

3. PRIVATE CAPITAL FLOWS TO THE ANDEAN REGION

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Up to the mid-1980s, the Andean countries subscribed to highly restrictive foreign investment regimes. The Andean Group investment regime, governed by Andean Commission *Decisión 24*, included mandatory registration and authorization, off-limits economic sectors, ownership restrictions, provisions for the transfer of technology, limits to local finance, ceilings on profit remittances and other restrictive measures. Like the rest of Latin America, these restrictions reflected the government activism of the times. Restrictive investment regimes, however, are not a historical constant -- prior to 1929, trade and investment regimes were generally open. While this openness was interrupted for much of the postwar period, in recent years changes have swept the economic landscape and this openness is being restored. The famous *Decisión 24*, abolished in 1987, seems to belong to a remote past.

This chapter examines the determinants of recent private capital flows to the Andean countries and focuses on U.S. participation within these flows. The implicit assumption is that private capital inflows are beneficial to these countries, whose savings and investment rates are below the levels generally thought to be required for sustained increases in social welfare. With sound overall economic policy and appropriate regulatory frameworks, the benefits of private capital inflows should greatly outweigh their costs. Setting aside inevitable variations in the size and composition of flows, the long-term trend is for increasing private capital inflows to emerging markets (Bruno 1996). The Andean countries, therefore, stand to gain if they can compete successfully with other developing countries inside and outside the Western Hemisphere to capture these foreign savings. More importantly, they must be able to channel the flows in ways that will facilitate capital formation, improve overall competitiveness, and spur the dissemination of new technologies, products and human resource skills in order to benefit their societies.

This chapter begins with a historical overview of the role of foreign capital in the Andean region. The next section presents a descriptive analysis of private capital flows during the last three decades. Rather than focusing on official flows or bank loans, which have been extensively studied elsewhere and have been declining as a percentage of private capital flows, the chapter will emphasize foreign direct investment (FDI) and foreign portfolio investment (FPI) flows. FDI flows—consisting of equity capital, reinvested earnings and other intercompany transactions—are considered to be less volatile and more apt to have a greater direct impact on the real economy. Portfolio investment flows—including financial securities—also exert an impact on the real economy through their influence on domestic financial markets. A comparison of U.S. private inflows with those from other countries is also detailed, as well as an account of the sectors that absorbed the inflows. The third section explores the determinants of capital flows into the region. Emphasis is placed on assessing whether internal policies or exogenous factors better explain the current flows of direct and portfolio investment. The last section addresses the possible macroeconomic impact of these inflows and outlines the risks and challenges that policy makers must face in an international environment increasingly characterized by private-to-private external capital flows.

HISTORICAL OVERVIEW

Historically, Latin American countries have been ambivalent toward foreign capital from dominant world economic powers—particularly the United States. Before World War I, of total foreign capital flows to the region, 15 percent originated in the United States; this was second to England which accounted for more than 50 percent (ECLAC 1965). Direct investment by private firms accounted for the bulk of these flows, while about a third were made up of bonds issued by governments to finance budget deficits and the construction of infrastructure. Within the Western Hemisphere, the Andean region accounted for a trifle, as the bulk of the flows went to the largest countries—Argentina, Brazil, and Mexico. Between the end of the first world war and 1929, the share of private U.S. capital had risen to a third. These were times of unimpeded flows of goods and

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financial capital across the world, underscored by domestic policies that embraced free market economics in Europe and the United States. The Andean countries also generally maintained open trade and capital accounts throughout this period.

Gradually this friendly attitude toward U.S. private capital gave way to a generalized skepticism about the benefits of liberal foreign investment regimes. This skepticism grew in tandem to the task of nation-state building in Latin America. The intelligentsia had already identified a disabling condition in the existence of fragile institutions—including unskilled civil servants, weak law enforcement capacity, outdated educational systems, and a lethargic class of local entrepreneurs. This weakened the countries' bargaining position vis-à-vis private firms domiciled in the most powerful country in the world. At its extreme, openness to U.S. private investment meant the perpetuation of economic dependence, if not the abdication of sovereignty and resignation to underdevelopment. This view was justified by the perception that the pattern of U.S. private capital flows to the region was similar to England's activities in the last quarter of the nineteenth century. These included direct investment in extractive industries and finance capital for infrastructure to link the sources of primary goods with the markets in the center. This modality of foreign investment was considered to be anathema to industrial development (and thus to the consolidation of the state) because the hefty revenues generated by highly productive activities were siphoned away by excessive profit remittances, adverse terms of trade, or unnecessary imports. At the same time, it was perceived that the economic power of U.S. firms enabled them to exert influence on domestic political affairs.¹

Following the end of World War II, and until the late 1960s, over 60 percent of total capital flows to Latin America came from official sources. During this period, in which most Latin American countries implemented import substitution industrialization policies, the manufacturing sector attracted increasing volumes of direct investment. For example, from 1950 to 1965, the value of investments in the manufacturing sector grew by 540 percent in Colombia, 393 percent in Peru and 933 percent in Venezuela (Furtado 1966). This period also witnessed the strengthening of the state and, not surprisingly, the imposition of new foreign investment rules and restrictions on the operations of foreign firms. In some cases, these measures included outright expropriation of foreign assets.²

In the early 1970s the demise of the Bretton Woods monetary system, financial deregulation in the eurodollar market, and the need to recycle revenues from oil price increases propelled private commercial bank lending to the Latin American region. During the period from 1976 to 1980, commercial bank loans accounted for 58 percent of total inflows and dwarfed those of private direct investment (19 percent) and those from official sources (13 percent) (IDB 1982). These massive inflows were accompanied by large fiscal deficits in most countries and led to huge current account deficits. As is well known, unproductive overborrowing and changing economic conditions in international financial markets touched off a severe economic crisis in 1982. The pain from accommodating domestic absorption to effect an outward transfer of resources during most of the last decade reinforced the perception that Latin American countries were locked in a vicious circle of dependence on U.S. private capital. Yet, however disgruntled governments and public opinion were, overall discontent did not translate into more autarchic policies or outright expropriation of foreign assets.³

In part this is explained by the recognition that *dirigiste* policies had reached a dead end. Policymakers probably also recognized that East Asian countries (with the exception of the Philippines), which since the 1960s had adopted more open trade and foreign investment regimes, emerged from the turbulence virtually unscathed. Countries were forced to adopt drastic economic stabilization programs and far-reaching structural reforms were subsequently enacted. Within the Andean region, changes in the foreign investment regime, in particular *Decisión 291*, enacted in March 1991, paved the way for significant liberalization. The new Andean regime guarantees

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¹ The literature is rich with descriptions of the predominant economic position of U.S. firms in Latin American countries and in the political power they wielded. For example, in Peru, Exxon-owned International Petroleum Company accounted for the bulk of oil production and was conferred quasi-sovereign rights to the fields and even to some ports located nearby. This was the source of nationalistic protests that largely dominated Peruvian politics for three decades. In Venezuela, a liberal law enacted in 1922 also conferred U.S. oil firms enclave rights.

