

Fostering Regional Development by Securing the Hemispheric Investment Climate



**In Support of the 6th
Defense Ministerial of the
Americas**

**Quito, Ecuador
November 2004**

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**Prepared at the request of the
United States Department of Defense
in support of the
6th Defense Ministerial of the Americas
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Introduction and Overview

In December 1994, the President of the United States hosted the 33 other democratically elected leaders from across the hemisphere at the Summit of the Americas in Miami. Together, they affirmed the region's commitment to democracy, justice, and opportunity, vowing to establish a new architecture for regional relationships built on “partnerships that would preserve the values we share and promote the prosperity that will ensure better lives for our children.”

US Secretary of Defense William Perry and his counterparts throughout the region were quick to respond to this mandate. In July 1995, the first Defense Ministerial of the Americas (DMA) was held in Williamsburg, Virginia gathering civilian and military leaders of the region together for the first time. During three days of intensive meetings, they discussed a broad range of security issues in an atmosphere of open dialogue and mutual confidence. The six "Williamsburg Principles" they established have guided hemispheric security policies since that time. These principles recognize that the preservation of democracy is the basis for mutual security and that armed forces must be subordinate to democratically elected leaders. Specifically, defense leaders agreed to:

- Uphold the promise of the Santiago Agreement that the preservation of democracy is the basis for ensuring mutual security.
- Acknowledge that military and security forces play a critical role in supporting and defending the legitimate interests of sovereign democratic states.
- Affirm the commitments made by their countries in Miami and elsewhere that armed forces should be subordinate to democratically controlled authority, act within the bounds of national constitutions, and respect human rights through training and practice.
- Increase transparency in defense matters through exchanges of information, through reporting on defense expenditures, and by greater civilian-military dialogue.
- Set as a goal for the hemisphere the resolution of outstanding disputes by negotiated settlement and widespread adoption of confidence building measures, consistent with the pace of hemispheric economic integration, *to recognize that the development of economic security profoundly affects defense security and vice versa* (italics added).
- Promote greater defense cooperation in support of voluntary participation in UN-sanctioned peacekeeping operations, and to cooperate in a supportive role in the fight against narcoterrorism.

The DMA quickly became the most significant forum that exists for discussions of defense and security issues in the Western Hemisphere. At the last DMA, held in Santiago, Chile, in November 2002, defense ministers set forth an ambitious new agenda, working within the original principles that took account of the new realities arising from September 11, 2001. Even as they agreed to continue their important work to consolidate democratic progress throughout the region, defense leaders endeavored to identify the new threats of the 21st century and to work together to meet them head on. Indeed, according to knowledgeable observers, the hemisphere has generally become a model of defense cooperation to address non-traditional threats of terrorism and cross-border

security concerns, and traditional areas including peacekeeping and collective security are receiving new emphasis.

As proof, one need look no further than the multinational peacekeeping force in Haiti, which enjoys the participation and support of Argentina, Brazil, Canada, Chile, and the United States, among others. Or the ongoing fight against illegal narcotics waged in source nations including Bolivia, Colombia, Ecuador, and Peru; transit nations including Mexico, Central America, and the Caribbean; and, consuming nations including Brazil, Canada, and the United States. Or cooperative exercises in defense of the Panama Canal between the United States, Panama, and Chile. Or the ongoing support of Colombia's efforts to eradicate guerrilla activity by the United States. Or cooperative efforts to penetrate the tri-border area of Argentina, Brazil, and Paraguay and other areas across the region to deny their use as havens for global reach terrorists and their financial supporters. Or efforts to reduce the threat of nuclear proliferation from nations with active nuclear programs.

The agenda is full as Ministers again gather for the November 2004 DMA in Quito, Ecuador. Now, democracy in the region is troubled as citizens increasingly question the concrete benefits they can expect under democracy and economic orthodoxy, and populism regains a foothold. Clearly, one of the greatest threats to democracy itself is the lack of hope citizens increasingly have that their lives will actually improve. Polls indicate that the region is not yet at a tipping point, and of course some nations like Chile are much stronger than others because they have stuck to a model of open market democracy that has delivered benefits to a broad range of citizens and demonstrably reduced poverty. There is still time to bolster the promise of democratic governance, but efforts must begin now.

As a result, for the first time, Ministers in Quito will undertake discussions concerning the defense-related aspects of open market development. They understand that strong democracies require a broad cross-section of populations who instinctively believe that the rules of the game are fair and transparent, that the government is their ally not their oppressor, that common citizens can have grievances heard and attended to either politically or judicially, and that they believe their absolute and relative economic conditions will improve over time. They also understand that capital accumulation is a fundamental building block of economic growth, and that domestic savings and direct foreign investment play critical roles in this regard.

Increasing direct foreign investment (FDI) flows and stock is perhaps the key variable to restoring regional economic growth. But FDI destined for Latin America and the Caribbean has dramatically lagged other regions of the world. This trend has resulted from numerous factors. What is important for purposes here is the mindset—the perceptions—of foreign investors in terms of their regional investment calculations and the relationship of risk to return. And the perceptions of risk, whether economic, financial, political, or security related, are high, and must be reduced significantly if Latin America and the Caribbean are to gain a larger share of global FDI.

Indeed, personal (in)security increasingly weighs heavily on the minds of foreign investors and has depressed their willingness to maximize FDI at a level they otherwise would. At bottom, these are questions of national security and law enforcement, and political leaders across the Western Hemisphere are struggling with the best ways to address them. The DMA in Quito thus occurs at a particularly fortuitous moment.

To aid in setting the DMA agenda, the US Department of Defense requested that the Council of the Americas provide recommendations to address overall security concerns as they impact the regional investment climate. As a result, during Summer and Autumn 2004, the Council organized and coordinated an exclusive working group of high level private sector leaders, many with extensive public sector experience in Latin America and the Caribbean, with a mandate to develop recommendations for incorporation into the Ministerial and resulting hemispheric agenda. In addition to meetings and extensive coordination among working group members, the Council also surveyed its membership, consisting of some 170 corporations active and doing business across the hemisphere, to gather their impressions for an aggregate picture of investment climate perceptions as they relate to security matters. It must be stressed that the survey results are not scientific; nonetheless, we believe they are reflective of general impressions that investors have about the region, and it is these impressions particularly at the level of corporate officers that in fact drive investment decisions in the real world.

One final note: this report speaks to the state of the Western Hemisphere as a whole. Comparisons to other regions of the world are made to illustrate shifts in trends and newly formed patterns. Exceptions and outliers will be discussed where appropriate.

