ESSAYS IN INTERNATIONAL FINANCE

No. 76, November 1969

HOW TO DIVEST IN LATIN AMERICA, AND WHY

ALBERT O. HIRSCHMAN

INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

This is the seventy-sixth in the series ESSAYS IN INTERNATIONAL FINANCE *published from time to time by the International Finance Section of the Department of Economics of Princeton University.*

Albert O. Hirschman is Lucius N. Littauer Professor of Political Economy at Harvard University. He is the author of several books in the fields of international economics and economic development, as well as of numerous articles in professional journals. With Professor Richard M. Bird, he was co-author of Essay No. 69 in this series, Foreign Aid—A Critique and a Proposal. *The present essay was written while Mr. Hirschman was a Fellow of the Center for Advanced Study in the Behavioral Sciences at Stanford, California.*

The Section sponsors the essays in this series but takes no further responsibility for the opinions expressed in them. The writers are free to develop their topics as they wish. Their ideas may or may not be shared by the editorial committee of the Section or the members of the Department.

FRITZ MACHLUP, *Director*
International Finance Section

ESSAYS IN INTERNATIONAL FINANCE

No. 76, November 1969

HOW TO DIVEST IN LATIN AMERICA, AND WHY

ALBERT O. HIRSCHMAN

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
Princeton, New Jersey

Copyright © 1969, by International Finance Section
Department of Economics
Princeton University
L.C. Card No. 70-107369

Printed in the United States of America by Princeton University Press
at Princeton, New Jersey

HOW TO DIVEST IN LATIN AMERICA, AND WHY

The dispute between Peru and the United States over the expropriation of the International Petroleum Company is only one of a monotonously long list of incidents and conflicts which call into serious question the wisdom of present institutional arrangements concerning private international investment. This paper will discuss the principal weaknesses of these arrangements, with particular emphasis on political economy rather than on economics proper, and will then survey a number of ways in which current institutions and practices could be restructured. It is written against the backdrop of rising nationalism and militancy in the developing countries, particularly in Latin America, and of an astounding complacency, inertia, and lack of institutional imagination on the part of the rich countries.

The basic position adopted here with respect to foreign private investment is that it shares to a very high degree the ambiguity of most human inventions and institutions: it has considerable potential for both good and evil. On the one hand, there are the celebrated and undoubted contributions of private international investment to development: the bringing in of capital, entrepreneurship, technology, management and other skills, and of international market connections, all of which are either wholly lacking in the poor countries, or are in inadequate supply given the opportunities and programs for economic development. On the other hand, foreign investment brings not only the dangers of economic plunder and political domination which are the stock-in-trade of the various theories of imperialism, but a number of other, more subtle, yet serious effects and side-effects which can handicap the development efforts of countries placing prolonged and substantial reliance on private investment from abroad. The picture that has sometimes been painted of the career of foreign investment is that at one time, long ago, the negative aspects predominated: there was sheer exploitation of human and natural resources as well as crude power play in the early free-wheeling days, when capital followed the flag or was, on the contrary, the "cat's paw of empire"; but this unfortunate phase has been outgrown, so it is widely thought, with decolonization, with the world-wide assertion of national sovereign states and their taxing powers, and with the desire, on the part of modern foreign investors, to perform as "good corporate citizens" of the host country and as

"partners in progress." Unfortunately, this edifying story of human progress is incomplete and one-sided. It can, in fact, be argued that certain negative aspects of foreign investment do not only continue to coexist with the positive ones, but typically tend to predominate over them as development proceeds, at least up to some point. These are the just-mentioned "more subtle" effects and side-effects that will now be briefly explained.

