

# Regional Trade Agreements and Foreign Direct Investment

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## Abstract

This paper reviews previous research on why firms pursue foreign direct investment (FDI) in certain countries and explores the relationship between FDI and regional trade agreements (RTA's). Researchers have focused on the determinants of FDI, but few have studied what effects RTA's may have on FDI. The first part of this paper examines the determinants of FDI for manufacturing industries in general and for the agricultural industries specifically. The second part of the paper explores how RTA's affect the determinants of FDI. Some important theoretical reasons why a firm might choose to invest in a foreign country are to avoid paying tariffs, to take advantage of lower factor prices, and to better serve a foreign market. Empirical studies on the locational determinants of FDI generally conclude that the last reason is most important. Most FDI migrates to countries with a high per-capita GDP (or high growth rate of GDP) and a large market size. The single greatest influence RTA's have on FDI is through their effects on market size and on GDP. RTA's, through trade liberalization, combine fragmented markets into a single large one and they generally increase the growth rate of member countries' GDP.

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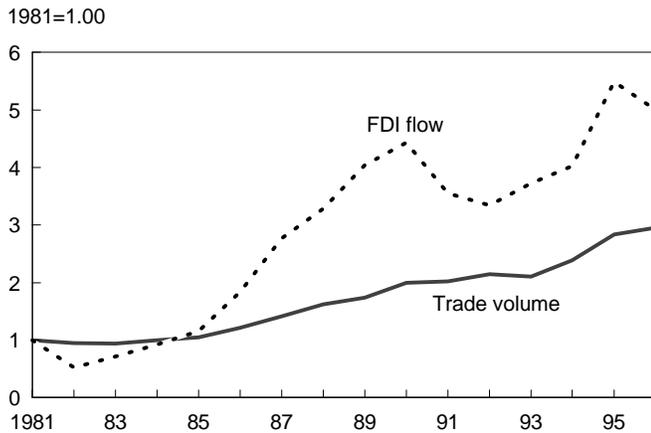
## Introduction

**F**oreign direct investment (FDI) has become a more visible topic because of its rapid growth in the last two decades. Among members of the Organization for Economic Cooperation and Development (OECD), who account for most of the world's FDI and trade, FDI outflows increased by five times whereas trade grew by three times from 1981 to 1996 (fig. 1). Yet nations have developed far more comprehensive agreements for trade than for FDI. Initially there was the General Agreement on Tariffs and Trade (GATT) which had a global focus. Then several groups of countries developed separate regional agreements such

as the European Union (EU) and the North American Free Trade Agreement (NAFTA). Although trade-oriented, these RTA's can affect the pattern and volume of FDI as well.

Here, I examine why firms pursue FDI in certain countries and explore the relationship between FDI and RTA's. Researchers have focused on the determinants of FDI, but few have studied what effects RTA's may have on FDI. I first examine the determinants of FDI for manufacturing industries and for agricultural industries specifically. I then explore how RTA's affect these determinants.

Figure 1  
Trade volume and FDI flow, OECD countries



Source: "International Direct Investment Yearbook" OECD, various years.  
"Yearbook of International Statistics," UN, various years.

### Determinants of FDI

The interaction of regional trade agreements and foreign direct investment became a concern in the 1960's with the formation of the European Economic Community (EC). More recently, with the formation of the European Union (EU) and the 1992 Single Market initiative, this concern has re-emerged. Still, very few studies have specifically addressed the interaction of RTA's and FDI. Researchers, however, have been studying the determinants of FDI since the early 1960's. Lessons learned from these studies can shed some light on how RTA's affect FDI.