² Chile, at that time a member of the Andean Group, nationalized its copper mines in 1971, with no financial compensation to its former owners. Exxon's oil fields, refineries and service stations in Peru were also expropriated in 1968. The subsequent takeover by the Peruvian state of other large U.S.-owned concerns in so-called strategic sectors of the economy followed this event. Venezuela nationalized its oil industry in 1974.

³ The exception was Peru during the administration of Alan García in 1985–90. Early in the regime, it expropriated Belco, a U.S.-owned oil concern.

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- (a) Peru and Bolivia are completely open to foreign investment. Colombia bars foreign investment only in defense, national security and garbage disposal activities, while petroleum and mining face some restrictions. In Ecuador, utilities, water, electricity, telecommunications and hydrocarbons are closed to foreign investors. Hydrocarbons is also the main sector proscribed to foreign investors in Venezuela.⁵
- (b) 100 percent foreign ownership of firms is allowed across the board in Peru and Bolivia. In Colombia and Ecuador 100 percent foreign ownership holds in most sectors, while Venezuela's only exception is the media.
- (c) Prior authorization, with the exception of operations in reserved sectors in Colombia, has been eliminated altogether, and registration procedures have been streamlined in all countries.
- (d) In all member countries, profits and capital can be remitted without prior authorization. No limits exist in the remittances of dividends.

Furthermore, in all Andean countries, economic liberalization reforms have been widely implemented. Tariffs have been lowered and import and export restrictions have been lifted. Foreign currency exchange controls have been virtually eliminated, so that both domestic and foreign investors can benefit from free exchange convertibility, and there are few, if any, restrictions on capital account transactions. These reforms, which figure so prominently in the decision making process of foreign investors, were introduced in time to face the new realities of international capital markets. Since 1990, private capital from the United States and other developed countries has defied pessimistic predictions following the severe economic crisis of the 1980s, with huge inflows into the region and emerging markets across the world.⁶ This time the flows were led not by commercial bank loans but by direct and portfolio investment, which comprised 92 percent of total net private capital flows in the period 1990 to 1994 (World Bank 1996). This late change of modality of flows breeds opportunities and risks for the recipient countries, which are addressed in later sections.

SIZE AND COMPOSITION OF PRIVATE CAPITAL FLOWS

As stated in the introduction, this description focuses on private FDI and FPI flows. In the last 25 years, FDI has played a larger role than FPI in all countries of the Andean region except Venezuela (see Table 3.1 on breakdown between FDI and FPI). While the region suffered following the 1982 debt crisis, during the 1990s the combined flows of FDI and FPI have surged dramatically in all five Andean countries.

⁴ Source: Price Waterhouse, *Doing Business in Peru, Venezuela, Colombia and Ecuador* and The Economist Intelligence Unit, *Country Profiles*.

⁵ However, in both Ecuador and Venezuela, exploration, exploitation and refining can be contracted out to foreign firms by the state company.

⁶ Total net capital flows to the developing world increased from \$101.9 billion in 1990 to \$207.4 billion in 1994. Of these, private flows accounted for forty-three percent of the total in 1990, and seventy-seven percent in 1994. The exceptionally high participation of private capital of late marks a return to the composition of flows that were observed early in the century (World Bank 1996).

TABLE 3.1. FINANCIAL FLOWS, 1970–94 (millions of dollars)

Country	Annual Average	Direct Investment	Portfolio Investment
Bolivia	1976–79	9.3	0.0
	1980–89	14.7	-0.6
	1990–94	23.2	1.3
Colombia	1970–79	53.1	0.9
	1980–89	478.5	26.6
	1990–94	862.4	219.6
Ecuador	1976–79	31.65	14.42
	1980–89	89.1	0.0
	1990–94	292.8	0.0
Peru	1980–89	28.9	0.0
	1990–94	740	162.4
Venezuela	1970–79	-102.1	126.4
	1980–89	100.7	304.9
	1990–94	836.2	3307

Source: IMF, 1995.

FDI in the Andean countries has generally followed the trends witnessed in Latin America. Historically, until 1975, Latin America was the largest recipient of FDI in the developing world. However, following the debt crisis of the early 1980s, South and East Asia and, to a lesser extent, Europe and Central Asia, have attracted a greater percentage of FDI targeted to developing economies (Massad 1993). Even after world FDI inflows to Latin America recovered from the debt crisis, and 11 percent of 1994 world FDI flowed to the region, South and East Asian countries received 23 percent of world FDI flows (IDB/IRELA 1996).

The recent recovery of FDI flows into the Andean countries has been impressive. Table 3.2 illustrates how, from 1990 to 1994, annual flows into each country have dramatically increased over the previous decade. The recovery of FDI in the Andean countries can also be highlighted by comparing it with the FDI net flows in Mexico and Mercosur (Chile included). As Table 3.2 shows, Mercosur and Mexico have seen a steady increase in average annual flows throughout the period. The Andean region, on the other hand, experienced net outflows from 1985 to 1990. Mexico's exceptional performance is easily understood in light of the expectations generated by the North American Free Trade Agreement (NAFTA) and the reforms enacted during the period. But the performance of the Andean countries in 1990–94 is no less impressive, as the growth rate of FDI net flows surpass that of Mercosur, a trade block that enjoys wider recognition in the world.

TABLE 3.2. AVERAGE ANNUAL FDI INFLOWS (millions of dollars)

	1980–84	1985–89	1990–94
Bolivia	0	0	2
Colombia	271	-451	159
Ecuador	20	53	83
Peru	143	-110	264
Venezuela	-16	101	743
Total Andean	417	-406	1250
Mexico	527	609	2727
Mercosur	1864	2207	4726

Note: Mercosur includes Chile.

Source: IDB/ IRELA 1996, Table 22, p. 109.

Foreign portfolio flows into the Andean countries, while recently dynamic, are still no match for the performance of FDI inflows, nor do they compare favorably with those received by the largest countries of the Latin American region. After a lull that spanned at least six decades, net FPI flows—composed of equity and

bond investments—to Latin America reemerged during the 1990s, representing half of total FPI net flows to developing regions. In 1994, however, largely due to external factors—such as rising U.S. short-term interest rates—and political and economic problems in Mexico, net flows declined and were surpassed by those to East and South Asia (World Bank 1996). The bulk of FPI flows destined to Latin America were concentrated in Argentina, Brazil and Mexico. Within the Andean countries, Venezuela stands out as a special case. This country's immense oil wealth afforded it relatively easy access to the international bond markets starting in the mid-1970s. In the period 1976 to 1983, portfolio inflows surpassed FDI inflows year after year. Following a period in which no activity registered from 1984 to 1988, and a net outflow in 1989, portfolio inflows resumed. In 1990, Venezuela received approximately 68 percent of total portfolio inflows to Latin America and the Caribbean. The bulk of this activity has been in the bond market. FPI flows to Bolivia and Ecuador have largely been immaterial, while both Peru and Colombia have experienced sustained expansion of these flows in the present decade, the former country primarily in equity and the latter chiefly in bonds.