PRIVATE FOREIGN INVESTMENT—AN INCREASINGLY MIXED BLESSING

The positive contribution of foreign investment to an economy can be of various kinds. In the first place, it can supply one of several *missing* factors of production (capital, entrepreneurship, management, and so forth), factors, that is, which are simply and indisputably not to be found in the country receiving the investment. This is the situation often prevailing in the earliest stages of development of a poor country. More generally, foreign investment can make it possible for output to increase sharply, because it provides the recipient economy with a larger *quantity* of comparatively scarce (if not entirely missing) inputs.

Another contribution of foreign investment, conspicuous in relations among advanced industrial countries and inviting often a two-way flow, is of a rather different nature: it can have a teaching function and serve to improve the *quality* of the local factors of production. By on-the-spot example and through competitive pressures, foreign investment can act as a spur to the general efficiency of local enterprise. This effect is likely to be particularly important in economic sectors which are sheltered from the competition of merchandise imports from abroad. Such sectors (services, industries with strong locational advantages) appear to expand rapidly at advanced stages of economic development. If foreign investment is successful in enhancing the quality of local enterprise, then its inflow will be providentially self-limiting: once the local business community achieves greater efficiency, there will be fewer openings for the demonstration of superior foreign techniques, management, and know-how. But what if local businessmen, faced with overwhelming advantages of their foreign competitors, do not respond with adequate vigor and, instead, deteriorate further or sell out? This is, of course, the nub of recent European fears of the "American challenge." I cannot deal here with this problem, but the fact that it exists has interesting implications for the topic at hand.

If foreign investment can fail to improve and may even harm the *quality* of local factors of production, then the question arises whether

it may also, under certain circumstances, lead to a decrease in the *quantity* of local inputs available to an economy. In other words, could the inflow of foreign investment stunt what might otherwise be vigorous local development of the so-called missing or scarce factors of production?

This question has been little discussed. (Important exceptions are the article by J. Knapp "Capital Exports and Growth," *Economic Journal*, September 1957, and the paper by Felipe Pazos cited below.) The reason for the neglect lies in the intellectual tradition which treats international investment under the rubric "export of capital." As long as one thinks in terms of this single factor of production being exported to a capital-poor country, it is natural to view it as highly complementary to various local factors—such as natural resources and labor—that are available in abundance and are only waiting to be combined with the "missing factor" to yield large additional outputs. But, for a long time now, foreign investors have prided themselves on contributing "not just capital," but a whole bundle of other valuable inputs. In counterpart to these claims, however, the doubt might have arisen that some components of the bundle will no longer be purely complementary to local factors, but will be competitive with them and could cause them to wither or retard and even prevent their growth.

The possibility, and indeed likelihood, that international *trade* will lead to the shrinkage and possibly to the disappearance of certain lines of local production as a result of cheaper imports has been at the root of international-trade theory since Adam Smith and Ricardo. This effect of trade has been celebrated by free traders through such terms as "international specialization" and "efficient reallocation of resources." The opponents of free trade have often pointed out that for a variety of reasons it is imprudent and harmful for a country to become specialized along certain product lines in accordance with the dictates of comparative advantage. Whatever the merit of these critical arguments, they would certainly acquire overwhelming weight if the question arose whether a country should allow itself to become specialized not just along certain commodity lines, but along factor-of-production lines. Very few countries would ever consciously wish to specialize in unskilled labor, while foreigners with a comparative advantage in entrepreneurship, management, skilled labor, and capital took over these functions, replacing inferior "local talent." But this is precisely the direction in which events can move when international investment, proudly bringing in its bundle of factors, has unimpeded access to developing countries. (In the fine paradoxical formulation of Felipe Pazos: "The main weakness of

direct investment as a development agent is a consequence of the complete character of its contribution." See his paper "The Role of International Movements of Private Capital in Promoting Development," in John H. Adler, ed., *Capital Movements and Economic Development*, 1967, p. 196.)

The displacement of local factors and stunting of local abilities which can occur in the wake of international investment is sometimes absolute, as when local banks or businesses are bought out by foreign capital; this has in fact been happening recently with increasing frequency in Latin America. But the more common and perhaps more dangerous, because less noticeable, stunting effect is relative to what might have happened in the absence of the investment.

