than NAFTA is the fact that it is being used by the member countries, especially Brazil, as their primary foreign affairs position. For instance, in the FTAA negotiations currently under way, the Mercosur countries negotiate as a block while NAFTA members negotiate individually. The same scenario is true for negotiations with the European Union. It is also possible that the democratic clause referred to earlier has a small impact. All these factors may impact positively on an investor's perceptions of Mercosur, and that of this agreement on country risk. On the other hand, the fact that NAFTA's impact is "seen" by the model as smaller than the impact from Mercosur could be explained by the fact that the NAFTA dummy variable picks up the 1994 Mexican peso crises.

Finally, a mention should be made of the fact that the country risk equation does not have very much explanatory power. That follows from the fact that it only explains approximately half of the variation on the country risk indices. However, this is consistent with the findings of other studies that include risk measures, such as Gastanaga

et al (1998). Clearly, past economic risk and membership into regional trade agreements only tell part of the story.

In conclusion, regional trade agreements in Latin America, with the notable exception of the Andean Pact, do impact the member countries' country risk ratings.

### 3.5 Diagnostics

As was argued in the last section, the simultaneous equation methodology using panel data provides a superior framework for the analysis of the impact of trade agreements and country risk on the inflows of FDI into L.A. countries. However, a few comments on the robustness of these results are in order.

The rejection of the hypothesis that regional trade agreements have a direct impact on the inflows of FDI might be partially driven by the nature of this data set. The rationale behind the hypothesis, as stated earlier, is that regional trade agreements create "regional" markets. Consequently, the market size of member countries is seen as a larger market. In this data set, market size is captured by nominal GDP. Given that there are large disparities in GDP size between countries in the data set, the large countries tend to drive the model. Thus, small impacts on market size would be seen as "insignificant."

Another shortcoming of the data set is its "aggregate" nature. Different kinds of FDI are attracted to countries for different reasons. In other words, the determinants of inflows of FDI are different for different kinds of FDI. For instance, investments that require large sunk costs, such as infrastructure projects, have different determinants than investments destined to the manufacturing sector. Consequently, this model must be understood from a macro perspective.

The data's aggregate nature does not allow for any identification of where the FDI is coming from. One might question whether the determinants of FDI into L.A. are the same for all investors. For instance, do American investors base their decisions on the same elements as European investors? Do investors from member countries use different

criteria than investors from outside the regional arrangement? Again, the limitations of this model must be kept in perspective.

An issue that is often mentioned when dealing with determinants of FDI is the openness of the country. Openness refers to the country's stand in relation to international trade and is calculated by adding total imports and exports and dividing this amount by GDP. This is an important issue regarding Latin America. As was mentioned in the Introduction, most countries in the region followed the developmental doctrine of import substitution for decades. Although these policies have been discarded, it is important to examine whether the change from one development framework to another has had an impact on the inflows of FDI to the region. Note that the impacts of openness could be either positive or negative. FDI could be attracted to "close" regions as a way to enter into the market. Consequently, when barriers are lifted, it might be preferable to export to that country (if the FDI was "manufacture" or "salable"). However, it could be positive if the country is more open and can be used as a base for exports to other markets. Note that FDI directed at infrastructure or privatization might not be affected by the openness of the economy.

In order to test the results of the simultaneous equation estimates' robustness the equations are re-estimated adding openness as an independent variable.<sup>42</sup> Note from the results presented in Table 3.7 that none of the previous estimates are substantially altered by the introduction of this variable. Further, the variable is insignificant. Consequently, in this model, the economy's openness is not a significant determinant of FDI.

Last, a few technical notes are offered. As mentioned in the cross section discussion, two out of the four years estimated revealed the presence of heteroschedasticity.

Heteroschedasticity was also present in the model estimated using the panel data.

Consequently, all estimations were made using White's robust estimators.

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<sup>42</sup> The number of available observations for open is 242 – whereas the other simultaneous estimation had 257 observations.

No significant autocorrelation problems were detected upon visual inspection of the equation's residuals. However, given that the standard Durbin Watson test for autocorrelation is not valid for panel data the following procedure was conducted to confirm the robustness of the simultaneous equation estimation results. (1) The CR equation was estimated using White's Robust Estimators; (2) The predicted values of CR were generated; (3) The FDI equation was estimated using a General Estimating Equation which allows for panel data correction of both autocorrelation and heteroschedasticity; (4) The coefficients were compared to the ones obtained in the Two Stage Least Square estimation. The results, reported in Table 3.8, are consistent with the model estimated with the simultaneous equations. There are only minor differences regarding the level of significance of country risk and the real GDP per capita. Consequently, one concludes that autocorrelation is not a major problem.