Geographical Sources

Countries tend to invest within their own geographical regions. Indeed, as stated in the introduction, the United States has been the major source of FDI to Latin America, as well as to the Andean region specifically (see Tables 3.3 and 3.4). Throughout the period 1980 to 1994, the United States dominated the share of FDI *stocks* in all of the individual countries except Peru. In Bolivia, the United States has consistently held two-thirds of total FDI stock. In this decade, the U.S. share is declining in Colombia, Venezuela, and Peru, due to increased flows to other regions -- especially offshore centers -- and displacement from European investment.⁷

TABLE 3.3. FDI STOCK IN ANDEAN COUNTRIES BY COUNTRY OF ORIGIN
(percent of total FDI stock)

	1980			1985			1990			1994		
	U.S.	EU	Japan	U.S.	EU	Japan	U.S.	EU	Japan	U.S.	EU	Japan
Bolivia	64.6	13.7	0.3	70.0	11.7	0.2	64.0	10.3	0.2	66.4	10.0	0.5
Colombia	54.1	23.6	1.1	64.1	21.5	1.8	70.6	16.6	1.2	57.5	17.7	1.8 /a
Ecuador	54.3	15.2	1.5	54.1	18.1	1.3	54.1	18.3	1.3	63.1	18.6	0.7
Peru	55.5	21.2	3.4	49.9	22.9	4.3	46.6	26.9	2.8	16.7	65.8	0.8 /b
Venezuela	56.9	17.0	0.6	52.9	24.0	2.9	49.1	30.6	4.6	48.8	30.3	3.4

EU = European Union. a as of June 1995; b. as of November 1995
Source: IDB/IRELA 1996, Tables 41, 44, 45, 47, and 48.

TABLE 3.4. AVERAGE ANNUAL FDI FLOWS BY SOURCE (millions of dollars)

	1980 -84			1985-89			1990 - 94		
	U.S.	EU	Japan	U.S.	Europe	Japan	U.S.	EU	Japan
Bolivia	—	0	0	—	0	—	—	2	—
Colombia	240	25	6	-473	21	1	169	-24	13
Ecuador	13	7	0	34	19	0	74	8	1
Peru	130	8	6	-78	16	-48	-41	310	-5
Venezuela	-62	44	1	7	85	9	569	137	36
Total Andean	321	84	13	-510	142	-38	771	433	46
Total Latin America	1,263	1,176	435	941	1,265	149	6,732	2,082	386

— . Not available. Source: IDB/IRELA 1996, Tables 24-26.

In the 1980s, U.S. FDI flows were curtailed dramatically, to the extent that the United States lost its dominance in the region in FDI terms. Of the \$1.26 billion in foreign direct investment that the United States sent to Latin America annually (on average) in the period 1980 to 1984, \$321 million, about 77 percent of all FDI to the region, went to the Andean countries. In the period 1985 to 1989, U.S. FDI to Latin America fell to \$941 million annually (on average), and the Andean countries experienced a net *outflow* to the United States of \$510 million. U.S. direct investment resumed in the early 1990s, nearly quadrupling between 1990 and 1994. The

⁷ This is based on the Economist Intelligence Unit, *Country Profiles* and IDB and IRELA, *op. cit.*

United States once again dominated net FDI flows to the Andean countries, with \$771 million annually, or 62 percent of total net flows to the group (IDB/IRELA 1996).

Europe has contributed significantly to FDI flows in Latin America, outpacing the United States from 1985 to 1989 (see Table 3.4). Even as U.S. and Japanese firms were divesting, FDI flows from Europe remained fairly consistent throughout the 1980s. During the latter half of the 1980s Europe's share of FDI rose to 53.7 percent. In the early 1990s, as U.S. investment increased dramatically, Europe's share fell to 22.6 percent, though its absolute contribution rose. Within the Andean region in particular, European private capital has steadily increased, from one-fifth of flows in the period 1980–84, to 35 percent in the period 1990–94.⁸

The share of foreign direct investment in Latin America by Japanese firms has been on a downward trend, in part for geographic reasons, as well as a reflection of the slow performance of the Japanese economy. At the same time, the Andean region has seen a slight increase in Japanese participation in FDI, as seen in Table 3.4.

It is also interesting to note that the 1990s are characterized by increasing intraregional FDI flows. This trend reflects the new openness of foreign investment regimes and the improved prospects for economic growth. In 1995, as much as 11.5 percent of FDI stock in Bolivia was held by private investors from Latin America. The participation in the rest of the countries is smaller — 6.8 percent in Colombia, 5.9 percent in Peru, 5.1 percent in Ecuador, and 0.9 percent in Venezuela. Significantly, the main Latin American holders of Colombian FDI stock are Ecuadorian and Venezuelan private firms, while in Ecuador they are Colombian and Venezuelan concerns (IDB/IRELA 1996).

Sectoral Distribution

The mining, quarrying and petroleum sectors attract the largest share of FDI in Bolivia, Colombia and Ecuador, while other sectors have replaced primary sector investment in Peru and Venezuela (see Table 3.5).

TABLE 3.5. SECTORAL DISTRIBUTION OF FDI STOCK

		Millions of \$	% of total	Millions of \$	% of total	Millions of \$	% of total	Millions of \$	% of total
		1980		1985		1990		1994	
Bolivia	primary	282	67.2	424	71.6	575	71.4	963	75.8
	secondary	62	14.8	84	14.1	106	13.2	138	10.9
	tertiary	76	18.0	85	14.3	124	15.4	159	13.3
	TOTAL	420	100.0	592	100.0	806	100.0	1,270	100.0
Colombia	primary	55	6.1	748	33.5	5,584	74.7	7,489	61.2
	secondary	750	70.7	1,127	50.5	1,485	19.9	2,487	20.3
	tertiary	246	23.2	356	15.9	408	5.5	2,256	18.4
	TOTAL	1,061	100.0	2,231	100.0	7,478	100.0	12,235	100.0
Ecuador	primary	201	27.9	244	24.9	341	249.0	1,391	51.4
	secondary	274	38.1	434	44.3	606	44.3	837	30.9
	tertiary	245	34.0	303	30.9	422	30.8	479	17.7
	TOTAL	719	100.0	982	100.0	1,370	100.0	2,708	100.0
Peru	primary	393	43.8	423	36.7	458	34.4	1,009	20.9
	secondary	308	34.3	394	34.2	438	32.9	655	13.6
	tertiary	197	21.9	335	29.1	434	32.7	3,161	65.5
	TOTAL	898	100.0	1,152	100.0	1,330	100.0	4,825	100.0
Venezuela	primary	28	1.8	39	2.5	192	5.4	216	3.2
	secondary	989	61.7	1,140	73.7	2,731	76.3	3,943	57.8
	tertiary	587	36.6	368	23.8	658	18.4	2,670	39.1
	TOTAL	1,604	100.0	1,548	100.0	3,581	100.0	6,826	100.0

Primary = agriculture, mining, quarrying and petroleum. Secondary = food, beverages, tobacco, textiles leather, clothing, chemicals, rubber, plastics, machinery, metals and transport equipment s. Tertiary = distributive trade, transport and communication, finance, insurance and other services.