The Council would like to thank especially Deputy Assistant Secretary of Defense Rogelio Pardo-Maurer for the support of his office and his personal support in preparing this report, and also US Commander in Chief of the Southern Command General James Hill. Thanks are also due to Assistant Secretary of State (INL) Bobby Charles for his timely and useful suggestions on an earlier version of this report. The Council also thanks its members who participated in the working group and in the preparation of this report, many of whom, due to the sensitive nature of the topics at hand, have requested that all comments be aggregated and not assigned to any particular individual. This we have agreed to do.

Finally, I would personally like to express my appreciation to the working group coordinator and primary author of this report, Luis Pinto.

Eric Farnsworth
Vice President – Washington
Council of the Americas
November 2004

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Primary Goals

When conceiving this report, the Council's main goals were twofold: the first was to show the connection between security, investment, and development in the Western Hemisphere. It is our contention that there are direct and indirect connections between perceptions of security to property and person and the amount of foreign investment that goes and stays in a country or region. The perception of security stems from a state's ability to provide adequate control over criminal activities, civilian control over its armed forces and police, judicial transparency, and to generally follow the rule-of-law.

Our second goal was to give concrete recommendations to hemispheric governments for steps to improve security in efforts to foster greater foreign direct investment and thus economic development. The recommendations we propose build on a survey of senior representatives from Council member companies.

This report will highlight investment trends over the past two decades and show some of the reasons why Latin American and Caribbean nations are losing investors to other regions of the world. We will also show how a lack of security directly and indirectly affects investment in the region. It is our hope that by addressing these issues, regional governments will begin to recapture an appropriate proportional share of global FDI, thus increasing economic growth and ultimately strengthening democracy and its institutions in Latin America and the Caribbean.

Where Does the Region Stand?

To understand the current situation this section will study where the region stands in relation to its main competitor, Asia, by using FDI, education levels, homicide rates, and kidnapping rates as the basis for a comparative analysis. This will bring to light some of the trends that have developed over the last decades and explain certain critical and representative variables that the private sector examines before investing.

The rate of FDI growth in Latin America and the Caribbean has fallen behind Asia and the Middle East

As charts 1A and 1B show, the percentage of total FDI for Latin America has fallen while growing in Asia.¹ That fact is undeniable, though the reasons for it are complex. At the heart of it, Latin America and the Caribbean have lost competitive advantage vis-à-vis other regions of the world. This is due to a combination of internal and external factors. It is said that foreign investment, like electricity, will always seek the path of least resistance. If a country or a region is more productive, has a larger internal market, has a more educated workforce, is stable, respects the rule-of-law, and

¹ United Nations Conference on Trade and Development (UNCTAD) database. www.unctad.org

provides a safe environment to conduct business, then, all other things considered, it will attract more investment than other countries or regions.

The following charts show how proportional FDI has shifted away from Latin America and the Caribbean toward the Asian markets.

Chart 1A:

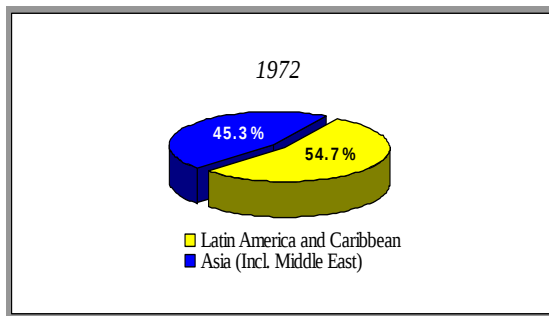
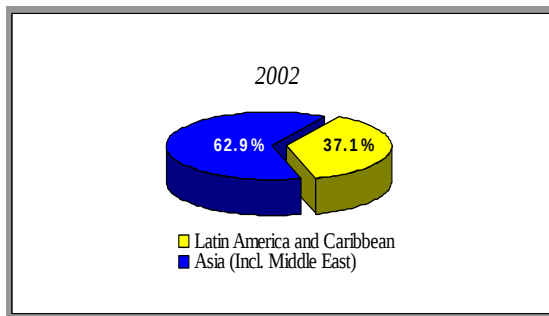


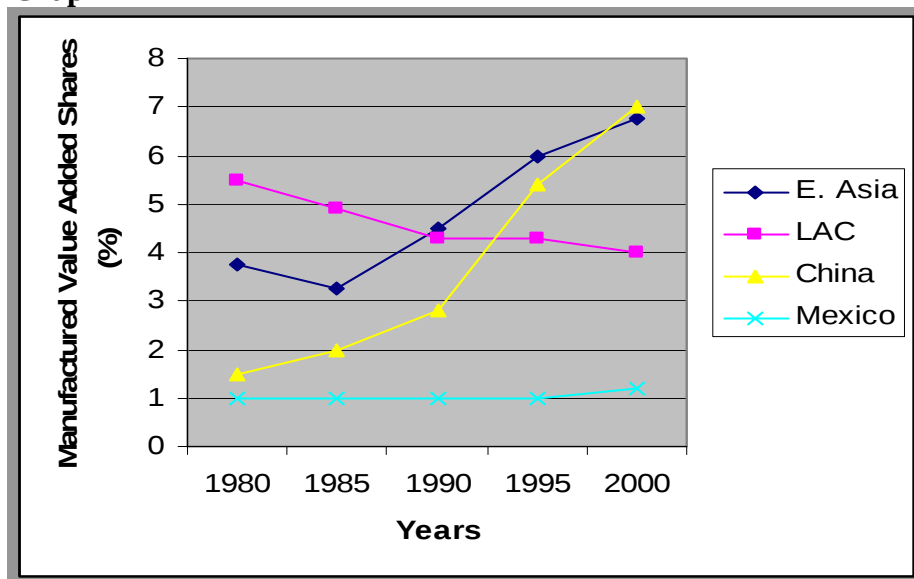
Chart 1B:



Comparative Productivity Growth

The shift in proportional FDI distribution can be explained in part by regional productivity trends. Graph 1 shows the percentage of manufactured value added shares to represent comparative productivity. Since 1980, Asia has soared, while Latin America and the Caribbean have dropped.

Graph 1



Two important outliers—Mexico in Latin America and China in Asia—must be disaggregated from the overall result. China is an emerging industrial giant whose production and exports are increasingly dominating global markets. As China's neighbors are also dynamic exporters, however, the impact of China's economic

emergence, specifically its abundance of low-wage workers, has been to force those other nations up the technology ladder in order to find new niches and maintain high employment numbers.

Mexico's economic impact is not as large, of course, and its impact on regional production is relatively small. However, its export performance is significant, a direct result of NAFTA. Mexico is gaining ground in all export categories, while the rest of Latin America is doing poorly in low technology and high technology manufactured goods.² Latin America without Mexico has lost shares except for the time period 1990-1995, when it stayed abreast of global productivity growth due to implementation of the first generation of economic reforms across the region.