### Determinants of FDI for Manufacturing Industries—Theoretical Studies

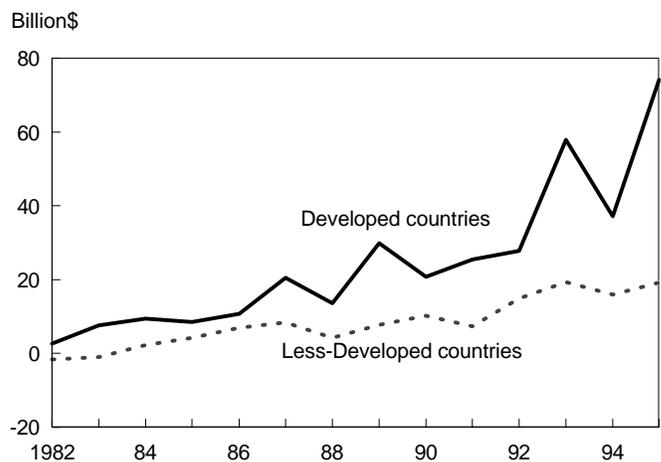
All firms must decide where best to locate their production. There are several theories on how firms make this decision. Ultimately, firms are seeking to maximize their profits, whether by investing abroad or expanding domestic production and exports. The earliest theories explain FDI as capital seeking its highest return. Therefore, capital should flow from

developed, capital-abundant countries to less-developed countries (LDC's) where capital is scarce and should earn a higher return. However, the capital-abundant United States has greater FDI flows to developed countries than to LDC's (fig. 2). This is the case with other developed countries as well.

Explanations of why FDI takes place between developed countries focus both on firm characteristics and on industry characteristics. Each theory explains a motivation for FDI, but none is able to explain all instances of FDI. By grouping many theories into an "eclectic paradigm" composed of three groups (ownership advantages, internalization advantages, and locational influences), a useful framework emerges. Many empirical studies are based on the eclectic paradigm.

Theories in the first group, "ownership advantages," posit that a firm will invest abroad only if it possesses some kind of advantage over its foreign competitors. Usually, this advantage is an intangible asset such as a well-recognized brand name or a superior technology. The advantage must be substantial enough to overcome the additional costs of operating in an unfamiliar foreign country.

Figure 2  
FDI outflows from the U.S.



Source: "International Direct Investment Yearbook" OECD, various years.

Another group of theories focuses on “internalization advantages.” These theories address the question of why firms engage in FDI rather than licensing or in some way providing their intangible assets for foreign-owned firms to use. One reason a firm may pursue FDI is to increase the firm’s market power, allowing it to earn a higher return. Foreign direct investment may also be the least expensive way to safeguard intangible assets. For example by keeping direct control of a foreign producer, the firm is better able to ensure the quality of its foreign production and thus protect the reputation of its brand name. It is also easier for the firm to prevent technological advantages from leaking to foreign competitors.

The last group of theories, referred to as “locational influences,” try to explain why FDI flows to a particular country rather than another, or not at all. One theory is that FDI is “tariff jumping”: firms may find it cheaper to produce their output in a foreign country rather than to export their domestic production and pay a tariff. Other factors that may influence the destination of FDI are market size, factor prices, and cultural similarity.

RTA’s affect locational influences but do not generally affect ownership or internalization advantages. One of the few theories developed about RTA’s and FDI predicts that an RTA should increase FDI into the integrated area as firms seek to take advantage of an expanded market now able to support projects with larger fixed costs. This occurs even if the integration involves lowering internal barriers without increasing external barriers. In other words, an increase in FDI is not necessarily due to tariff jumping. This might explain the surge in the early 1990’s of FDI into the EU, which has generally lowered internal barriers without increasing external barriers.

Blomström and Kokko (1997) provide a heuristic, but more comprehensive, analysis of how RTA’s affect investment. First, they separate the effects of RTA’s along two dimensions; the indirect effects on FDI through trade liberalization, and the direct effects from changes in investment rules connected with the RTA.

Trade liberalization has two opposing effects on FDI. Lowering intraregional tariffs can lead to an expanded market and an increase in FDI. But, lowering external tariffs can reduce FDI to the region if tariff-jumping investments are scaled back in favor of exports.

The effect of an RTA will vary by industry and country. Those industries with direct investments based on ownership or internalization advantages have less incentive to change their level of investment in response to a change in external tariffs than do industries engaged in tariff jumping investments. Countries with the strongest locational advantages will receive most of the FDI oriented toward serving the regional market. Countries with weak locational advantages will see little change in their level of incoming FDI as a result of the RTA. In fact, they may experience FDI outflows as firms relocate production to the most competitive country in the regional agreement.

RTA’s may have provisions explicitly protecting and facilitating FDI, such as a national treatment standard for foreign investments or a guarantee against expropriation of those investments by the foreign government. To the extent that the provisions improve the investment climate, FDI will increase. Even if the change in investment policy is not large, the effect may be large because the change is negotiated in the context of an RTA, giving it a credibility that it otherwise would not have.