Source: IDB/IRELA Tables 50, 53, 54, 56, 57.

In Colombia the dramatic shift of stocks to the primary sector has come at the expense of the secondary sector. This may be testimony to Colombia's poor record of attracting FDI in the manufacturing sector in the last two decades—despite the exceptionally large size of its domestic market, excellent geographical location and, most importantly, its dynamic, regionally competitive industrial base. In Ecuador, mining, quarrying and

⁸ This figure is skewed by the huge increase in European investment to Peru in 1994, totaling \$1.48 billion alone.

petroleum now account for more than half of FDI stock, nearly doubling in importance since 1980. This higher participation coincided with declines in both the secondary and tertiary sectors. During this same period in Peru, on the other hand, the mining, quarrying and petroleum sectors, and manufacturing saw large declines. The latter probably reflected the phasing out of many industries that were long sheltered by high tariff walls. FDI shifted increasingly to the transportation and communication sectors—from 0.5 percent in 1980 to 42.1 percent in 1994. Finally, in Venezuela, the bulk of FDI stock has consistently been concentrated in the secondary and tertiary sectors. The combined shares of these sectors reach 97 percent (IDB/ IRELA 1996).

FDI flows from the United States have generally followed sectoral trends (see Table 3.6). U.S. FDI in the Latin American region focused mainly on primary goods during the first four decades of this century. Since then, the manufacturing industry has been the major recipient of U.S. FDI flows, though recently natural resources and services have received more inflows, with more open legislation and increased privatization in host countries.

TABLE 3.6. U.S. DIRECT INVESTMENT BY SECTOR
(stocks as percent of total U.S. direct investment)

		Petroleum	Manufacturing	Wholesale	Banking	Finance	Services	Other
		Trade			(a)			
1995	Colombia	37.9	32.7	4.0	0.0	9.1	0.5	0.0
	Ecuador	77.8	15.3	5.8	0.0	0.0	0.0	0.0
	Peru	8.3	5.4	4.9	0.0	0.1	0.0	78.5
	Venezuela	0.0	51.8	11.8	0.0	2.4	0.8	23.9
	Bolivia	41.1	0.0	0.3	0.8	0.0	0.0	57.9
1990	Colombia	27.5	35.4	4.7	0.0	1.8	-0.2	0.0
	Ecuador	36.4	28.2	10.0	0.0	0.0	0.0	0.0
	Peru	0.0	9.7	11.0	1.0	0.0	0.0	71.0
	Venezuela	10.4	62.0	16.5	0.0	0.0	2.1	1.2
	Bolivia	85.7	0.0	1.0	0.5	0.0	0.0	12.8
1985	Colombia	48.1	29.2	2.8	0.0	3.5	0.7	0.0
	Ecuador	0.0	38.6	5.7	-1.4	3.1	2.3	0.0
	Peru	42.3	5.3	5.0	0.5	0.1	0.0	0.0
	Venezuela	4.2	53.1	15.6	1.1	12.1	5.7	8.3
1970	Colombia	2.1	23.5	42.8	4.5	6.3	0.0	0.0
	Peru	0.0	9.0	21.0	-0.1	4.7	0.0	3.2
	Venezuela	3.5	64.3	18.6	0.0	0.0	4.1	1.5
1960	Colombia	0.0	55.0	21.7	6.6	10.8	0.0	0.0
	Peru	60.7	15.9	7.1	3.8	8.5	0.0	4.0
	Venezuela	0.0	77.7	7.0	1.2	6.4	0.0	0.0

Source: U.S. Department of Commerce, Bureau of Economic Analysis 1997.

In 1960, the petroleum sector received the greatest proportion of U.S. direct investment flows in all of Latin America and comprised the majority of U.S. FDI stock in Colombia and in Venezuela. In Peru, mining represented the largest portion of U.S. FDI stock in 1960. By 1970, reflecting the results of the import substitution industrialization model, FDI flows were geared toward manufacturing. By 1985, U.S. FDI stock in manufacturing in Colombia and Peru had declined significantly, as the importance of the petroleum sector increased. In Venezuela, on the other hand, the share of manufacturing had risen to over half of U.S. FDI stock, reflecting the expansion of private and public consumption that followed the successive hikes in oil prices in the 1970s. In the 1990s, mining industries (especially oil and coal) in Peru, Colombia, and Ecuador have received greater attention from U.S. firms. In Venezuela, U.S. companies took advantage of the privatization program to become involved in the service and power-generation industries (see Table 3.6).

The shifting trends in the 1990s are unmistakable. As noted, there has been a tremendous growth in Peru's transport and communication sectors, with 65 percent of all U.S. FDI in the present decade. While the U.S. Department of Commerce does not isolate this sector, the sudden concentration of U.S. FDI into Peru's

“other” sector reinforces the conclusion that the United States is playing an important role in this increase. U.S. investment in petroleum still dominates in Bolivia, Ecuador and Colombia. In Venezuela, the manufacturing sector is still the greatest recipient of U.S. FDI stock.

With respect to FPI flows, U.S. portfolio investment in the Andean region has greatly increased in the 1990s in the three largest economies, as illustrated in Table 3.7. Andean long-term investment liabilities to the United States⁹ were small and mainly negative through the 1980s, with the majority of activity in Venezuela and Colombia. In the early 1990s, transactions with the U.S. grew quickly, and to a large extent, U.S. purchases of Andean securities have greatly outweighed U.S. sales, especially in Colombia and Peru. In both Venezuela and Colombia bonds dominate while in Peru stocks are most actively traded.

TABLE 3.7. U.S. NET PURCHASES OF ANDEAN BONDS AND STOCKS, 1980–96
(millions of dollars)

	Colombia		Peru		Venezuela	
	Bonds	Stocks	Bonds	Stocks	Bonds	Stocks
1980	-16	2	-1	0	-63	-1
1981	-8	-2	0	0	-10	-2
1982	-3	-1	-5	0	-25	2
1983	-3	3	-2	0	71	-4
1984	-11	-3	-5	1	-204	1
1985	0	0	-3	0	-19	-1
1986	-24	2	-3	-1	-65	-2
1987	1	-1	-27	7	-50	-1
1988	-6	-3	16	0	14	-6
1989	-23	-1	-13	4	-12	1
1990	-63	1	13	0	2,096	-1
1991	-63	-6	7	-2	-69	-49
1992	-26	16	-34	40	-290	79
1993	-38	81	-94	160	264	-6
1994	515	329	33	414	-39	35
1995	234	120	48	87	-344	-41
1996	693	144	13	283	-241	-72

Source: U.S. Treasury Department, *Treasury Bulletin* various issues.