Skill and Educational Levels of the Population Aged 25 and Over

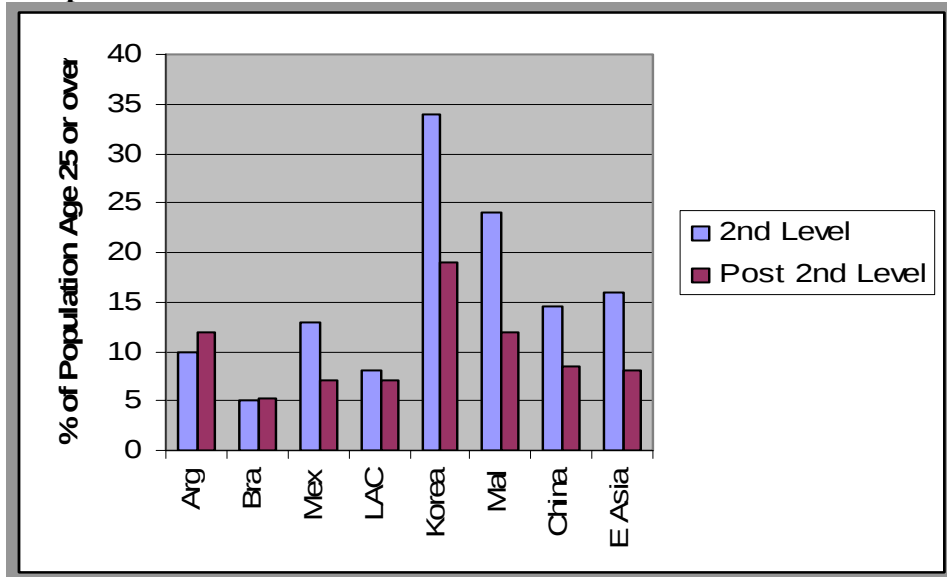
It is difficult to measure the stock of skills or current skill formation for a country as a whole, much less a region. A significant part of skill creation is informal, or the result of work experience and other forms of training that are not reported in national statistics. However, in order to have a comparable analysis of education levels most analysts use enrollment rates in formal education.

From graph 2, one can see several trends. The most obvious is that there are large variations across regions, though those differences are more pronounced in Asia. The highest Latin American nation (Chile) is well behind the Asian leader (South Korea), which also leads the world in formal educational training. As is well known, Latin American and Asian post secondary level numbers are almost identical, even though levels of primary education in Asia far exceed those in Latin America and Caribbean. Additionally, a 2002 Inter-American Development Bank report suggested that, "a significant quality gap [exists] between Latin America and East Asia. For instance, in an international study of student achievement in mathematics and science both Chile (1999), Latin America's leader in education, and Colombia (1995) performed poorly, scoring well below the average. In mathematics, Chile scored 392 and Colombia 385, while Korea scored 587, Malaysia 519, and Thailand 467."³

² Lall; Albaladejo; Moreira. *Latin American Industrial Competitiveness and the Challenges of Globalization*. IDB working paper, 2004.

³ Arellano. "International competitiveness and education in Latin America and the Caribbean countries." *The Latin American Report 2001-2002*. New York: Oxford University Press for the World Economic Forum. 2002.

Graph 2



A recent World Bank study perhaps summarizes the educational situation in Latin America best:

Over the course of the last two decades, the mean years of education of the adult population over 25 has gone up by 1.7 years in Latin America (from 4.1 to 5.8 years). On average, however, Latin American adults have 1.4 years fewer of education, and East Asian adults have 0.4 more years of education than would be expected from their income levels. This gap in the stock of educational attainment is a reflection of relatively slow and sometimes inadequate education investments in the past. It is therefore particularly worrying to observe that the flow of new educated workers is also inadequate. The region [Latin America] has large deficits in enrollment, particularly at the secondary school level, as well as a problem with the quality of education. Latin America has an aggregate deficit of around 20 percentage points in net tertiary enrollment and 10 percentage points in gross tertiary enrollment give its average income level, while East Asia has surpluses of more than 17 and 5 percentage points, respectively.... Finally, we discussed the quality of students “produced” as each level of education as a given by the performance of Latin American students and adults on standardized tests.... Not only do Latin American countries (other than Cuba) under perform relative to an income-adjusted benchmark, they also under perform relative to much poorer countries.⁴

Corruption and the Rule of Law

Corruption is also a critical variable that foreign investors review when considering international expansion because it raises costs, puts investors at comparative disadvantages vis-à-vis competitors who do not follow the Foreign Corrupt Practices Act, and increases uncertainty in areas such as contracting and government procurement. A

⁴ Buira (Editor). *Challenges to the World Bank and IMF*. London: Athens Press. 2003.

standardized source of the measurement of national corruption is the Transparency International Corruption Perceptions Index (CPI).⁵

For the purpose of this report, we compared the 1998 and 2002 CPI surveys to show trends between and within regions. To make a comparison, we added the scores of the 11 Latin American countries that appeared on the 1998 and 2002 surveys,⁶ to get the average score we then divided the sum by 11. We then did the same with the top 11 Asian countries on the survey.⁷ Asia ranked “less corrupt” in both surveys. Additionally, the average rank of Asian countries rose while Latin American nations got worse.

In 1998 the average score for Latin America was 3.92, while Asia’s average score was 4.55. In 2002 Latin America’s average score was 4.17, while Asia’s was 5.02. While the scores themselves seem arbitrary, how the countries ranked in relation to one another is telling. The average rank of a Latin American country in 1998 was 51.63; the average rank of an Asian country was 50.72 (lower numbers signify less corruption). In 2002 Latin America’s average rank rose to 59.27, while Asia’s decreased to 42.8. Of course, patterns such as these weigh heavily on the minds of investors.

Perceptions of Personal Security - Intentional Homicides

Perceptions of personal security are fast becoming a more important variable in the hemispheric context. The term “personal security” encompasses many different aspects of day-to-day life. From homicide rates to the number of kidnappings, highjackings, and robberies, security has become a rallying point across industries.

We expanded on two World Bank figures that, we believe, serve to explain the concerns that foreign investors have when considering investing in the region.⁸ The results show two important insights. The first is that while intentional homicide rates have risen from a world average of five per 100,000 in 1970 to just below eight per 100,000 in 2000, homicide rates in Latin America have leaped from just above the world average in 1970 to an estimated 17 homicides per 100,000 in 2000. The second insight is that Asia’s intentional homicide rates have traditionally been well below the world average, *dropping* from 2.2 homicides in 1970 to an estimated 1.7 in 2000. Graph 3, taken from the same report, shows trends across different regions. Regional discrepancies are clear, especially those between Asia and Latin America. Importantly, even sub-Saharan Africa scores better than Latin America since 1970, though the trend line is comparable.