Blomström and Kokko predict that the effect of an RTA depends on two factors—the attractiveness of a country as a site for FDI and the magnitude of that country’s liberalization of trade and investment policies. For instance, a country with strong locational advantages undergoing a significant liberalization of trade and investment in an RTA will see the largest increase in FDI. What this framework does not tell us is how significant the liberalization of policies needs to be to affect FDI. Nor does it tell us which locational advantages are most important for attracting FDI. At this point the issue becomes an empirical one.

### Determinants of FDI for Manufacturing Industries— Empirical Studies

Studies on the locational determinants of FDI flows in the manufacturing industries generally arrive at similar conclusions. The most influential locational advantages for outflows of FDI from the United States are per capita GDP, the growth rate of GDP, and market size. This fits with the general observation that most FDI flows to developed countries. FDI not bound for developed countries goes to the few LDC's with large markets and high growth rates such as China, Mexico, and Malaysia.

Factor prices appear to play a secondary role in determining the destination of FDI. Lower capital costs (in the form of lower interest rates) attract FDI. Lower labor costs also attract FDI but to a lesser extent. This is likely due to the fact that manufacturing industries tend to be capital-intensive. Labor claims a smaller share of total costs than does capital.

The fact that market size has a greater influence on FDI flows than do factor prices suggests that most FDI in the manufacturing industries is market-seeking. It is oriented toward serving local or regional markets rather than using a country as an inexpensive production site for exports to other parts of the world.

Trade barriers do not seem to significantly influence FDI from the United States. Studies either find a weakly positive effect or no effect at all. By contrast, Japanese FDI appears to be sensitive to trade barriers or the threat of trade barriers. One study reports that Japanese firms are more pessimistic about protectionism than are U.S. firms. When asked about the EU, 66 percent of Japanese companies surveyed expected the EU to strengthen its external trade barriers. Only 44 percent of U.S. companies had the same expectation. This is likely due to the fact that Japanese exporters have faced more source-specific trade barriers, such as voluntary export restraints of automo-

biles, than have U.S. exporters. Although Japanese companies are more concerned about protectionism in the EU than are U.S. companies, that concern is not central to their decision to invest. In a separate survey, most Japanese firms did not cite trade barriers as a major reason for not investing in the EU.

### Determinants of FDI for Agricultural Industries

FDI in the agricultural industries (processed foods and related products) claimed 6 percent of total U.S. FDI in the manufacturing industries in 1996. Agricultural FDI follows patterns similar to other manufacturing industries. The agricultural industries are capital-intensive and undertake FDI (rather than licensing) to maintain quality, protect a trademark, and take advantage of economies of scale. Most U.S. FDI flows in the food and agricultural industries are bound for Europe.

As with manufacturing, per capita GDP, growth rate of GDP, and market size are the major determinants for FDI in the agricultural industries. The costs of labor and capital inputs are less important. This suggests that agricultural FDI is undertaken to serve a market rather than to create a platform for exports.

The effect of trade barriers and FDI in agricultural industries is unclear. Several studies do not find a consistent effect of trade barriers on agricultural FDI. One study suggests that trade barriers may lead to more FDI through indirect means. An increase in protection appears to increase the sales of foreign affiliates, which may eventually lead to an increase in FDI.

Another factor influencing agricultural FDI is "cultural distance." FDI tends to go to countries with a similar language or system of laws. This is similar to the behavior of other manufacturing industries in that they agglomerate in countries where previous FDI and trade has been highest. A strong level of intellectual property protection appears to encourage FDI as well.

### Effect of RTA's on FDI

The most significant RTA to U.S. agricultural industries is the EU. The majority of agricultural FDI is bound for the EU. FDI into the EU has increased dramatically with the formation of the EU in 1992, with most of it (78 percent) coming from the United States and Japan.

The EU has attracted FDI because its trade liberalization policies enhanced GDP growth and expanded market size. The EU transformed a group of fragmented markets into a single integrated market, and its size is still growing with the recent addition of several countries and more on the horizon. The formation of a common market is expected to add 5 percent to the average growth rate of the EU member countries for the next several years. Several studies find that membership in the EU is a positive factor in attracting FDI.

