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CASE STUDY

ENVIRONMENT FOR U.S. DIRECT PRIVATE INVESTMENT:
ARGENTINA, BRAZIL, COLOMBIA, MEXICO

by

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Department of Commerce

TWELFTH SESSION
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SUMMARY

The paper makes the point that sweeping generalizations about attitudes or the economic/political situation are of little value in helping to make investment policy. Each country of Latin America represents a different situation. The paper describes plus and minus factors for U.S. direct private investment in the four countries covered, and also enumerates a few major considerations for the attention of prospective investors.

ENVIRONMENT FOR U.S. DIRECT INVESTMENT:
ARGENTINA, BRAZIL, COLOMBIA, MEXICO

It is a cliche of United States policy that we have a special relationship to the countries of Latin America. Given the current emphasis on private investment as the primary means of development, this means that U.S. Government encouragement and assistance should be extended to private U.S. investment in Latin America. Yet, it would be unfair and costly to the investor and contrary to the long-run economic and political interests of the United States, to foster such investment where it is unlikely to prosper, or where it is unwelcome and could remain only on sufferance and for a limited time period.

A quick survey of the Latin American scene reveals an apparent anomaly. U.S. direct investment is substantial--about $11 billion as of the end of 1968 (book value). Perhaps of more importance to Latin American development, and to hemisphere relations, is the direction of the investment. From 1961 to 1968, while the total employed in the extractive industries--petroleum, mining and smelting--remained unchanged at $4.3 billion, the total employed in manufacturing, trade and other industries rose from $3.1 billion to $5.9 billion.

Left to the free play of the market, this trend could be expected to continue. The markets within Latin America are expanding under the impetus of population increase and growing per capita income. While still far from fulfilling the hopes of their founders, the Central American Common Market, LAFTA, and the Andean Common Market are nevertheless already contributing to the size and diversity of the market area. Further, the possible establishment of United States or broader developed country tariff preferences would make Latin America a magnet for American investors, just as Puerto Rico has been.

Also, on the positive side, one may add the recognition by academicians and government planners, as well as by businessmen, that foreign capital is a resource of great value to the development process, not only because it can mobilize resources, but because it can employ them effectively in production and marketing, and as a side benefit raise the level of economic competence in the host country.

Yet, while direct U.S. investment in Latin America is apparently flourishing; when the role of such investment in the development process is being appreciated and welcomed; and when our own aid policy has turned away from government-to-government assistance, and toward the encouragement of private direct investment, great anxiety is being experienced in the recipient countries about the effect of such investment on their ability to control their own destiny.

I should make clear at this point that I am excluding from this discussion the extractive industries. The governments of Latin America have made very clear that they intend to maintain full control over their subsoil resources. Foreign investment in this area is consequently subject to special treatment.

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However, investments in manufacturing and services are trickier to control. The rise of the multinational corporation has given pause even to Canada and the countries of Western Europe, while Japan has persistently subjected directed foreign investment to careful screening and close limits. The fear of problems--economic, political and social--which may arise from foreign control of a country's economic underpinnings is understandable in countries whose economic base is small, and where alternative economic activities cannot easily be found.

There exists in Latin America a widespread attitude that the majority ownership in manufacturing and service industries should be locally held. This has led recently to the logical conclusion that all foreign equity in Latin American companies should eventually be localized. Therefore, it would be better for all concerned if this were recognized in the beginning so that the investor would not be surprised when it happened and the local investor or government would equip himself financially for the change in ownership when the appointed time of changeover arrived.

Perhaps the most extreme statement of this view is expressed in Professor Albert Hirshman's essay on "How to Divest in Latin America and Why."

> "If these political arguments are added to those pertaining to economics and political economy, one thing becomes clear: a policy of selective liquidation and withdrawal of foreign private investment is in the best mutual interests of Latin America and the United States." p. 9.