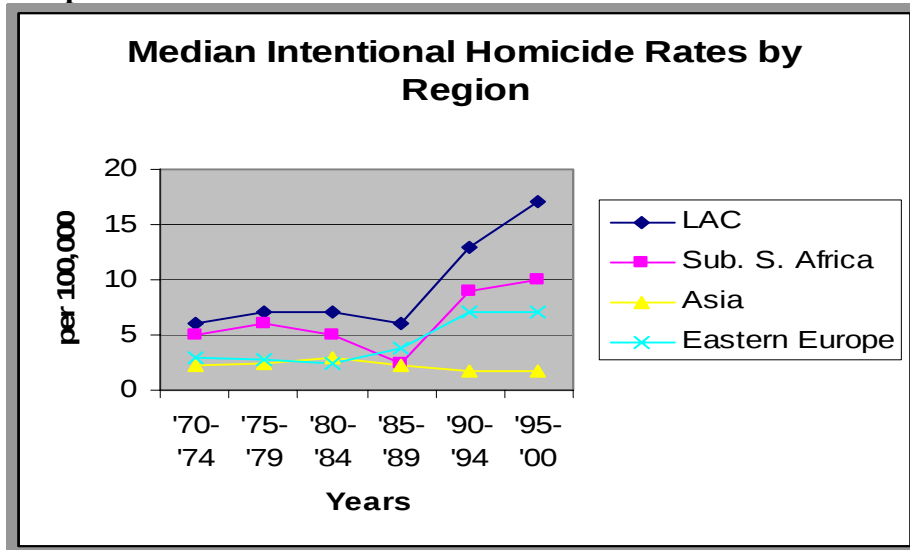
⁵ Transparency International Corruption Perception Index (1998 and 2002). Available at: www.transparency.org.

⁶ Countries: Chile, Costa Rica, Peru, El Salvador, Brazil, Argentina, Mexico, Colombia, Bolivia, Venezuela, and Ecuador.

⁷ Singapore, Hong Kong, Japan, Taiwan, Malaysia, South Korea, China, Thailand, Philippines, Vietnam, and Cambodia.

⁸ Fajnzylber; Lederman; Loayza. *Determinants of Crime in Latin America and the World*. World Bank Latin American and Caribbean Studies, Viewpoints. 2000.

Graph 3



Although the larger countries are the ones most affected by crime in absolute numbers, the smaller countries, especially those that are heavily dependant on tourism, are equally susceptible to crime. In Jamaica, for example, tourism is the largest source of foreign income, earning about 15 percent of GDP. In a recent speech, Jamaican Minister of Industry and Tourism Aloun N'Dombet Assamba said, "There is nothing I can do... to move forward if we are constantly having to fight the battle against crime." The speech was given after reports that there had been more than 900 murders in Jamaica to that point in 2004, compared to 975 for all of 2003.⁹ In fact, a 2000 World Bank survey of 69 multinational companies found that security was rated as the most important risk facing investors.¹⁰ Our own survey results mirrored the World Bank.

As is the case in other regions, Latin American urban centers are where a majority of crime occurs. Mexico City, Buenos Aires, Caracas, and Rio de Janeiro have seen the largest increases in crime. In Brazil, for example, over 60 percent of homicides occur in the four major metropolitan centers; 40 percent of all homicides occur in either Rio de Janeiro (49.9 per 100,000) or São Paulo (39.2 per 100,000). A *Centro de Estudios Nueva Mayoría* survey in the Capital Federal and Greater Buenos Aires during March 2004 revealed that 35 percent of those polled acknowledged having been a victim of crime during calendar year 2003, up from 20 percent in late 2001. On top of personal experience with crime, 54 percent of those surveyed acknowledged family members had been victimized by crime, as well.¹¹

Not coincidentally, major cities are where most companies choose to locate corporate activities and where most news is gathered and reported, thus high crime rates in major metropolitan areas, particularly capital cities, has an disproportionate impact on

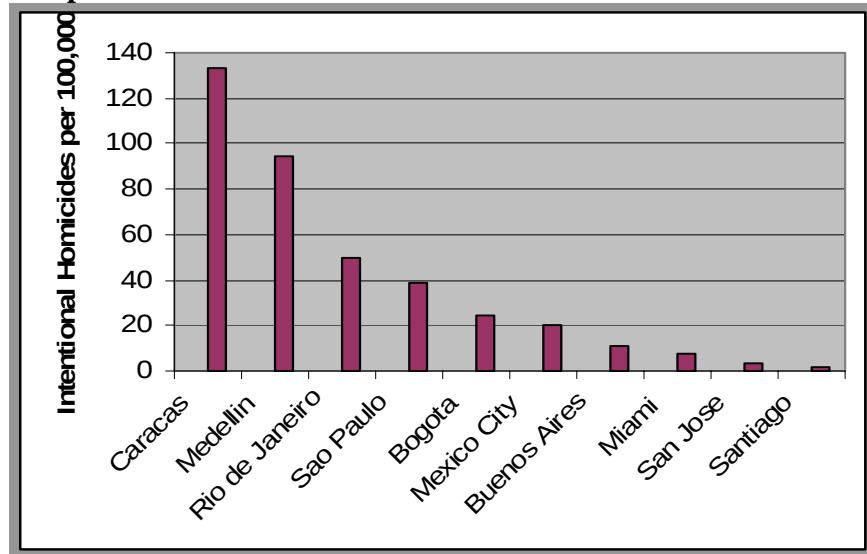
⁹ CNN.com. *Minister: Jamaican Crime Hurting Tourism*. August 30, 2004.

¹⁰ Lilly; Killinck. *Corporate Security Arrangement: A Conflict Prevention Perspective*. International Alert.

¹¹ Fraga. *Meaning and Scope of the Claim for Insecurity*. Nuevamayoria.com

foreign investment decisions. The same survey cited above asked company executives to rank the three most dangerous cities in the hemisphere, with unsurprising results: 57 percent voted Bogotá one of the three most dangerous, followed by Caracas (41 percent), São Paulo (26 percent), Mexico City (25 percent), and Buenos Aires (12 percent). Perceptions, of course, are influenced by actual crime rates. As a result, when asked about their perceptions of change in security and general quality of life over the past three years, 91 percent of executives agreed that security had improved in Bogotá, while 70 percent felt that the situation had deteriorated in Buenos Aires.

Graph 4



Perceptions of Security - Kidnappings

In direct correlation with homicide rates, kidnapping rates have followed similar patterns across the world. The following chart was taken from a report published by the Foreign Policy Centre in England that examines changes in the nature of kidnapping, from an ideological/political tool to a profitable business. The report indicates that economic kidnappings tend to take place where the risks for kidnappers, including detection, arrests, prosecution, and potential penalties, are fairly low.”¹² Kidnappings tend to flourish where political or economic conditions are unstable, and where government and security institutions are weak. Latin America and the Caribbean are no exception.

