FOREIGN INVESTMENT CYCLES IN EMERGING ECONOMIES

by Amy L. Chua[*]

Alejandro Escobar, Daniel Price and David Small have been discussing how most effectively to implement international investment regimes in emerging economies. I would like to offer a different perspective: a historical perspective, which revisits the question that Professor Vandevelde first raised, about the sustainability of foreign investment regimes, or marketizing regimes more generally, throughout the developing world. Please keep in mind that my remarks apply only to the developing world, especially when I come to policy suggestions, because I suspect that some of my copanelists will vehemently disagree with some of the things that I am going to say.

Let me begin by drawing your attention to a phenomenon in the developing world that has been broadly overlooked. (For purposes of my talk, I'm going to limit myself to Latin America and Southeast Asia.) The phenomenon I'm referring to is the existence of a historical cycle in which developing countries in both Latin America and Southeast Asia have oscillated between promarket regimes and anti–free-market regimes for as long as they have been independent. Consider the history of Mexico. In Mexico, independence was followed by a long period of economic liberalism: that is, private property regimes generally accompanied by the vigorous promotion of capital investment and, in particular, an openness to foreign capital and influence. This period of laissez-faire was followed by the Mexican Revolution, which culminated with President Lázaro Cárdenas's nationalization of the railroad and oil industries in the 1930s. Not surprisingly, foreign investment (one of Cárdenas's main targets) declined dramatically during this period; in some industries, foreign investment was eliminated altogether.

This revolutionary period was followed by another period of free enterprise, in which many of the industries previously nationalized—for example, the petroleum and sulphur industries—were reprivatized, and foreign investment was once again vigorously courted. This was followed by another round of nationalization and statist policies under which key industries were again closed off to foreigners, and then by the current period of economic liberalization in Mexico, in which foreign investment laws are again being rapidly amended to bring foreign capital back into the same key sectors: for example, petroleum, mining, communications, transportation and utilities.

A similar pattern of market policies followed by backlash against the market holds throughout Latin America, with almost no exceptions, and in Southeast Asia as well,

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although in Southeast Asia one sees fewer oscillations, because the countries there achieved independence much later than the countries of Latin America. If anyone is interested in the empirical support for this claim of cyclicality, I can refer you to an article of mine in the *Columbia Law Review*.[1]

Recognizing this cyclicality raises a set of questions that are different from the ones that my copanelists have been focusing on: Specifically, why has this happened in the past? Are things different today? Professor Vandevelde mentioned the collapse of the Soviet Union and the excellent track record of the East Asian countries. Have the relevant conditions, both internal to developing countries and international, changed sufficiently? Or are today's liberalized foreign-investment regimes subject to the same kind of backlash that has occurred so many times before?

I would like now to address these questions. First, why have there been cycles in Latin America and Southeast Asia? That is, what are the pressures that have repeatedly caused developing countries to move away from the free market, especially since nationalization and state-interventionist policies have historically, and repeatedly, been such failures (under any number of economic indicators)? Part of the answer has to do with something I am sure you are all aware of. That is, in the past, free-market, pro-foreigner regimes in the developing world repeatedly benefited the foreign investors far more than the local populations. In fact, in the past, during periods of economic liberalization, the vast majority of Mexicans, or Peruvians, or Indonesians or Malays experienced little or no benefit from a liberalized market. As a result, politicians (often themselves from the elite classes) found that they could whip up populist support for themselves by playing on these antiforeigner sentiments. And in fact, in case after case, leaders in the developing world came to power on explicitly antiforeigner, anti-imperialist, anti–free-market platforms. This was true of Juan Perón in Argentina, Getúlio Vargas in Brazil, José Batlle y Ordóñez in Uruguay, Salvador Allende in Chile, Sukarno in Indonesia and U Nu in Burma (now Myanmar), among others.

But that is only part of the explanation. There is another equally important dynamic going on that is internal to developing countries. Free-market policies in the developing world (including liberalized foreign-investment regimes) have tended to benefit disproportionately not just Western foreigners but certain resented *internal foreigners* (this is the term I am going to use for economically dominant ethnic minorities in these countries), vis-à-vis the rest of the population.

Who are these internal foreigners? In Southeast Asia I'm referring principally to the Chinese. In countries such as Malaysia, Indonesia, the Philippines, Thailand and Vietnam, during free-market periods the Chinese minority, the so-called "Jews of the Orient," who make up much of the commercial class in these countries, prosper disproportionately. In stark contrast, the predominantly rural "indigenous" majorities in these countries basically remain impoverished, experiencing little or no benefit from the free market. The Chinese are not the only entrepreneurial minority in Southeast Asia. In Myanmar (as well as East Africa and the Caribbean), historically it was the very small Indian minority who tended to become economically dominant under free-market conditions, relative to the indigenous majority. In Sri Lanka it was the Tamil minority, as opposed to the Sinhalese.