DETERMINANTS OF PRIVATE CAPITAL FLOWS

The determinants of private capital flows can be classified as external—taking place at the source—and internal—in the recipient countries. Among the external factors, current account surpluses, economic growth, and a decline in real interest rates in source countries may increase capital outflows. Conversely, recession at home coupled with rising real interest rates dampen outflows of capital and cycles of slack growth, in combination with high finance costs dampen profits and thus limit the possibilities for expanding overseas. The retrenchment of direct investment and portfolio outflows from U.S. firms in the 1980s may have been associated with the increasing domestic demand for capital that was in part necessary to finance the wave of mergers and acquisitions in the United States during the last decade. Notwithstanding the fact that European companies also focused more on investments within their own countries, their investment expenditures in the Latin American region did not slow down. Finally, Japan, never a large player in the Andean countries as a capital exporter, decreased its international investments due to economic and financial problems at home.

The most important internal factors that determine private capital flows are:

- (a) Macroeconomic stability, including an economic environment free of high inflation and interest and exchange rate fluctuations, as well as a reasonable expectation that balance of payments crises will not occur and that the burden of foreign debt can be adequately managed.
- (b) Expectation for high rates of economic growth and access to domestic and export markets.
- (c) An investor-friendly foreign investment regime and a stable regulatory environment.

⁹ Following the U.S. Treasury Bulletin methodology, long-term investment liabilities of a country to the U.S. consist of U.S. purchases of the country's stocks and bonds minus U.S. sales of that country's stocks and bonds.

Foreign Direct Investment

If conditions for foreign direct investment are ripe in source countries, both the *location* and *modality* of the flows become central issues. The Andean countries compete for direct flows from the United States not only with Mercosur, Mexico and Central America, but also with developing countries outside the Western Hemisphere. The success that the Andean countries have had in attracting private capital flows—especially FDI—in the 1990s suggest that this group is holding its own very well vis-à-vis other active blocks within the region, such as Mercosur. Modality, on the other hand, is strongly related, at least in the short run, to structural economic conditions of host countries and to the corporate strategies of the investors. For example,

- (a) Firms may target domestic markets of the recipient countries. Profits depend largely on the unimpeded access to imported inputs and on protection from foreign competitors. In general terms, this strategy fits with an industrial strategy that favors industrialization via import substitution in host countries.
- (b) Firms may choose countries as export platforms of manufacturing products to other countries. In this case, operating costs—labor unit costs, public utilities, transportation—as well as the tax rate determine profits.¹⁰
- (c) Firms may be attracted by the natural resources of the host country, under the expectation that the exploitation of agricultural, mining and petroleum products may be cheaper than if acquired at the source. This type of investment also depends on international commodity prices.
- (d) Firms may seek to exploit opportunities in the services sector, such as in transportation, finance, energy and telecommunications. In this case, the focus is on the domestic market, but there are cases where export of some of these services, that is, energy, to neighboring countries is a distinct possibility.

In our opinion, the key determinants to attracting FDI flows are internal factors. For all practical purposes, it is these internal factors that determine the profitability of capital investment in host countries. That is, private firms expect not only a reasonable return on investment, sufficiently high to cover the perceived country risk, but also a higher return than that which they can obtain both in their own countries and in other developing regions.

There are several main internal factors that account for the larger FDI flows that have been observed in recent years. The first is the expected natural recovery from the very low levels of foreign direct investment observed in the 1980s. As the debt-induced foreign exchange constraint subsides, transactions costs of importing intermediate goods decrease and the remittance of dividends eases, attracting foreign capital again. In fact, this is precisely what happened, as debt service ratios declined considerably in the period 1989 to 1995, most notably in Colombia, Ecuador and Venezuela. This period, significantly, also signaled the end of severe balance of payments constraints as the region experienced sustained increases in the accumulation of foreign reserves.¹¹

A second important determinant has been the better prospect for economic growth that has resulted from increased macroeconomic stability.¹²

Within the Andean region, the record is uneven. Notwithstanding the unfortunate developments of 1996, which can be largely traced to disputes with the United States, this is probably not an issue in Colombia. This country is distinguished by a strong reputation of macroeconomic stability dating from the 1960s. Fiscal deficits, as a rule, have been kept in check and financed in noninflationary ways. Nevertheless, other than oil and mining, the foreign direct investment inflows are relatively much smaller than in similar countries, such as Argentina, Chile and Mexico, which have been characteristically unstable in the last thirty years. Macroeconomic stability probably is relevant in Peru, which has experienced a spectacular turnaround of its economy in this decade, through the application of a draconian stabilization program that has introduced far-reaching structural reforms

¹⁰ The early industrialization stages in East Asian countries and Mexico's policies to promote *maquiladoras* fit this strategy. *Maquiladoras* are in-bond manufacturing and assembly operations with special status that allows them to import raw materials and component parts duty free then re-export the finished product.

¹¹ The exceptions were Bolivia in 1993 and Venezuela, which suffered severe losses of reserves in the period 1992 to 1995, probably explained by the political crisis of 1992 to 1993 and the collapse of the banking system in 1994. Colombia, Ecuador, and Peru showed substantial increases in reserves. In the last two countries, however, the rising reserves masked unserviced debt payments to private commercial banks. While the relationship between foreign capital flows and the level of reserves are positively correlated, it is wrong to ascertain that a healthy level of reserves is a cause of expected larger inflows of foreign investment. For example, in Peru the reverse was true.

¹² As with the relationship between reserves and foreign investment, causality between prospects for high economic growth and foreign direct investment runs both ways. While the former may attract the latter, foreign direct investment can also contribute to higher economic growth.

and has brought inflation down to single-digit levels for the first time since the 1960s. In Venezuela, a country as rich as if not richer than Colombia, the question is to what extent inflows would have come in had the country been spared from the political turmoil and financial crisis that rocked the economy in 1992–95. Lastly, Bolivia and Ecuador, the poorest members of the group, exhibit deeper macroeconomic fragilities and are vulnerable to the vagaries of foreign aid and to adverse changes in the prices of international commodities.

The structural reforms introduced by the countries in this decade have played a prominent role in attracting foreign direct investment. Trade, exchange and financial reforms improve the investment environment by promoting competition, encouraging private domestic enterprise and, ultimately, obtaining higher levels of output and productivity. In Peru, for example, comprehensive financial reform has led to the entry of foreign banks, not merely through the acquisition of state banks but also via greenfield investments. The trade and exchange reforms likely also account for increases in FDI flows to the mining sector. A typical tradable activity, mining development is no longer hampered by restrictions on foreign exchange convertibility or by import quotas. On the other hand, some historical examples demonstrate that foreign direct investment can be vibrant under less-than-liberal regimes. For instance, during the period 1971 to 1977, when the highly restrictive *Decisión 24* was enforced, the annual increase of foreign direct investment was 7.6 percent in the Andean countries (White 1986).