Countries like Brazil, Mexico, Venezuela, and of course Colombia have had to deal with high numbers of kidnappings for several years. Special police units have been assembled and trained in order to combat this specific crime, though solid results are yet to be seen. In fact, the trends are in the wrong direction. In Mexico City, for instance, kidnappings rose from 141 in 2000 to 185 in 2003. In the state of Mexico, the numbers

¹² Briggs. *The Kidnapping Business*. The Foreign Policy Centre, 2002.

rose from 65 to 135 during the same period.¹³ With the changing nature of kidnapping from a political crime to a crime of extortion, kidnapping targets tend to be those whose families or companies can pay large ransoms. Hence, the business community has become a more likely target and the impact on investors is significant.

Figure 1 **Kidnapping Hot Spots**

1991		1999		2002	
1	Colombia	1	Colombia	1	Colombia
2	Pakistan	2	Mexico	2	Mexico
3	Brazil	3	Brazil	3	Brazil
4	USA	4	Philippines	4	Venezuela
5	Mexico	5	Venezuela	5	Argentina
6	India	6	Ecuador	6	Philippines
7	Philippines	7	FSU	7	Ecuador
8	Venezuela	8	Nigeria	8	Nigeria
9	Italy	9	India	9	FSU
10	Bolivia	10	South Africa	10	South Africa

Spreading political and economic uncertainty has exacerbated the problem. Argentina is a case in point. Since the onset of the economic crisis there in 2001, the number of kidnappings in Argentina has increased by more than 500%.¹⁴ Kidnapping has become such a problem in Argentina that it has received international attention. On August 17, 2004, during a visit to Argentina, several German legislators commented during a press conference that, “Interior security plays a very important role and it would be very difficult to get [German] companies to set up headquarters in a country where there exists a real danger of kidnapping.”¹⁵ And Argentina is not alone. Several countries that historically have not been able to deal with kidnapping on a broad scale have seen recent increases. Venezuela, for example, has seen kidnapping rates rise 150% since 2002. Smaller countries in the Caribbean have also seen the number of kidnappings for ransom increase dramatically in recent years. For example, Trinidad and Tobago saw fewer than 10 abductions in 2001, with 29 in 2002. According to a police source on the anti-kidnapping squad, there were 142 kidnappings in 2003 and 95 the first three months of 2004 alone.¹⁶ In fact, during a conversation with a member company with expertise in security, we were told that in 2003, *75 percent of the world’s total kidnappings occurred in Latin America and the Caribbean* despite the region having less than 10% of the world’s population. Though not the only reason for investor apprehension, these issues rank right at the top in terms of importance.

¹³ The Economist. *Fear and Captivity*. June 17, 2004.

¹⁴ Buenos Aires Ministry of Security. <http://www.mseg.gba.gov.ar/>

¹⁵ La Nación. “Advertencia de Diputados Alemanes: Por los Secuestros no Habría Inversiones.” August 18, 2004.

¹⁶ Trinidad Guardian. <http://www.guardian.co.tt/HamidGhany.html>. June 5, 2004.

Insecurity Raises the Cost of Doing Business in Latin America and the Caribbean

Protecting personnel and assets has always been an important part of doing business in emerging markets. However, in a global investment environment, an increase in operating costs of even two or three percentage points can radically shift a company's ability and willingness to invest. Compared with Asia, where total security costs for some companies range between two and four percent of annual operating costs, companies doing business in Latin America have had to devote between six and eight percent on average to security.¹⁷ In this section, we will examine how a country's lack of security can permeate all facets of corporate operations and investment decisions.

Security Costs Raise Expenses for the Private Sector¹⁸

Throughout the region the private sector has had to make up for the lack of effective police presence through private security measures, including the hiring of private security guards and developing in-house investigative capabilities. Astoundingly, there are over 2.5 million private security personnel throughout the region. In some countries, this means that there are more private security personnel than police officers. Companies must pay for costly background investigations before they can hire new security personnel. In the most extreme case, Colombia, total private investment in security was US\$766 million, or 1.5% of GDP, in 2003.¹⁹

Apart from basic security functions (prevention of petty theft and personnel and product transportation), private security guards, whether in-house or outsourced, now have to be better trained and certified on weapons and emergency procedures. Newer weapons (higher caliber and automatic), uniforms, body armor, armored cars for executives, and communication equipment must be purchased. High-tech security systems have to be installed and monitored at production facilities and executive housing. At production facilities, new security measures have to be written, published and distributed among company personnel. Training must occur. New procedures must then be followed, impacting productivity.

Along with new security personnel and monitoring technology, companies have to provide health and life insurance for their employees who may be operating in insecure environments. Insurance premiums for both of these are higher in countries where public security is low. Property insurance, which must be provided for executives' homes and production plants, is also higher. In Brazil, for example, the total cost to provide security for one executive per year can exceed US\$ 80,000. Included in that total cost is the newest form of insurance, kidnap and ransom (K&R).

¹⁷ Figure from Council of the Americas member survey

¹⁸ Examples taken from Council of the Americas member survey

¹⁹ Facts from the Instituto de Estudios para el Desarrollo y la Paz (Indepaz)

As crime has evolved over the years, so have security measures to minimize the risks to companies. Kidnapping concerns have led to the development of K&R insurance which is growing at a rate of 15-20 percent per year worldwide.²⁰ K&R insurance covers policy-holders against losses stemming from a kidnap incident, in the same way that fire insurance covers a residence in case of fire. As well as the ransom payment, the insurance may include consultants to advise on how to manage a crisis situation, travel or living costs, hostage ransom, and any counseling the hostage or his family may need upon resolution of the case.

Permissive security environments also lead to inventory loss due to attacks on or destruction of infrastructure such as pipelines and telecommunications facilities, and hijackings of goods in transit and pilfering at ports of entry and exit. Besides being highly aggravating, these incidents raise costs and cause senior executives to question the long-term viability of projects. As a result, investments that are made tend to be more speculative in nature, occupying a more limited position in magnitude and importance in a corporation's global portfolio of assets.

Lack of Security Leads to Speculative Underinvestment

As this report stated earlier, the countries that have the most severe problems with security are in the middle of political or economic transitions, which create instability and reduce the risk of criminal behavior. The lack of effectiveness of government institutions such as the police, military, prosecutors, judges and other public entities has led to the current situation. This lack of institutional strength raises security concerns internally, while raising investment concerns internationally. Rating agencies, private banks, and International Financial Institutions (IFI's) take several indicators into account when approving loans. If the political situation in a country is unstable, then country ratings are downgraded, which leads financial institutions to raise interest rates on loans and demand a higher rate of return on investment. Simply put, as the cost of money to investors goes up, the desire to invest goes down.