Similar refrains are to be found in the background papers and deliberations of the Sixth Annual Meeting of the IA Ecosoc, June 1969, in the sections dealing with the role of private foreign investment in the development of Latin America.

The anxiety felt by Latin Americans over possible loss of control over their economic destiny is all the stronger for being coupled with the fear that foreign investors will be the ones to profit most from economic growth, benefitting especially and disproportionately from regionalization. As a consequence, a great deal of thought is being given to the design of regulations that will deny foreign investors an overly large share of the benefits without actually preventing the investment.

The desire to localize ownership of investment will no doubt continue to affect the way Latin Americans feel about direct foreign investment, since it both satisfies the nationalistic yearnings of the intellectuals and politicians and helps to maintain the economic ascendancy of the present local possessors of capital. Accepting that these attitudes exist, however, and that some limitations on the role of direct foreign investment will result, there still remains to be determined the extent to which significant obstacles are raised to such investment.

In the present circumstance, all involved seem to agree that an interruption of the flow of direct foreign investment from the United States to Latin America would be undesirable. My visit has convinced me that the negative or questioning attitudes described above will not result in bars to responsible investors. On the contrary, the welcome mat is out for foreign investment which will fit into each country's development plan.

The question for potential investors, and for the U.S. Government, is therefore not what is the attitude of Latin Americans toward direct U.S. private investment, but what kind of operating environment will the investor find. Specifically, is there an opportunity to earn an acceptable rate of return and to grow with the country; will it be possible to remit profits; is the investment safe from expropriation; and is the political structure stable enough to allow affirmative answers to the first three questions.

My visit to four countries in two and one-half weeks was obviously too short to enable me to do investigation in depth, or to compile detailed information about how to do business in each country. Fortunately, this information has been gathered by others, as listed in the attached bibliography. What I was after was an impression as to the nature of the legal and political environment; the extent to which operating conditions actually reflect the letter of the law; economic potential; similarities or differences in the treatment of domestic and foreign investors; and a prognosis for the long-term role of American direct investment.

I am going to risk giving some flat answers. At this point, I am going to stop talking about Latin America. True, there are some similarities present in the four countries I visited. But generalities about attitudes or structure can, I believe, do a disservice in the analysis of investment potential. While some attention is being given to the coordination of treatment of foreign investment, within the context of the regional groupings, this is a project of a decade or longer. Meanwhile, each country has not only its own laws and regulations, its own political and economic environment, but also its own style of accommodation and response to foreign investment.

<u>Argentina</u>

It has taken remarkable talent for a country with the resource potential of Argentina for her to remain for so long economically stagnant. The period of stagnation now appears to have ended. The peso, which

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was last devalued in 1967, is fully convertible and the government is determinedly pursuing economic growth through incentives to both domestic and foreign investment.

Recently, the government has called for the formation of a public industrial entity in order to mobilize Argentine capital for use in financing Argentine industry. This is designed to counter the greater ability of foreign investors to obtain capital, and in this way to increase the efficiency and competitiveness of Argentine industry. However, the burden of development remains definitely with the private sector. One important sign of economic maturity is the intent to realign and reduce import tariffs in order to force improvements in local operations. This means that both domestic and foreign investors will lose some of the assurance of profit so far enjoyed by industries established behind the tariff wall. But, for the long term, it means far greater ability for Argentina to earn its way through international trade.

One must note some caveats. Although the peso is now freely convertible, all international transactions of $100,000 or more are subject to review. Second, foreign capital must be registered with the government--for its own protection, in case the balance of payments position should some day require exchange controls. Finally, there is the lurking specter of a return to the economic policies of inflation and stagnation if there should be a change in the political leadership.

Although it is the clear intent of the Argentine Government to remain economic master in its own house, the implementation of regulations as they apply to foreign-based companies appears to be reasonably efficient and straightforward. I would have no hesitation in recommending Argentina as a target of direct U.S. private investment.