As already mentioned, foreign investment can be at its creative best by bringing in "missing" factors of production, complementary to those available locally, in the early stages of development of a poor country. The possibility that it will play a stunting role arises later on, when the poor country has begun to generate, to a large extent no doubt because of the prior injection of foreign investment, its own entrepreneurs, technicians, and savers and could now do even more along these lines if it were not for the institutional inertia that makes for a continued importing of so-called scarce factors of production which have become potentially dispensable. It is, of course, exceedingly difficult to judge at what point in time foreign investment changes in this fashion from a stimulant of development into a retarding influence, particularly since during the latter stage its contribution is still ostensibly positive—for example, the foreign capital that comes in is visible and measurable, in contrast to the domestic capital that might have been generated in its stead. One can never be certain, moreover, that restrictions against foreign investment will in fact call forth the local entrepreneurial, managerial, technological, and saving performances which are believed to be held back and waiting in the wings to take over from the foreign investors. Nevertheless, a considerable body of evidence, brought forth less by design than by accidents such as wars, depressions, nationalist expropriations, and international sanctions, suggests strongly that, after an initial period of development, the domestic supply of routinely imported factors of production is far more elastic than is ever suspected under business-as-usual conditions. If this is so, then the "climate for foreign investment" ought to turn from attractive at an early stage of development to much less inviting in some middle stretch—in which most of Latin America finds itself at the present time.

The preceding argument is the principal economic reason for anticipating increasing conflict between the goals of national development and

the foreign-investment community, even after the latter has thoroughly purged itself of the excesses that marred its early career. The argument is strengthened by related considerations pertaining to economic policy-making, a "factor of production" not often taken into account by economists, but which nevertheless has an essential role to play. In the course of industrialization, resources for complementary investment in education and overhead capital must be generated through taxation, the opening up of new domestic and foreign markets must be made attractive, institutions hampering growth must be reformed, and powerful social groups that are antagonistic to development must be neutralized. The achievement of these tasks is considerably facilitated if the new industrialists are able to speak with a strong, influential, and even militant voice. But the emergence of such a voice is most unlikely if a large portion of the more dynamic new industries is in foreign hands. This is a somewhat novel reproach to foreign capital, which has normally been taken to task for being unduly interfering, wire-pulling, and domineering. Whatever the truth about these accusations in the past, the principal failing of the managers of today's foreign-held branch plants and subsidiaries may well be the opposite. Given their position as "guests" in a "host country," their behavior is far too restrained and inhibited. The trouble with the foreign investor may well be not that he is so meddlesome, but that he is so mousy! It is the foreign investor's mousiness which deprives the policy-makers of the guidance, pressures, and support they badly need to push through critically required development decisions and policies amid a welter of conflicting and antagonistic interests.

The situation is in fact even worse. Not only does policy-making fail to be invigorated by the influence normally emanating from a strong, confident, and assertive group of industrialists; more directly, the presence of a strong foreign element in the dynamically expanding sectors of the economy is likely to have a debilitating and corroding effect on the rationality of official economic policy-making for development. For, when newly arising investment opportunities are largely or predominantly seized upon by foreign firms, the national policy-makers face in effect a dilemma: more development means at the same time less autonomy. In a situation in which many key points of the economy are occupied by foreigners while economic policy is made by nationals it is only too likely that these nationals will not excel in "rational" policy-making for economic development; for, a good portion of the fruits of such rationality would accrue to non-nationals and would strengthen their position. (For some interesting remarks along these lines, see Hans O. Schmitt, "Foreign Capital and Social Conflict

in Indonesia," *Economic Development and Social Change*, April 1962.) On the other hand, the role and importance of national economic policy-making for development increases steadily as the array of available policy instruments widens, and as more group demands are articulated. Hence the *scope* for "irrationality" actually expands as development gains momentum. That its *incidence* increases also could probably be demonstrated by a historical survey of tax, exchange-rate, utility-rate and similar policies that were aimed directly or indirectly at "squeezing" or administering pin pricks to the foreigner, but managed, at the same time, to slow down economic growth.