As with any individual company, industry, or nation, capital formation is a key to growth. The ability to attract new investment is the life's blood of national development. Without new investment, jobs are not created, and social programs for citizens are unfunded. Higher risks demand higher returns to lenders and investors. In the medium term, the international investment community turns highly speculative, with a mindset of making money and getting out as soon as possible. As bad money drives out good, the nature of investment changes, leading to an influx of more speculative investments, rather than long-term investments from blue-chip corporations. The volatility of capital flows increases, making planning difficult, and in a downturn, capital flight becomes a significant problem.

Additionally, although countries like Argentina, Brazil, and Mexico are natural locations for the establishment of regional headquarters, violence rates in Buenos Aires,

²⁰ Briggs. *The Kidnapping Business*. The Foreign Policy Centre, 2002.

São Paulo, and Mexico City have forced companies to reconsider the locations of their regional headquarters. Companies instead have established regional headquarters elsewhere. Companies have been forced to take these decisions because executives assigned to dangerous locales have been unwilling to expatriate their families with them. In addition to the higher costs of security mentioned previously, this tends to lead to increased leave time and travel expenses by executives as they return home more often. At times, it has even led to increased salary requirements in the form of danger pay or other benefits to entice executives to the region. This might be good news for local communities such as Miami or Santiago. For the company, however, it can mean reduced senior managerial oversight in the largest markets in the region.

In an era of globalization, where emerging markets are competing with each other to attract a finite pool of international investment, Latin America and the Caribbean find themselves fighting an uphill battle. With limited resources to invest in education and infrastructure, the region is falling behind other markets, such as Asia, with larger internal markets, larger and better educated labor forces, and more stable political environments. Unless Latin America and the Caribbean turn the tide on the violence and corruption that plague their societies, they will continue to under-perform economically—with all that implies politically—by being unable to attract the FDI that will allow them to invest in their countries' futures.

Recommendations to Increase Public Security in the Hemisphere

The third section of this report will focus on recommendations by the private sector on how regional governments can increase both the perception and reality of security in the hemisphere, of critical importance in attracting and retaining new investments throughout the region.

The Council of the Americas acknowledges and fully appreciates the historical sensitivity of these issues, especially in the Latin American and Caribbean context. There is perhaps nothing more sensitive politically across the region than the respective roles of the military and police, civilian control, corruption in the security services, human rights protections, and intelligence coordination among security forces in neighboring nations. These issues are freighted with significant historical baggage, and indeed, significant abuses have occurred in the past that limit the desirability or possibility of specifying certain actions that, in a vacuum, it might otherwise make sense to recommend.

For example, US law is explicit in the types of cooperative relationships that the United States can pursue with Latin and Caribbean militaries and police. It is not the intent of the Council in the form of the following recommendations to revisit some of

these settled issues. Rather, it is our intent to take as given the history of the region, coupled with the new prevailing threat environment and existing realities inherent in the democratic process, to recommend practical steps that can be taken in the near term to improve the security environment. Clearly, these recommendations are not exclusive to other ideas, nor are they necessarily sufficient. But they are a start of the dialogue, and as such, the Council of the Americas submits them for consideration and concrete implementation by hemispheric governments before security matters deteriorate further, impacting FDI and the longer-term development of the Americas.

Recommendation 1

Improve national threat assessments and analysis by centralizing functions within Ministries of Defense or other appropriate national bodies under strict civilian control, and coordinate more closely within each country and with neighboring nations

Latin American and Caribbean governments are simply unprepared to deal with existing security threats in addition to the emerging threats that include global reach terror and gang-inspired criminal activities. As a first step to addressing these problems, better security coordination is required for threat identification, intelligence gathering and analysis, and information dissemination. Of course, such centralization is appropriate only in the context of democratically elected governments and strict civilian control of security forces. A more harmonized response to threats will minimize internal (interagency) infighting and allow for the appropriate security entity to respond to the threat in an appropriate manner. In this regard, it is also important to standardize a consultative process with the private sector and civil society to identify relevant security issues impacting the investment climate and to develop appropriate responses that address the problems while protecting human rights and civil liberties.

Consolidation of national security analysis will also facilitate cross border coordination among countries and regions. In the case of Central America, joint declarations by the Governments of El Salvador, Honduras, Guatemala, Nicaragua, and Panama have standardized civil codes to combat gangs in the region. Extradition of captured criminals has been facilitated through cooperation agreements between the governments, which have also allowed intelligence agencies to work together and in conjunction with the United States and multilateral organizations. To combat gangs, civil awareness and education programs have also begun in these countries in conjunction with civil society.

This coordination to combat gangs within Central America is a model that should be more aggressively developed by hemispheric governments to address financial crimes, illegal narcotics trafficking, kidnapping, counterfeiting, and global reach terrorist activity. Without a commitment to strengthen intra- and inter-governmental security synchronization, efforts to stop cross border criminal activity will prove unworkable in the long run.

Recommendation 2

Based on national threat assessments, rationalize force structures in the hemisphere

As threats in the region evolve, so should responses. Regional governments must rethink the role of standing militaries in the 21st century. Certain traditional and non-traditional roles of the military will likely always exist, including global and regional peacekeeping, border security, counter terrorism and disaster relief. Training, equipment, inter-operability with other nations, history, and resources make militaries uniquely qualified to perform these roles. Ideally, the fight against illegal narcotics would be handled primarily by the police, though current hemispheric realities dictate that regional militaries are also involved to a greater or lesser degree.

To facilitate these important regional military functions, the United States is obligated to ensure the full implementation of its own technical transfer regulations and laws. If different militaries are expected to work together to address cross-border threats, they must have access to similar technology and equipment to coordinate their efforts more effectively. National budgets should be brought in line with revised military requirements and allocated appropriately among security forces based on national strategic threat assessments.

Many threats, however, require different, non-military responses better handled by police. Such threats include kidnapping, organized crime, cyber crime, and human trafficking, where investigations and law enforcement activities, including judicial actors, are more appropriate. To be effective, the role of the police must be re-thought, with a focus on crime solving including investigative technique and training in forensic sciences, education, and crime prevention including anti-corruption within the police forces themselves. Police forces must be a part of the solution to crime, not a part of the problem.

Recommendation 3

Promote better security at points of entry and exit while facilitating economic activity

Border control is a significant issue requiring greater attention from hemispheric governments. It is a difficult balancing act, because in the course of improving border security, the lifeblood of hemispheric integration—cross-border commerce—cannot be impeded.

To address this dilemma, nations should take better advantage of existing technologies and tactics to restrict the flow of narcotics, illegal entry, and contraband. To be successful in these endeavors however, governments must also begin to look to their neighbors for help by creating official networks that will allow for cross-border intelligence sharing and cooperation. It is the only way to ensure that adequate international attention is given to cross-border matters.