The question immediately arises as to whether Americans should look for Argentine equity participation. There is no doubt that this would be preferred by the Argentines--although they would like this to be on a reasonably equal basis, and not through the facade of an Argentine name or perhaps even an old established company fallen on hard times. However, there is still a place for wholly-owned subsidiaries, although this should at minimum entail a retainer for a good Argentine law firm.

<u>Brazil</u>

Brazil is currently enjoying very rapid economic growth, with the gross domestic product estimated to have increased by 9% in 1969, and both business and government circles are optimistic regarding the likelihood of continued growth. The rate of inflation is still high--24% in 1969--but although the figure was the same as for the preceding year, its makeup is believed to show a healthier trend, with a substantial part of the price increase resulting from a drought-induced shortage, rather than from an increase in the money supply. Fixed investment continued to rise as a proportion of GNP, reaching 17.1% in 1969.

Brazilian foreign exchange is under tight government control. The current regime in Brazil is highly oriented toward the private sector, and foreign investment is welcome, especially if it will bring in new technology, contribute substantially to Brazilian exports, or establish itself in areas which are in particularly bad economic straits. Considering the current emphasis on development through the private sector, the size of the Brazilian market--90 million people, growing at the rate of 3.5% per year--and its great natural resource base, Brazil certainly appears to be a good target for American direct investment.

Many American companies are already operating there, some in participation with Brazilians, but a considerable number as wholly-owned subsidiaries. However, I have the strong impression that the government of Brazil has very great administrative flexibility in dealing with business questions, and that companies wholly or even partly foreign-owned must give very close attention to their contacts within the Brazilian government.

There appears to be a kind of ambivalence within the Brazilian Government. On the one hand, the present government is highly oriented toward the private sector, not only welcoming foreign investment but recently going so far as to restrict the sphere of operations of the national petroleum monopoly to give broader scope to private investment, including foreign investment, in petrochemicals. On the other hand, the sale of rural land to foreign investors has been prohibited--a prohibition aimed at land speculators but inhibiting industrial investment, especially since the rule goes behind the nationality of the company to the individual shareholders. A further potential bar on foreign investment in industry is a recent limitation on the proportion of industrial land in any city which can be foreign-owned. The prohibition against the payment of royalties also appears counter to the desire for joint investment with Brazilians in high technology enterprises.

In sum, while there are strong economic reasons for investing in Brazil, very serious consideration should be given to obtaining Brazilian equity participation, and to the importance of learning the local style in dealing with Brazilian government officials.

<u>Colombia</u>

It used to be said of Brazil that it was the country of the future and always would be. My impression is that at the present time this questionable accolade belongs to Colombia. According to a recent business policy study prepared for the National Industrial

Conference Board, "Economic and administrative obstacles have replaced the major obstacle of political instability cited frequently in 1964-65 by prospective investors." Additionally, political instability has returned. Four candidates are now campaigning for the Presidency, of whom one is an outsider and three represent a serious split within the ruling party. It remains to be seen whether the victor can maintain the economic momentum which was slowly beginning to gather.

However, my doubts as to the desirability of Colombia as a target for American investment will remain no matter who wins the election. Perhaps a more precise formulation would be my feeling that an investor deserves a higher rate of return for doing business in Colombia than in the other three countries I visited.

The potential for economic growth in Colombia seems very great. The earnings from coffee and petroleum put a floor on foreign exchange earnings. Other types of exports are over the two hundred million dollar mark. And there are still unexploited mineral resources, of which nickel is one, which can add greatly to the country's economic underpinning.

Unfortunately, the Government of Colombia appears to be more interested in a doctrinaire, nationalistic organization of development than in development itself. The search for perfection in the rule governing foreign investment apparently makes the negotiating process a very protracted and difficult one, and requires the input of an inordinate amount of executive time. Of course, there is already a substantial amount of foreign direct investment in Colombia, and there is room for more. But it is acceptable only under a set of rules which suffer from being at the same time very lengthy and detailed and subject to interpretation by administrative officials.