### 3.6 CONCLUSION

The objectives of this chapter were to examine whether regional trade agreements have affected the FDI inflows to Latin America and, if so, to investigate the affecting mechanisms. The hypotheses tested were that these arrangements could impact the inflows of FDI directly and/or indirectly. The direct influence would occur, mainly, as a consequence of the "locational advantages" while the indirect effects would be a result of investors' perceptions of country risk.

The results obtained indicate that regional trade agreements, with one exception, impact the inflows of foreign direct investment to Latin America indirectly. The mechanism is: trade agreements have a positive influence on investors' perceptions of country risk and, in turn, country risk has an impact on the inflows of foreign direct investments.

TABLE 3.7

<i>Pooled Two Stage Least Square Estimation</i>		
Simultaneous Equations on FDI, Country Risk, and their Determinants including OPEN		
Independent Variable	Dependent Variable	Dependent Variable
	FDI	CR
Intercept	-1133.162*	25.439***
	(733.902)	(2.681)
FDI	0.985***	
Lagged one period	(0.110)	
GDP	0.004***	
	(0.001)	
GROWTH	-761.659	
Lagged one period	(1636.429)	
RGDPcap	-0.075**	
	(0.038)	
CR	23.581*	
	(13.460)	
OPEN	-399.767	
	(362.021)	
ER		1.065***
Lagged one period		(0.087)
MERC	-86.452	10.651***
	(258.570)	(1.197)
MERCO	-39.321	9.137***
	(411.838)	(1.648)
NAFTA	-1158.099	9.049***
	(1351.559)	(2.356)
GRUPO3	932.086**	2.334
	(432.776)	(1.741)
ANDEAN PACT	2.512	0.886
	(105.742)	(1.346)
CARICOM	365.167	7.571***
	(266.904)	(1.358)
CACM	-0.731	3.515**
	(113.642)	(1.400)
N	242	242
R <sup>2</sup>	.90	.56
F Stat.	35.31	54.88
F Stat.on Joint Null for all Trade Agreements =0	1.88	17.99

Note: all errors were corrected for heteroscedasticity  
Standard Errors reported in parentheses.

\* Significant at 10% level \*\* Significant at 5% level \*\*\* Significant at 1% level

TABLE 3.8

<i>Pooled Two Stage Least Square Estimation and General Estimating Equation</i>		
<b>Simultaneous Equations on FDI, Country Risk, and their Determinants</b>		
Independent Variable	Dependent Variable	Dependent Variable
	FDI	CR
Intercept	-1386.004* (838.995)	23.931*** (2.394)
FDI Lagged one period	0.942*** (0.208)	
GDP	0.004*** (0.001)	
GROWTH Lagged one period	-513.342 (666.672)	
RGDPcap	-0.047* (.0.026)	
CR (PREDICTED) ER Lagged one period	24.104* (13.488)	1.106*** (0.079)
MERC	-146.867 (180.965)	10.644*** (1.177)
MERCO	-24.689 (532.397)	9.027*** (1.594)
NAFTA	-1090.866 (723.121)	9.316*** (2.300)
GRUPO3	699.786 (520.054)	2.273 (1.669)
ANDEAN PACT	38.904 (155.434)	1.108 (1.263)
CARICOM	112.249 (131.229)	4.568*** (1.594)
CACM	-59.117 (93.161)	3.782*** (1.330)
N	248	279
R <sup>2</sup>		.53
F Stat.	X2=64336.61	65.50

Note: all errors were corrected for heteroscedasticity

Standard Errors reported in parentheses.

\* Significant at 10% level \*\* Significant at 5% level \*\*\* Significant at 1% level

The hypothesis that regional trade agreements have a direct impact on the inflows of FDI was rejected. However, this rejection must be considered in the context of the model's design. As mentioned earlier, one of the possible reasons why they do not appear to impact FDI directly is that market size is a significant determinant in itself. Hence, the theory that trade agreements would create "regional markets" insofar as FDI inflows is derailed by the presence of dominating markets such as Brazil and Mexico. On the other hand, the evidence seems to point to the fact that investors are still very cautious when it comes to believing that these agreements really mean a completely integrated regional market.

In sum, the results do not support Dunning's theoretical hypothesis that protectionist government policies increase the inflows of foreign direct investments into a region, at least not into Latin America. That is, there are no direct effects of regional trade agreements on foreign direct investments in Latin America. However, it does find support for the locational/internalizational theoretical construct. Although trade agreements are not an important variable in this respect, market size and other variables are. Finally, the results support Blomström and Kokko's hypothesis that trade agreements impact investors' perceptions of country risk, and in turn, foreign direct investment inflows.