For the private sector, secure points of entry and exit are essential to doing business. The free flow of goods and the demands of the global economy to ensure “just in time” delivery requires that the process of securing major ports, airports, and free trade zones does not unduly slow trade flows. One way to increase security while simultaneously improving the business climate would be for regional governments to target corruption at points of entry and exit. By doing so, they would reduce the costs of doing business while lowering the risk that illegal actors—such as terrorists or drug smugglers—can exploit security breaches to achieve their goals.

Recommendation 4

Prioritize and enforce judicial reform and focus on anti-corruption

As in our case studies, those countries that make a commitment to reform their security forces, protect human rights, and improve judicial effectiveness have made the greatest strides in increasing security throughout their respective nations. With the help of the international community, countries must work together to raise standards and effectiveness.

One way is through the US Department of Justice International Criminal Investigative Training Assistance Program (ICITAP), designed to help build law enforcement institutions worldwide. Created in 1986 to respond to a request from the State Department for assistance in training police forces in Latin America, ICITAP's activities have expanded to encompass the development of police forces in the context of international peacekeeping operations, and the enhancement of capabilities of existing police forces in emerging democracies. Assistance is based on internationally recognized principles of human rights, rule of law and modern police practices.²¹

Another alternative to bringing security personnel together to learn from each other and share information would be the establishment of an International Law Enforcement Academy (ILEA) in the Americas. Currently, with funding from the State Department, ILEAs have been established to serve Europe, Asia, and Africa, with a graduate facility in Roswell, New Mexico.²² An academy in the Americas would help countries increase the confidence of international investors over time by developing higher levels of transparency and professionalism among national law enforcement communities. It would also build the case for a greater commitment of resources to ensure that law enforcement officials and officers of the courts are better paid throughout the Americas, directly addressing a key aspect of corruption.

Finally, better systems for selecting qualified judges need to be devised, as well as for removing corrupt ones. Greater use of international arbitral institutions and a willingness to accept unfavorable decisions, along with higher levels of transparency and professionalism in the court system based on benchmarks, will assist in the prompt,

²¹ <http://www.usdoj.gov/criminal/icitap/>

²² <http://www.state.gov/g/inl/ilea/>

adequate, and effective resolution of investment disputes, a situation that has proven to be problematic for many multinational companies throughout the hemisphere and has depressed FDI accordingly. Aggressive implementation of the Inter-American Convention Against Corruption is also appropriate.

Recommendation 5

Mobilize capital to promote research and development of new technologies and develop entrepreneurialism through public-private partnerships

As with many other indicators, Latin America and the Caribbean lag other regions in both applied research and development, and also the entrepreneurial spirit that promotes risk taking and job creation. While preventing the brain drain, governments of the region must also mobilize capital to promote the development of new technologies and new businesses through public-private partnerships.

There is only a limited culture of private capital financing new ideas in the region, in part due to the cost of money, in part due to the fact that many of the region's best and brightest remain where they are after being educated in the United States and Europe. Together, these two factors dramatically lessen the entrepreneurial spirit that modern economies require for continued growth and development.

To mobilize capital, governments should consider creating partnerships with entrepreneurs by developing "regional incubators" of new technologies, where, with government subsidized bank loans, local solutions can be found to local problems. For example, the US government has created In-Q-Tel, a CIA-funded venture capital activity that identifies, nurtures, and funds promising technologies with applications for the government. Similar models could also work in the Latin American and Caribbean contexts, whereby security agencies or other entities fund and promote technologies that can directly address security problems identified above. In addition to improving the security environment, such activities would encourage entrepreneurial activities, many dual use, that could help create jobs and identify spin-off activities for further commercial exploitation.

Recommendation 6

Take full advantage of trade agreements as a means to promote alternative development and create jobs for less skilled workers

Security deteriorates when economic conditions stagnate and under- and unemployment increases. Increased economic options decrease the lure of gangs, crime, and the illegal economy. Trade expansion must be an important part of the strategy for improving both economic and security conditions.

The Council strongly believes that it is in the economic and national security interests of the United States to pursue open trade and investment relationships in the

Western Hemisphere. In Latin America, whole industries have been created as a result of a progressive US trade policy. For example, the Andean Trade Promotion and Drug Eradication Act (ATPDEA) provides Bolivia, Colombia, Ecuador, and Peru with duty-free access to U.S. markets for approximately 5,600 products.²³ According to the Colombian Ministry of Foreign Trade, between 1992 and 1999, the Andean Trade Preferences Act (the predecessor to ATPDEA) generated \$1.2 billion worth of output and more than 140,000 direct jobs in Colombia.²⁴ The cut flower industry in Colombia and Ecuador was a virtual creation of US trade preferences, and has flourished, providing critically needed jobs to those who might otherwise be tempted to engage in illegal activities for their livelihoods.

Alternative development must be part of the strategy to secure the hemisphere. But alternative development only works if markets exist for the goods that are produced, particularly in the agriculture and textiles sectors where Latin America and the Caribbean maintain comparative advantages. As a strategic matter, US trade policies that promote openness in these areas should be supported and expanded. Policies that restrict trade in these sectors should be dismantled.

Conclusion

In the eyes of the private sector, the conduct of business in the Americas has become less secure, particularly in relation to other areas of the global economy, and thus less likely to encourage FDI. Increased costs in securing personnel and assets have made the proposition of doing business in the Americas a risky one. Unless these issues are concretely addressed, investment will continue to lag other regions, and Latin America and the Caribbean will fall further and further behind.

Civilian Defense Ministers have a role to play in reversing this trend. Working together with other interested parties, they can have a dramatic impact on the Latin American and Caribbean investment climate. These matters are of critical importance. Efforts to address them must begin now.

²³ http://www.ustr.gov/Document_Library/Fact_Sheets/2002/New_Andean_Trade_Benefits.html