Accordingly, in Southeast Asia, these movements against the free market—in favor of restrictive investment policies, nationalization and redistribution—historically have been far more expressions of *ethnic nationalism* than of Marxism or socialism. Unlike

[1] Amy L. Chua, *The Privatization-Nationalization Cycle: The Link between Markets and Ethnicity in Developing Countries*, 95 COLUM. L. REV. 223 (1995).

the experience of the former Soviet Union or China, during these antimarket periods in Southeast Asia there has really never been an attempt to eliminate private property or to level the class structure (Vietnam is the exception). Rather, in these countries, antimarket movements have principally been attempts by certain "indigenous" groups to reclaim resources and economic power from other groups identified as "foreigners." And again these foreigners include not only Western "imperialist" foreigners but also these "foreigners within."

For example, in Indonesia, President Sukarno's sweeping nationalizations in the 1950s and 1960s were directed not just at the Dutch but also (indeed, most viciously) at the country's Chinese minority. In fact, through nationalization and other measures of economic nationalism, Sukarno successfully "indigenized" Indonesia's financial sector, its mining sector and most of the modern industrial sectors—all of which had been formerly dominated by the Chinese minority, along with the Europeans.

Similarly, in Burma, General Ne Win's nationalization of over 15,000 enterprises in the 1960s and 1970s expressly targeted not just Western but Indian proprietors (many of whose families had lived for generations in Burma and many of whom considered themselves Burmese). Those nationalizations were accompanied by extensive violence against the Indian minority.

These examples are typical. If one looks at history, it is clear that ethnic nationalism—not socialism—has repeatedly been the driving force behind anti–free-market movements in Southeast Asia. This is important because it means the fact that the Soviet Union has collapsed—and that socialism has been "discredited"—does not ensure the sustainability of today's market regimes.

Let me turn now to Latin America. The social structure in Latin America is quite different from that in Southeast Asia, in at least three salient ways. First, in Latin America, because of historically high rates of racial intermarriage (as well as concubinage and polygyny), one tends not to find discrete ethnic groups living and working separately from each other (as, for example, the Malays, Chinese and Indians do in Malaysia). Second, whereas in Southeast Asia, economic and political power are divorced—the "indigenous" majority holds political power, while an ethnic minority holds economic power—in Latin America political and economic power have historically been concentrated in the same hands. Third, as a result of the first two factors, nationalization and antimarket movements in Latin America have typically assumed an antielitist cast that gives them a much more explicit dimension of *class* conflict than is present in Southeast Asia.

Nevertheless, I think that what has been happening in Latin America is directly analogous to the dynamic in Southeast Asia. It is true that ethnic and racial lines in Latin America are much less starkly drawn than in Southeast Asia. But there exists in Latin America what sociologists have long recognized as a *pigmentocracy*: a spectrum with taller, lighter-skinned, Spanish-blooded aristocrats at one end; shorter, darker, Indian-blooded masses at the other end; and a good deal of "passing" between.[2]

As a result, there's a significant degree of overlap between class conflict in Latin America and ethnicity. In fact, just as in Southeast Asia, during periods of free enterprise or economic liberalism a small, ethnically definable group—I am talking about the Spanish-blooded, Europeanized, Caucasian elite—prospers disproportionately. And again, during periods of nationalization and antimarket sentiment, this group comes to be depicted as a "foreigner within," and nationalizations are directed not just at Western foreigners, but at this internal foreigner as well.

[2] *See* MAGNUS MÖRNER, RACE MIXTURE IN THE HISTORY OF LATIN AMERICA 54 (1967).

Indeed, if you look at Latin American history, nationalization movements have repeatedly presented themselves in just such ethnically tinged, nationalist terms. For instance, the revolutionary movement in Mexico at the beginning of this century was an explicitly nationalist movement, and it had an explicitly ethnic dimension: Indian blood was glorified as the mark of a true Mexican. Accordingly, Cárdenas's nationalizations targeted not just Yankees up north but internal foreigners as well: the white landowners with their links to foreign capital and their European cultural pretensions.[3]

Similarly, in Peru and Bolivia, nationalization programs early in this century were accompanied by slogans such as, "The only true Peru is Indian Peru" and "The land to the Indians, the mines to the state."[4] Indeed, in every Latin American country, the idea of an internal foreigner has been a powerful organizing, mobilizing force for politicians championing nationalization.[5]

To summarize, in country after country in Southeast Asia and Latin America, liberal, market-oriented policies have distributed their benefits disproportionately to Western foreigners and to certain resented internal foreigners; as a result, these market policies have fueled backlash reactions culminating in the return of xenophobic, antiliberal economic programs.