Two policy instruments of a transitory, or ad hoc, nature, privatization and debt-equity swaps, may have been determinants of foreign direct investment in the Andean countries. Colombia is the exception: this country never suffered from an acute debt overhang problem, its debt notes were not traded in the secondary market at deep discounts, and authorities probably deeply distrusted the alleged tradeoff of the explicit subsidies inherent in swap transactions in return for additional investment. Thus, a debt-equity swap program à la Chile never transpired in Colombia. Neither has privatization been a factor, probably because of domestic political opposition, but also because public sector reform in Colombia has not taken on the urgency of other countries in the region. In Venezuela, on the other hand, debt-equity swaps have been a major determinant of foreign investment flows in 1989 and 1990, while the privatizations (in particular, of the national telephone company and the national airline) accounted for the majority of total direct investment flows in 1991. Subsequently, in 1992 through 1995, FDI inflows, as in Colombia, were led by regular direct investment. In Peru, privatization of state-owned concerns has been the catalyst of FDI. The sectors that have received the most attention by foreign investors have been communications, mining, electricity and banking. In Bolivia, privatization has only lately emerged as a source of significant FDI flows,¹³ while in Ecuador, it has yet to play a decisive role.

The privatization transactions in Venezuela, Peru and recently Bolivia have illustrated the sectoral shift of FDI flows observed in the 1990s that were detailed in the last section. In effect, foreign investment-via-privatization has not materialized in manufacturing, but in telecommunications, mining, oil, energy and transportation. What this signals is that foreign investors in the Andean region have embraced a modality that reveals strong preference for natural resources and services in the host countries. Neither manufacturing nor *maquila*-type investments appear to be part of the corporate strategies of foreign investors, at least for the time being. The Andean countries, consequently, now experience a return to the modality of yesteryear, which is explained by the dynamics inherent in globalized production and technological change, by the more liberal orientation of their overall economic policies, and by the profit incentives that emanate from these. In this regard, both natural resources and services activities now offer plenty of opportunities, the former because of lower operation costs vis-à-vis production in developed countries, and the latter for the huge rents that potentially can be earned.¹⁴

Higher returns on investment do not provide a clear explanation for the flows to the Andean region. Notwithstanding the progress made, the Andean countries have not offered the higher returns obtained in East Asian countries, at least until 1996. In the 1980s, the annual rate of return of U.S. direct investment in Latin America rose from 6.6 percent in 1984 to 12.5 percent in 1988, while that for East Asia and other

¹³ U.S. firms have been most active in the electricity and oil and gas sectors. The telecommunications, railroads and airlines companies were bought by Italian, Chilean, and Brazilian concerns, respectively.

¹⁴ Telecommunications, energy and, to a lesser extent, transportation are sectors with market structures that approximate natural monopoly or oligopolistic conditions.

developing countries varied between 13.2 percent and 24.9 percent per year in the same period.¹⁵ More recently, during the period 1990 to 1995, the annual rate of return on U.S. direct investments in the Latin American region has increased on average to 14.5 percent. With the exception of Ecuador, where the average annual rate of return declined to 8 percent, the performance in the rest of the Andean countries improved considerably. It was led by Venezuela, which posted an annual average rate of return of 23.5 percent, the highest in the Latin American region, followed by Colombia (17.5 percent) and Peru (8.5 percent) (ECLAC 1996). However, there have been limits to higher returns, such as the presence of segmented domestic markets, inefficient mobilization of internal resources and, most critically, the low quality of economic infrastructure. Political and social instability also increases the risk and cost of investments. Within the Hemisphere for example, the Andean countries cannot yet match the political and social stability that Chile offers. Some, most notably Colombia and Peru, are still beset by guerrilla or domestic violence and social unrest, while Ecuador and Bolivia are still riddled by widespread poverty and inequality.¹⁶

We conclude by noting that the fact that the Latin American region was an early recipient of foreign direct investment in primary activities does not doom the region to remain specialized in natural resources. Nor does it imply that the export of commodities is the only way for the region to integrate into international markets. Unfortunately, for many decades the prevailing view among policymakers was that in order to break the vicious circle of dependence it was necessary to promote protected industrialization *à outrance*, even to the neglect of the development of the primary sector.¹⁷ Within the Andean region, in the period 1980 to 1994, as noted before, the share of mining, quarrying and petroleum in Bolivia's total stock of FDI has never been below two thirds, which is indeed consistent with the historical record of this country. However, in Peru, also historically a "mining" country, the share of these activities now account for only a fifth of total FDI stock, while that for Colombia and Ecuador has significantly increased in the last fifteen years. This suggests that the economic sectors within countries may become more or less attractive relative to each other with the passing of time. If there is a match of investment opportunities with the corporate strategy of transnational corporations, then foreign direct investment presumably follows. Whether these investments permanently benefit the host countries will depend on the overall direction of economic policy.

Indeed, the growth rate of foreign direct investment in the Andean region would undoubtedly have been much higher in the 1970s if *Decisión 24* had been scrapped earlier. Colombia's oil and mining sectors would today be the recipients of substantially larger inflows, had these sectors been subject to a more open regulatory framework. The enactment of more liberal foreign investment codes dates back to 1990 in Bolivia and Venezuela, 1991 in Ecuador and Colombia, and 1992 in Peru. These codes cannot thus be identified as main determinants of the current flows, especially in a region that is still widely perceived, with the notable exception of Colombia, as handicapped by a recent history of unstable, unpredictable "rules of the game."¹⁸ However, with the passing of time, if the overall characteristics and orientation of the new regimes stay, it is expected that they can play a more fundamental role in attracting larger flows of foreign direct investment.

¹⁵ See The Institute of International Finance Inc, *Fostering Foreign Direct Investment in Latin America*, July 1990. Within the Andean region Ecuador was the stellar performer, with an annual average rate of return of 14.52 percent for the period. It was followed by Venezuela and Colombia, which posted average rates of return of 9.36 percent and 4.96 percent respectively. Peru performed very badly with an annual average of -1.7 percent. No data was available for Bolivia. By way of comparison Chile, which instituted a very liberal foreign investment regime in the 1970s, and which implemented a debt swap program to attract new foreign investment, showed an annual rate of return of 44 percent, the highest in the entire Latin American region.

¹⁶ In the region, especially in Peru and Colombia, it is not uncommon for local and foreign firms to spend hefty resources in personnel security. Kidnappings of executives and workers, unfortunately, are far from being isolated incidents, and take place both in cities and in production sites in the countryside. Recent developments in Colombia, for example, have led foreign oil firms to halt exploration activities.

¹⁷ The unfortunate consequence was sluggish productivity growth and loss of competitive position vis-a-vis producers of other regions. But, as the development historical record of Malaysia shows, the promotion of investments in natural resources (in this case rubber) does not oppose the growth of manufacturing industry.

¹⁸ It is worth highlighting the fact that Steiner and Gordon, in their penetrating analysis of the Colombian experience, do not give much weight to the foreign investment regime as a determinant of the flows. The corporate strategy of foreign firms and macroeconomic conditions in Colombia are assigned higher explanatory power. Their findings are based on a survey of firms.