²⁴ Ibid

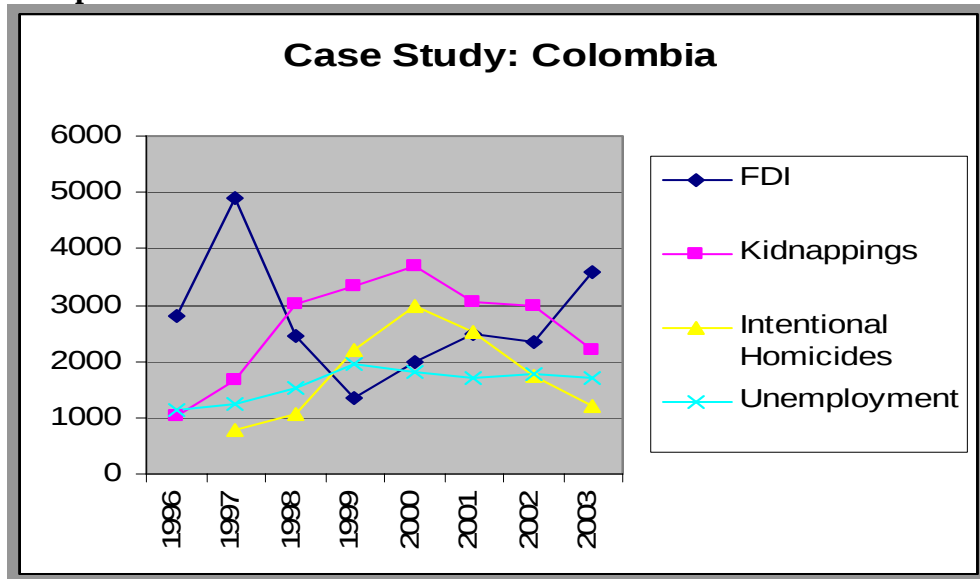
Appendix - Case Studies

Several countries in Latin America have taken on a proactive agenda to increase the security environment in efforts to entice the private sector to invest more aggressively in their respective countries. This section will focus on three countries, Costa Rica, El Salvador, and Colombia, to show how a secure environment, among other factors, has lead to an increase in foreign direct investment.

Colombia

Colombia is in the middle of a long-standing internal conflict. To meet the needs of the conflict it increased its armed forces from 112,000 in 1985 to 164,000 in 2002.²⁵ With significant assistance from the United States, Colombia has been able to increase security throughout the country. Homicides (3,000)²⁶ and kidnappings (almost 4,000)²⁷ reached an all-time high in 2000; those numbers were reduced to about 1,000 and 2,000 respectively by 2002, and they continue to show a downward trend. In 2000, there were 165 municipalities without a police presence; in 2003, the government reported that there was a police presence in all Colombian municipalities.²⁸ As security has increased through a broad program of cooperation between all branches of the federal government, military and police, as well as local entities, the number of homicides has decreased. Killings by leftist guerillas (FARC and ELN) as well as paramilitaries (AUC) have also decreased since they peaked in 2000.

Graph 4



²⁵ Country Watch, Colombia. www.countrywatch.com

²⁶ Presentation by Santiago Montenegro Trujillo, Director, Plantación Nacional, Colombia. July 2, 2004.

²⁷ Fact sheet by the Colombian Ministry of Defense (FONDELIBERTAD). 1996-2003.

²⁸ Report by the Colombia Ministry of Defense. *Democracy Security and Defense Policy*. 2003.

This is not to say that Colombia's recovery is complete. As General James T. Hill, Commander of the US Southern Command, has put it, "Colombia is at a decisive point and the test bed of our resolve...and I am seeing significant progress. I am guardedly optimistic that President Uribe will establish security and stability in that country."²⁹

Investors clearly believe the situation in Colombia is improving. The perception of increased security has helped the restoration of FDI flows that were reduced during the height of violence. As kidnapping and intentional homicides increased, FDI decreased. As violence has decreased, FDI has begun to return. Coupled with progressive US trade policies that encourage the creation of non-traditional sectors such as the cut flower industry, unemployment has dropped, reducing the economic pull of guerrilla or narcotics activities.

Costa Rica

One of the most politically stable countries in the region, Costa Rica has been cited as an example for other countries to follow. The country's economy depends on tourism, agriculture, and electronics exports, the result of a massive investment made in microchip manufacturing in the mid-1990's. Foreign investors are attracted by the country's political stability and high education levels, and eco-tourism continues to bring in foreign exchange. Poverty has been substantially reduced over the past 15 years, and a strong social safety net has been in place since the beginning of constitutional democracy in 1949. Without external threats, Costa Rica dismantled its military, while nonetheless redirecting funds to focus on police activities. In fact, security spending (0.4% of GDP or about \$64 million in 2003)³⁰ is higher than what other countries in Central America are spending on defense. Directing funds to where they are needed has allowed Costa Rica to remain "safe" over the years in spite of security issues that have plagued its neighbors.

One of the telling statistics that shows Costa Rica's commitment to internal security is that while homicide and kidnapping rates have increased in neighboring countries, homicide rates in Costa Rica have remained constant and very low (between four and six per 100,000).³¹ This environment has provided a strong incentive for FDI flows, reinforcing investments in education thus drawing further investments. High technology is now Costa Rica's top export earner. Tourism has also benefited accordingly. At bottom is a secure and stable environment that has drawn long term investors. Without such an environment, such investment surely would have gone elsewhere.

²⁹ General James T. Hill. Commander, Southern Command, United States Department of Defense. *Remarks for CSIS*. September 10, 2003.

³⁰ CIA Fact book: Costa Rica

³¹ Report by Estado de la Nación, Costa Rica. www.estadodelanacion.or.cr

El Salvador

After the close of a 12-year civil war in 1992 which cost about 75,000 lives, the government and leftist rebels signed a treaty that provided for military and political reforms. More than ten years later, substantial institutional changes have been made. The military has continuously decreased its standing forces from 59,000 in 1989 to 16,000 in 2004.³² Military spending has also decreased; in 2003, military spending was 1.1% of GDP or about \$157 million.³³ Now, security threats arise primarily from gang-related activities, kidnappings, armed robberies, and the like.

To combat such activities, the Salvadoran police has worked with police forces in the United States to gain expertise on fighting this specific crime. The executive branch has given full support to combating gangs, which has allowed for unprecedented cooperation with the judicial branch to modernize penal codes, and the legislative branch to fund the security forces. There has also been unprecedented regional cooperation among the governments of Central America in fighting gangs. In 2003 and 2004, El Salvador and its neighbors signed pacts that codified gang activity as well as drug trafficking as transnational crimes which allows for the deportation of criminals and the sharing of intelligence across borders.

Although El Salvador has made large strides in strengthening its democratic institutions, much remains to be done. Its progress has, however, has caught the eyes of international investors. Seeing a large unemployed yet motivated labor force after the civil war, textile manufacturers began to move in to El Salvador to take advantage of favorable trade terms under the Caribbean Basin Initiative. In fact, FDI has consistently increased from \$59 million in 1996 to some \$240 million in 2002.³⁴ During the same period, homicides decreased from around 140 per 100,000 to around 40 per 100,000.³⁵ Kidnapping rates have also dropped dramatically, from 140 kidnappings for ransom in 2000 to eight in 2003.³⁶ Even so, due to an increased presence of violent gangs, homicides remain relatively high an increasingly worrisome condition throughout the region.

³² Country Watch, El Salvador. www.countrywatch.com

³³ CIA Fact book: El Salvador

³⁴ ECLAC. Preliminary Overview of the Economies of Latin America and the Caribbean, 2003.

³⁵ World Health Organization. www.who.org

³⁶ Silvia Aguilar, Vice Minister of Justice, El Salvador. Presentation for CSIS. August, 24, 2004.

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