By the very stringency of controls, I believe that the Colombian Planning Ministry is losing the major benefit of the entrepreneur, his unique ability to organize production and distribution. I have refrained from using anecdotes because of possible embarrassment to my contacts. But I think it important to relate that, while in all four countries there was free access to the ear of government officials, it was only in Colombia that I got the impression that there was no real dialog--you could discuss problems at length with government officials, after which they proceeded as previously planned.

Mexico

Mexico is, of course, a success story in Latin America. Her GNP rose at a compound annual rate of 6.4% during the sixties. In absolute figures the GNP more than tripled from 1950 to 1968--from $8.7 to $25.8 billion--while the population grew by not quite 100%--from 26.3 million to 48.9 million. After decades of bloody civil strife punctuated by a long period of authoritarian rule, Mexico in 1939 finally achieved a stable national consensus. People in Mexico talked to me quite unselfconsciously of the "Mexican Way," and of disputes being settled in the interests of Mexico.

The policy of prohibiting foreign investment in certain industries and of insisting on majority ownership of equity by Mexicans in many others, does, of course, limit the attractiveness of Mexico to many investors. However, even 51% equity ownership is by no means synonymous with control, in today's corporate world, and I would recommend to potential American investors in Mexico that they examine the total business climate before rejecting a possible opportunity because of pressure to Mexicanize. In any event, no foreign investor should consider going into business in Mexico without establishing close relations with appropriate government departments through a Mexican intermediary. But Mexico is willing to let you make a profit if your operation is considered good for Mexico, and if you have a good proposition, a modus vivendi will be earnestly sought.

General comments

Although I am in principle opposed to generalizations about Latin America, I think the following comments worth making:

1. Expropriation. This seems highly remote for investments in manufacturing or commerce.

2. Localization of equity ownership. Pressure for increased local participation can be expected to grow as local capital becomes available. The best approach would be for this to take place through the broadening of stock exchange activity, and I would hope that the U.S. would encourage this kind of "Peoples' Capitalism." I would hope that it will not be our policy to make loan capital available to transfer equity from U.S. or other foreign to local ownership. This would not appear to assist in the development process or in the mobilization of local capital, but it might well contribute to the economic position of the few families who would have access to such funds, or to the increase in government control over what should be the private sector.

3. Redirection of investment from import substitution to export potential.

The governments of Argentina, Brazil and Mexico appear to have faced up to the fact that industries founded behind high tariff walls are costly to their economies and postpone the day when the export of manufactured goods can contribute to a healthy balance of payments. Tariff structures are being modified, and local industries are being forced to bring their costs into line with world costs--although exceptions are permitted. Mexico, for example, still allows prices from 25% to 90% in excess of world price, on some commodities of domestic manufacture. While healthy for the economies of these countries, this means that investors have to use a sharper pencil in figuring local costs. (This trend may also be present in Colombia, but in my short visit I found what appeared to be evidence in favor of the status quo for tariff protection. However, all four countries are eager to receive new investment that promises substantial export earnings.)

4. Regulations that don't regulate. In several instances I was told that regulations that are apparently restrictive but do no more, in fact, than acknowledge what is actually taking place. Examples of this are the Colombian limitation of 14% of registered capital on the repatriation of earnings. This is evidently substantially higher than is earned by many foreign-based companies and far exceeds the actual dividend remittance record of less than 4% in recent years. Another example is a Brazilian rule with regard to the proportion of a bank's capital which can be loaned to foreign-based companies. The more rules, of course, the more chance of running afoul of one at some critical time, and would-be investors are advised to look at the entire scene before concluding that seemingly innocuous regulations will not at some time become a problem. Perhaps the areas of greatest significance in this connection relate to the tariff treatment of machinery and spare parts; the raising of capital locally; the remittance of dividends; and the employment of foreign nationals whose skills the host government feels are available locally. One way to deal with these issues is to try to get a favorable ruling at the outset, when the investor's bargaining power is at its peak.

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