The preceding pages have said next to nothing about the direct cost to the capital-importing country of private international investment nor about the related question of the balance-of-payments drain such investment may occasion. While these matters have long been vigorously debated, with the critics charging exploitation and the defenders denying it, the outcome of the discussion seems to me highly inconclusive. Moreover, undue fascination with the dollar-and-cents aspects of international investment has led to the neglect of the topics here considered, which, I submit, raise issues of at least equal importance and suggest a simple conclusion: strictly from the point of view of development, private foreign investment is a mixed blessing, and the mixture is likely to become more noxious at the intermediate stage of development which characterizes much of present-day Latin America.

Hence, if the broadly conceived national interest of the United States is served by the development of Latin America, then this interest enters into conflict with a continuing expansion and even with the maintenance of the present position of private investors from the United States. Purely political arguments lend strong support to this proposition. Internal disputes over the appropriate treatment of the foreign investor have gravely weakened, or helped to topple, some of the more progressive and democratic governments which have held power in recent years in such countries as Brazil, Chile, and Peru. Frictions between private investors from the United States and host governments have an inevitable repercussion on United States-Latin American relations. In a number of cases such disputes have been responsible for a wholly disproportionate deterioration of bilateral relations. The continued presence and expansion of our private-investment position and our insistence on a "favorable investment climate" decisively undermined, from the outset, the credibility of our Alliance for Progress proposals. Land reform and income redistribution through taxation are so obviously incompatible, in the short run, with the maintenance of a favorable investment climate for private capital that insistence on both could only be interpreted to sig-

nify that we did not really mean those fine phrases about achieving social justice through land and tax reform.

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. Such a policy can be selective with respect to countries and to economic sectors and it ought to be combined with a policy of encouraging new capital outflows, also on a selective basis and with some safeguards.

THE "LOST ART" OF LIQUIDATING AND NATIONALIZING FOREIGN INVESTMENTS

Before the possible elements of such a policy are examined, it is worth noting that liquidation of foreign investment has frequently happened in the history of capital movements. But, as a result of convergent developments, such liquidation has strangely become a lost art. Worse, this art has not been properly recorded by economic historians. In part, this is so because economic historians, like both the advocates of foreign investment and its critics, have been far more interested in the tides of capital flow than in its occasional ebbs. Moreover, the tides have been more regular and easier to detect and measure.

Some of the "mechanisms" which in the past permitted partial liquidation of foreign investment have been the unintended side-effects of such large-scale, sporadic, and wholly unedifying happenings as wars and depressions. The two World Wars led to a substantial decline in both the absolute and the relative importance of foreign investment in the national economies of Latin America. In the first place, with most Latin American countries joining the Allies, German investments, a not unimportant portion of the total (think of all those prosperous breweries!), were expropriated. Secondly, the British were forced in both World Wars to liquidate a good portion of their security holdings, in order to pay for vitally needed food, materials, and munitions. Some of these securities were acquired by the citizens of the countries for which they had originally been issued. Thirdly, Latin American countries acquired large holdings of gold and foreign currencies during the wars, as they continued to export their primary products, but were unable to obtain industrial goods from the belligerents. These accumulated holdings made it possible for them to buy out some foreign investments in the immediate postwar period. The most conspicuous, but by no means the only, instance of this sort of operation was the purchase from their British shareholders of the Argentine railways by the Perón government in 1946. Finally, the wars led to a complete interruption

of capital inflow. Since, at the same time, Latin America's industrial growth was strongly stimulated, the relative importance of activities controlled by foreign capital declined substantially.