Foreign Portfolio Investment

While internal factors play the determining role in the pattern of FDI, external factors, most notably economic recession and the decline of short-term interest rates in the United States, determine FPI flows.¹⁹ With regard to bonds, the spreads between U.S. Treasury bills and yields in the largest Latin American economies were particularly wide during the early 1990s. Among the Andean countries, Colombia and Venezuela have been active participants in the international bond market. In these two countries, unlike in the larger countries outside the Andean region, the public sector played a large role during the period 1993 to 1995—77 percent in Colombia and 95 percent in Venezuela. This was so for entirely different reasons. In the case of Colombia, bonds were issued to finance public works and operations of state enterprises and state development banks, while in Venezuela the government issued bonds to offset the sharp drop of domestic savings and investment that followed the economic crisis and banking collapse of 1994. In addition, the severity of the crisis made it all but impossible for private firms to have access to the international bond market (ECLAC 1996).

With respect to equity, rule 144-A of the U.S. Securities and Exchange Commission enables Latin American firms to issue American Depository Receipts (ADRs) directly in U.S. capital markets in substantially less time and at lower costs than what is normally required for ADRs traded in the New York Stock Exchange (ECLAC 1996). These instruments have been very useful in attracting foreign capital. In the period 1990 to 1994, Colombian firms showed a strong preference for equity issues placed internationally (68 percent of total equity portfolio inflows). In Peru and Venezuela, international issues played a smaller role (28 percent and 24 percent, respectively) vis-à-vis inflows channeled directly into domestic capital markets. Colombia's preference for international placements suggests that firms find it less expensive to raise funds in New York than domestically. On the other hand, Peru and Venezuela's capital market are even less developed than Colombia's. It is highly plausible that the higher share of domestic placements in Venezuela is related, not unlike the situation in the international bond market, to the difficulties that private firms have sustained as a result of the crisis. In Peru, this may be due to the relatively small number of firms that have both the resources and the credit rating to place issues internationally. In addition, the interest of foreign investors in Peru's domestic capital market may also reflect the expectation of substantial equity appreciation.

Larger inflows of FPI have helped bolster the dynamism of capital markets in the Andean region. These events have forced the countries to introduce important regulatory reforms which, in turn, should help attract a larger volume of inflows in the future.

As of 1995, as evidenced by an analytical survey (Daly, Harris, and Tacker 1995), the record among the five countries was uneven. In terms of total market capitalization and volume of daily trading, capital markets were developing very rapidly in Colombia and Peru and very slowly in Ecuador, Bolivia and Venezuela. Corporate equity was actively traded in Colombia and Peru, but not in Ecuador, Bolivia and Venezuela. Laws and regulations were considered to be adequate in Colombia, Peru and Ecuador, but inadequate in Venezuela and Bolivia. Investors were reasonably protected in Colombia and Peru, but not in Ecuador, Bolivia and Venezuela. Information disclosure requirements were adequate in Colombia, Peru and Ecuador, but not in Bolivia and Venezuela.

MACROECONOMIC IMPACT, RISKS, AND CHALLENGES

The importance of private capital flows in the Andean economies has grown in the 1990s. Relative to economic size, the impact has been greater in Peru, Bolivia and Ecuador than in Colombia and Venezuela. Table 3.8, which depicts net FDI flows as a percentage of gross domestic product (GDP) for the period 1990 to 1995, illustrates this point.

¹⁹ Recent studies include Guillermo Calvo, Leonardo Leiderman, and Carmen Reinhart. 1993. *Capital Flows to Latin America: The Role of External and Domestic Factors*. International Monetary Fund (IMF) Staff Papers.

TABLE 3.8. FDI NET FLOWS, 1990–1995 (percent of GDP)

	1990	1991	1992	1993	1994	1995
Bolivia	0.26	2.02	2.41	2.4	2.45	6.79
Colombia	1.32	1.15	1.69	1.85	2.29	2.35
Ecuador	1.28	1.45	1.48	3.42	3.36	2.9
Venezuela	0.96	3.66	1.07	0.64	1.33	0.97
Peru	0.14	-0.02	0.5	0.94	4.71	3.18

Source: ECLAC 1996.

Privatization processes are the primary explanation for the spectacular increases in Peru since 1993 and in Bolivia in 1995. Venezuela's poor showing is definitely associated with the political and economic crises that the country has endured since 1992.

The importance is also highlighted when considering FDI net flows as percentage of gross investment. This is demonstrated in Table 3.9. Since 1990, Bolivia's and Ecuador's gross capital formation has increasingly relied on inflows from foreign investors. This is not surprising at all, for more openness in these smaller economies unveils the inherent weakness of local entrepreneurs. In Peru the role of FDI in capital formation was significantly higher since 1993, but this is chiefly tied to privatization. Once this process is finished, it is expected that the contribution of foreign investment to gross capital formation will gradually decline, as was already evident in 1995.

TABLE 3.9. FDI NET FLOWS (as a percentage of Gross Investment and Gross Investment coefficients)

		1990	1991	1992	1993	1994	1995
Bolivia	FDI Flows	2.07	12.96	14.44	13.61	14.83	34.84
	Coefficient	12.5	15.6	16.7	16.6	14.4	15.2
Colombia	FDI Flows	7.12	7.21	9.81	8.73	10.84	9.33
	Coefficient	18.5	16.0	17.2	21.2	23.3	23.5
Ecuador	FDI Flows	7.3	6.53	6.99	16.93	17.77	15.57
	Coefficient	17.5	22.2	21.2	21.1	19.0	18.7
Peru	FDI Flows	0.89	-0.17	3.02	5.09	21.42	13.14
	Coefficient	21.1	20.2	20.5	22.2	23.8	24.3
Venezuela	FDI Flows	9.37	19.57	4.53	3.4	10.06	6.13
	Coefficient	10.2	18.7	23.7	18.7	12.8	11.5

Source: For FDI Flows, ECLAC (1996). For coefficients, IDB (1997).

Since Peru probably has the most open foreign investment regime among the members of the group, the relative weight of foreign investment in gross capital formation will probably remain higher than Colombia's unless, of course, this country takes decisive steps to attract more inflows in the manufacturing and service sectors. In Venezuela, the relative weight of net FDI flows has been erratic. Following the large privatizations in 1991 that sent the contribution of net FDI flows to gross investment soaring to 19 percent, this coefficient declined sharply in 1992 and 1993.

Table 3.9 shows that it is not clear whether FDI is contributing to capital formation in the Andean countries. In Colombia, the gross investment coefficient increased but the contribution of FDI flows to total investment has held steady. Therefore, it is plausible that domestic investment flows better explain the increase in gross capital formation. In Ecuador, increasing FDI flows have been accompanied by *lower* gross investment coefficients. This raises the possibility that FDI, rather than contributing to gross capital formation, may be perversely *displacing* domestic investment. In Bolivia, while the share of FDI in gross capital formation also increased substantially, the gross investment coefficient has remained stable. This suggests a very weak response of total investment to larger FDI flows. On the other hand, it is quite plausible that FDI has had a greater impact on capital formation in Venezuela and Peru.²⁰

²⁰ As noted before, privatization largely explains the FDI flows in Venezuela and Peru. The fact that larger FDI inflows-via-privatization correlates with increases of gross investment coefficients in both countries (1991 in Venezuela and from 1992 to 1995 in Peru) suggests that privatization was not merely a transaction of asset exchange. To the contrary, there is every reason to believe that privatization was largely accompanied by a commitment by the new owners to modernize equipment and expand operations. Spain's Telefónica, which acquired the state telephone company in Peru, provides a clear example.