## **C o n c l u s i o n**

Are regional trade agreements in the Americas just about trade? No, they are not. This thesis has shown that they are about a lot more than trade.

From the post-war days to the approaching the new millennium, Latin American countries have shifted their approach to development. From the closed-in, import substitution paradigm they began with, they have come to embrace an open, market liberalization economic framework. In this new development paradigm, governments are leaving the active economic play to the private sector and increasingly, through different policies, taking the role of market environment creator. In this context, market liberalization, a new regulatory framework, privatization, commitment to trade and investment agreements, and encouragement of foreign direct investments are all seen as engines of growth and development.

These “growth motor” policies are being implemented in evolving and constantly changing environment. They interact with other domestic policies, and more importantly, they are an element of the process of globalization. Understanding, quantifying, and analyzing this process is presenting a challenge to scholars and commentators alike. Insightful analysis can not be undertaken from one single perspective, holding everything else constant, because all policies are interconnected and affect one another simultaneously.

This is the premise of this study. The analysis of the impacts of regional trade agreements on the ability of signatory countries to attract foreign direct investments is modeled as a simultaneous system with both direct and indirect effects. In theory, regional trade agreements may affect foreign direct inflows both directly, by creating a regional market, and indirectly by changing investors’ perceptions of the riskiness of signatory countries.

Current economic theory treats the direct impacts as a simple matter. That is, a regional trade agreement has the direct impact of either increasing or decreasing the inflows of

foreign direct investments. On the other hand, the theory behind indirect impacts is more complex: regional trade agreements impact investors' perceptions of country risk, and this variable impacts foreign direct investment inflows. As mentioned several times in this study, while some theoretical work has been published on the effects of regional trade agreements on the inflows of foreign direct investments into developing countries, empirical work on the subject is almost non-existent.

This study is a first step towards filling this void. As predicted, the simultaneous approach leads to analysis which provides insightful results. According to these results, and contrary to prevailing thought, regional trade agreements have no statistically significant direct impact on the inflows of foreign direct investment into Latin America. They do, however, have a statistically significant impact on country risk ratings, which in turn, has an impact on the inflows of foreign direct investments into the region. In themselves, these results show that the scenario is a great deal more complex than scholars originally hypothesized. More interesting however, is the conclusion that both direct and indirect effects hinge on investors' perceptions.

As explained, direct effects are based on the assumption that regional trade agreements create regional markets. However, are these regional markets a reality in Latin America? After all, the regional trade agreements in the Americas have not, yet, created a completely integrated market. Moreover, as Chapter 1 showed, the evolution of these treaties does not lead one to believe that all will be well and that, this time, the region's dreams and aspirations will come true. It is a curious fact that both scholars and the media point to this future uncertainty with one hand, and with the other claim that investors have embraced these agreements as having created "de facto" regional markets. This study shows that international investors might not be quite so gullible. It could be argued that, as it has been pointed out, this result could be a function of the disparity in economic size of the countries of the region, which would have the consequence of overemphasizing individual country's market size to the detriment of regional market size. Maybe country size should be emphasized because country market size does make a difference in the region. A trade agreement that includes Brazil, such as the Mercosur,

is important because of the very fact that Brazil, with its 160 million people, does have a huge market. Consequently, if market size is the driving force behind the direct impact of a regional trade agreement on the inflows of foreign direct investments, investment in Argentina will only take place if investors perceive the Mercosur as a creator of such a market.

In this world of perceptions, indirect effects are best at capturing uncertainties. The fact that risk variables are an important component of investment decisions is well documented in the investment literature. However, in the case of international investments in developing countries, the empirical evidence is being gathered, but is not yet conclusive. This thesis stretches the envelope a bit further by treating country risk as an endogenous variable.

The final model leads to the conclusion that, in Latin America, foreign direct investment inflows are dependent on past inflows (positive), GDP (positive), real GDP per capita (negative), and country risk (negative). Note that country risk itself, depends on past economic risk and regional trade agreements. The direction of the variables' impact, i.e. whether their impact is positive or negative, are as expected with one exception – real GDP per capita. The negative relationship means that as real GDP per capita increases, foreign direct investments decrease. As mentioned in chapter three, this result is counter-intuitive, however, it highlights an important issue which lies outside the scope of this study – the impact of extreme inequality of income distribution in Latin America.

In all, regional trade agreements in the Americas are influencing areas far beyond their original intent, in ways that have not been anticipated. Their indirect impact on foreign direct investment inflows is, clearly, only one of their many effects. The relationship between economics and politics can not be dealt with here but, is obvious to even the casual observer. In the end it is all about development. Ironically, the new development paradigm which is exactly opposite to the one originally suggested by Raul Prebisch, might in the end, achieve his dream: that of a integrated Latin American market in a global village.

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