The depressions which periodically afflicted the centers of capitalist development until the Second World War had similar results. Again, capital inflow would stop for a while during periods in which the Latin American economies frequently received growth impulses because, with foreign-exchange receipts low, imports had to be throttled, giving domestic industrial production a fillip. Moreover, when overextended corporations based in the United States and Europe fell on hard times, a sound management reaction was frequently to retrench and consolidate. In the process, foreign branch plants and subsidiaries were sold off to local buyers, a process which has been well documented in the case of American investments in Canada during the depression of the thirties. (See H. Marshall, F. A. Southard Jr. and V. W. Taylor, *Canadian-American Industry*, 1936, pp. 252-262.) Sometimes, especially in the case of European firms, these transfers took the form of ownership and control passing into the hands of the parent company's local managers who, while of foreign origin, would eventually become integrated into the local economy. Finally, of course, there were cases of outright bankruptcy and forced liquidation.

The quantitative importance of these various factors remains to be established. But, in the aggregate, they must have had a substantial limiting effect on the foreign-investment position in Latin America during the first half of the 20th century.

Actually, a less cruel mechanism permitting the nationalization of foreign investment was also at work before the "good old days" of portfolio investment had been eclipsed by direct investment. While those days were of course by no means wholly good, portfolio investment, which took primarily the form of fixed-interest bond issues, did have several advantages for the capital-importing country. Among these, the lower cost and the existence of a termination date have been mentioned most frequently. There is, however, one further property of portfolio investment which is of particular interest in the context of the present essay. This is the fact that nationalization of portfolio investment could take place at the option of the borrowing country and its citizens, who were free to purchase in the international capital markets securities that were originally issued and underwritten in London or Paris. I have collected (and hope eventually to publish) considerable evidence that these so-called "repurchases" of securities by nationals of the borrowing countries took place on a large scale in such countries as the United States, Italy, Spain, Sweden, and Japan in the

late 19th and early 20th centuries. They also occurred in much poorer countries, such as Brazil, and were in general so widespread that the phenomenon is referred to in one source as "the well-known *Heimweh* [homesickness] of oversea issued securities." (J. F. Normano, *Brazil: A Study of Economic Types*, 1935, p. 157.) As a result of this *Heimweh*, then, an increasing portion of maturing bond issues often came to be owned by the nationals of the borrowing country, so that payment at maturity did not occasion any balance-of-payments problem.

This is not the place to speculate on the reasons for which the bonds issued abroad became so often a preferred medium of investment for national capitalists; suffice it to say that patriotism or nationalism on the part of local investors probably had little if anything to do with it. Whatever the reason, it appears that international investment, as formerly practiced, permitted the gradual transfer, via anonymous market transactions, of foreign-held assets to nationals, entirely in accordance with the capabilities and wishes of the borrowing country's own savers.

Today's arrangements are totally different, of course. Transfer to local ownership and control of foreign-held subsidiaries requires either an initiative on the part of the parent company or a decision to expropriate on the part of the host government. A valuable mechanism of smooth, gradual, and peaceful transfer has become lost in the shuffle from portfolio to direct investment.

Up to this point, it has been established (1) that progressive liquidation and nationalization of foreign private investments is likely to become desirable in the course of economic development, and (2) that mechanisms to this end functioned, if unwittingly and irregularly, in the 19th and through the first half of the 20th century, but have no longer been available over the past 25 years or so.

The purpose of recalling these mechanisms was to sharpen our institutional imagination and perception for substitute mechanisms which it may be desirable to put into place at the present time. An open and far-ranging discussion of various possible alternatives is obviously desirable. The following pages are meant as a contribution to such a discussion, rather than as a fixed set of proposals.

A SURVEY OF POSSIBLE DIVESTMENT MECHANISMS

An attempt will now be made to sketch possible answers to the following questions:

1) What arrangements should be made to permit the transfer to local ownership and control of existing foreign-held investments?

2) What arrangements should exist for this transfer in the case of new foreign investments?