Another macroeconomic impact that must be considered relates to the level of foreign reserves, the current account and the exchange rate. As noted in the previous section, the larger volumes of FDI and FPI inflows have been associated with rising levels of foreign reserves. Certainly these types of inflows have been but a fraction of the total inflows sustained in this decade and thus cannot be held as the sole cause of the accumulation of reserves or the current account deficits that subsequently followed.²¹ In any event, substantial accumulation of reserves as a percentage of total net capital flows in Colombia (65 percent), Ecuador (45 percent) and Peru (40 percent), clearly reflect the priorities of policy makers (Hausmann and Rojas-Suárez 1996). Colombian authorities, probably judging inflows to be composed primarily of short-term maturities and thus inherently volatile, chose to build reserves which, in turn, led to excessive growth of monetary aggregates. During the period 1991 to 1994, while average reserve accumulation as a percentage of GDP was two percent, average growth of M1 was over thirty percent (Hausmann and Rojas-Suárez 1996). In the end, the authorities resorted to partial sterilization in order to avoid an excessive appreciation of the real exchange rate. The authorities in Ecuador faced a similar dilemma. During the same period, average reserve accumulation was slightly above two percent of GDP and the average growth of M1 reached 28 percent. In Peru, on the other hand, while average reserve accumulation was 5.5 percent of GDP, average growth of M1 shot up to 62 percent (Hausmann and Rojas-Suárez 1996). This, however, was a welcome development for policy makers. On one hand, following the mismanagement of the García Administration, foreign reserves, had to be replenished and, on the other hand, a faster pace of monetization was necessary to offset the contraction of money supply engineered during the stabilization program of 1990–91.

As a general rule in Latin America, long periods of large capital inflows have been accompanied by current account deficits and real exchange rate appreciation (as in the 1970s, for example, in the period of commercial bank borrowing that preceded the debt crisis of 1982). Large outflows correlate more with sharp adjustment of the current account and real exchange rate depreciation (as in the 1980s). The 1990s have been no exception to this rule. Larger capital inflows were matched by larger current account deficits, most notably in Colombia and Peru. In Colombia, increases in gross domestic investment appear to be the cause, rather than a decline in domestic savings. In Peru, the response was probably effected through a combination of substantial public savings (because of the sharp cuts in public consumption and investment that accompanied the stabilization process) and increases in private investment and consumption. On the other hand, in both Ecuador and Venezuela, current account deficits were smaller and thus financially manageable, not unlike Colombia and Peru, and were accompanied by real exchange rate appreciation.²²

Excessively large current account deficits and substantial real exchange rate appreciation together point to two of the most important risks that can accompany large private capital inflows. The risks are compounded when the inflows induce unpredictable fluctuations in nominal interest and exchange rates, when they lead to high sterilization costs, or when they are prone to quick reversal. To be sure, the danger stems more from portfolio inflows, especially if they are of short-term maturity and volatile in nature, than from direct investment inflows that are presumably more stable and longer-term. However, there is reason to believe that, unlike the largest debtors of the region, portfolio inflows did not pose much of a problem in the Andean countries. In effect, the fact that capital markets in both Colombia and Peru escaped the worst effects of the *tequila* crisis virtually unscathed suggests that capital flows were either judiciously managed by the authorities or that their weight in GDP was not as large as in Mexico and Argentina.²³ Moreover, as lessons from the Mexican crisis are gradually learned, economic authorities in the Andean countries can confidently take steps to transform local capital markets into efficient vehicles of financial intermediation. Hopefully, portfolio inflows can thus

²¹ Total capital inflows would include, other than FDI and FPI, flows through the services account, current transfers, official creditors, commercial bank loans, supplier loans and demand deposits.

²² While in the Andean countries—and in the Latin American region at large—there was a tendency for real exchange rate appreciation during the period 1990–94, East Asian countries, also the recipients of large capital inflows, experienced a real exchange rate depreciation. What this reveals is a process of *premature* real appreciation. The largest Latin American economies—not to mention those of the Andean region at less advanced stages of economic development—have yet to show a qualitative shift in industrial and export structures to accommodate high rates of economic growth with a relative appreciation of the exchange rate. At this stage, what appreciation probably reflects is the persistence of relatively high-cost productive sectors that emphasize the lack of international competitiveness and that explain, at the same time, why the return on real assets in Latin American countries was lower than in East Asian countries during that period.

²³ Hausmann and Rojas-Suárez have estimated that the weight of *total* capital flows on GDP for the period 1991–94 was just 2.5 in Colombia. In Peru however it was 13 percent, the highest in the entire Latin American region.

contribute to provide greater liquidity to meet short-term domestic financing needs and also to finance new investment. Nevertheless, there is always the risk that this will not happen in practice.²⁴

The greater risk from private capital flows is, in our opinion, excessive indebtedness. This can be addressed by promoting FDI inflows oriented to expand the export capabilities of the countries of the Andean region. The Andean countries failed to do this during the period of import substitution industrialization with the consequence that subsidiaries of foreign firms became *de facto* allies with domestic industrialists, shoring up profits through excessively protected local markets. Now, as FDI flows move to exploit tradable opportunities in the primary sectors of Bolivia, Colombia, Peru and Ecuador, foreign investment has come full circle. This modality, however, will not be enough to fully exploit the benefits of FDI. The greatest challenge to policy makers will be to attract FDI flows into competitive manufacturing, not of the *maquila* type, but with strong linkages to the local economy so that new technologies and new skills can be disseminated across the board. Simply adopting ultra-liberal foreign investment regimes will not suffice. To the contrary, this requires efficient government activism, through the design of incentives and enforcement of performance to ensure that desired goals—export growth, employment, managerial training, opening of new markets, transfer of technologies, tax contributions, and so forth—materialize as rapidly as possible.

Are the Andean countries up to this task? Unfortunately, with the exception of Colombia, the civil service of the Andean countries simply lacks the skills and capabilities to enact and monitor these policies effectively. Under these circumstances, these actions will probably be corrupted in practice and therefore lead to counterproductive results. Consequently, for the time being, it behooves countries to press for changes in the direction of eliminating restrictions, not of enacting regulations that promise uncertain results at best. Efficient regulations, aimed at maximizing the benefits from FDI in *competitive manufacturing* will materialize once governments restore their own capabilities and make the civil service once again a respectable career track that can attract capable young professionals. Naturally, this critical task should be complemented with nationwide measures aimed at improving the quality of human capital and physical infrastructure, which in the end leads to higher total factor productivity, the catalyst for lower production costs, for a more competitive economy and, ultimately, for more flows of foreign investment.

²⁴ Foreign portfolio investors are attracted by the expectation of asset appreciation. Proceeds, say from equity sales, may be destined for capital investment, or used for consumption, or plowed back in the stock market. An expansion of liquidity would originate from depositing the proceeds in domestic banks.

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