To return to the present, the real question then is whether there is a danger that this cycle could happen again. I think the answer is clearly yes. Throughout Latin America and Southeast Asia, one already sees resentment starting to form against both the Western foreigner and the internal ethnic foreigner. In Indonesia, for example, where the Chinese make up less than 5 percent of the population but control "an estimated 70 percent of the country's private domestic capital," the Minister of Technology has publicly advocated "reclaiming" the country's industry and technology from the Chinese minority; many think that Minister Habibie will eventually succeed Suharto as President.[6] In fact, just a few days ago the front page of the *New York Times* reported riots against the economically dominant Chinese. Similarly, in Mexico, a well-known columnist has recently charged that privatization "has made multimillionaires of 13 families," while the rest of Mexico, some 80 million people, continues to live in poverty.[7] If one looks, the warning signs are there.

The solution is certainly not to scrap the market—there is no question that the market and foreign capital will have to be part of any developing country's long-term solution. Rather, the point is that today's foreign investment treaties and marketization programs, to be effective, to last, to be sustainable, are going to have to focus in a way they never have on the problems of nationalism and ethnicity in the developing world.

As to specific policy suggestions, ideally the concrete steps to be taken would be the result of sophisticated bargaining by governments and private firms, with the assistance of economists and international organizations. But what I want to do right now is to

[3] *See* Chua, *supra* note 1, at 276–77.

[4] Fredrick B. Pike, *The Problem of Identity and National Destiny in Peru and Argentina*, *in* LATIN AMERICAN HISTORY 182 (Fredrick B. Pike ed., 1969); MAGNUS MÖRNER, THE ANDEAN PAST 205 (1985).

[5] Not surprisingly, in more Europeanized Latin American countries with smaller Indian populations (for example, Argentina, Chile and Uruguay), the internal foreigner tends to be defined in class-based terms. Even in these countries, however, nationalizing leaders have sought to harness ethnicity and the resentment it generates in ingenious ways. *Chua, supra* note 1, at 277–79.

[6] THOMAS SOWELL, MIGRATIONS AND CULTURES 176 (1996); *see* Raphael Pura, *Technology Guru Stands Out in Indonesia*, WALL ST. J., Nov. 21, 1994, at B6D.

[7] Anthony DePalma, *Mexico Sells Off State Companies, Reaping Trouble as Well as Profit*, N.Y. TIMES, Oct. 27, 1993, at A1, A8 (quoting Alvaro Cepada Neri).

throw out some very general suggestions that could be building blocks or discussion points in addressing the kinds of problems I've described.

First, and I am sure Mr. Price and Mr. Small will disagree, in developing countries some foreign ownership restrictions may well make sense in certain sectors, for example, highly sensitive, high-profile sectors, such as oil in Mexico, teak in Myanmar and silver in Peru. These are sectors with symbolic value, sectors with a history of nationalization and renationalization. Foreign investors and the international community should realize that, in the long run, it will be the presence of indigenous owners along with the foreign owners that safeguards the sustainability of liberal investment regimes.

Second, perhaps foreign investment treaties, whether bilateral or multilateral, should address in an effective way the possibility of holding Western investors to higher environmental and labor standards. For example, when 8,000 Costa Rican workers are sterilized because U.S. companies such as Chiquita and Dow Chemical used chemicals that were *banned* in the United States, you have a recipe for backlash against foreign investment.[8]

Finally, I want to address performance requirements. Again, in the context of developing countries, states with emerging economies should think seriously about requiring major foreign investors to undertake projects intended to benefit the general population. I worked on the privatization of Teléfonos de México (Telmex), Mexico's national telephone company, for four years, representing the Mexican Government. Under Mexico's telecommunications laws the new owners of Telmex (who include Southwestern Bell) must comply with a detailed operating concession. The concession in turn requires Telmex to expand and modernize the telephone system in ways specifically intended to benefit Mexican consumers. In particular, Southwestern Bell is required to bring telephone service to sparsely populated rural areas.[9] (This is something that was done in the United States in the 1930s.) Along these lines, governments of developing countries could perhaps work with economists to come up with ways to require foreign investors to put in water purification plants, hospitals or much-needed infrastructure, with a view to long-term efficiency and development.

Other methods would be appropriate for trying to handle the even more difficult problem of market-triggered backlash against the internal ethnic foreigner. Employee participation schemes, intended to disperse the benefits of the market, have been successful enough in Chile (the Endesa privatization) and in the United States (the United Airlines Employee Stock Ownership Plan) to warrant attention to such strategies. Again, for lack of time, I refer you to my *Columbia Law Review* article.[10]

The problem, of course, with all these suggestions is that they entail short-run efficiency costs; in the short run, they make it marginally less desirable for foreign investors to invest in emerging economies. But the international community as well as foreign investors should realize that such short-term costs may be necessary to ensure the long-term stability of an effective international investment regime.

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[8] *See* David Scanlan, *U.S. Companies Used Pesticides Banned at Home*, S.F. CHRON., Mar. 15, 1994, at A1.
[9] *See* Final Prospectus of Teléfonos de México, S.A. de C.V. 37–38 (May 11, 1992).
[10] *See* Chua, *supra* note 1, at 292–303.
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