The effects of regional integration are not uniform across the region. RTA members with stronger locational advantages than others attract most of the FDI. In the case of the EU, Britain is the most common destination for FDI from the United States. Britain's chief advantages, versus other EU members, are a large home market, cultural similarities, low factor costs, and U.S. firms' extensive experience there from earlier investments.

Another effect of the EU is a change in the structure of FDI across the integrated region. Some U.S. food companies have reduced the number of production plants in Europe while the total value of their European assets has grown. This indicates that the firms are consolidating their production into a smaller number of sites, presumably to take advantage of economies of scale.

It is unlikely that trade barriers, or the threat of trade barriers, has played a significant role in the recent surge of U.S. FDI into the EU. The "1992" Single Market initiative has centralized a fragmented system of trade barriers. EU members are not as free to make

unilateral restrictions on imports from nonmember countries as before.

The effect of NAFTA on FDI appear minor for the United States, Canada, and Mexico. Canada and the United States had liberal trade and investment regimes before NAFTA. Mexico had restrictive trade and investment policies, but many of those restrictions were relaxed in advance of NAFTA in 1989.

The reduction of Mexico's trade and investment restrictions in 1989 led to a tripling of the U.S. investment position in Mexico from \$4.9 billion in 1989 to \$15.2 billion in 1993. Just like the EU, prospects for a high rate of GDP growth in Mexico attracted U.S. FDI. This was especially true for agricultural FDI, which is primarily market-seeking. Unlike the EU, Mexico started out with restrictive investment policies and then relaxed them. This certainly played a major role in attracting U.S. FDI.

Even though Mexico relaxed its investment restrictions in 1989, there were still concerns. In a 1991 survey, 25 percent of firms in the U.S. food industry felt that Mexico's intellectual property protections were too weak for them to transfer their newest or most effective technology to Mexico. NAFTA is intended to allay those and other investment concerns. Since the enactment of NAFTA in 1994, however, U.S. FDI into Mexico has grown very little. This is partly due to Mexico's currency devaluation in 1995 and low rate of growth. Some studies point out that U.S. firms had already made their investments in advance of NAFTA when Mexico unilaterally relaxed its investment and trade provisions. One study estimates that U.S. agricultural FDI into Mexico is 0.91 percent higher in 1996 than it would have been without NAFTA.

Since the enactment of NAFTA, FDI into Mexico from other countries has increased even though U.S. FDI has remained flat. This indicates that the investment policy changes, not market growth, attracted non-U.S. FDI. One explanation is that Mexico's inclusion in NAFTA gave its recently liberalized investment and trade regime greater credibility in the eyes of foreign investors.

Two other RTA's, AFTA and MERCOSUR, are less comprehensive than the EU and NAFTA. MERCOSUR—which consists of Argentina, Brazil, Paraguay, and Uruguay—began liberalizing trade in 1991 and established a customs union in 1995. It provides for free trade between the member countries, but several significant industries are excluded. Unlike the EU and NAFTA, some external barriers to trade increased with the adoption of the RTA. The effect of MERCOSUR on FDI appears to be small. FDI to Argentina increased dramatically after 1991, but a majority of the increase was due to the privatization of public enterprises. Brazil did not experience an increase in FDI until 1994 when it implemented macroeconomic reforms. FDI to Paraguay and Uruguay has been lagging. MERCOSUR in its present form will have only a small impact on future FDI to the region.

AFTA (ASEAN Free Trade Area) is unique in that large increases in FDI and trade in the region have led to the agreement instead of the other way around. By 2003, tariffs will be down to 0-5 percent for the “included” industries. The “excluded” industries, a majority, are exempt from the tariff cuts. Although far from comprehensive, AFTA is projected to significantly boost GDP growth in the region. To the extent the AFTA increases GDP growth, FDI flows into the region will be enhanced as well.

AFTA does not significantly change the investment policies of its member countries. Despite this, FDI flows into the region have increased dramatically in the last 5 years. This supports earlier findings that market size and growth are the most important factors influencing FDI.

### Conclusion

RTA's can affect FDI both directly through investment provisions and indirectly through trade liberalization. The evidence so far suggests that it is the changes in per capita GDP, GDP growth, and market size—factors influenced by trade liberalization—that most affect the

flow of FDI into a region. This applies to both agricultural and nonagricultural industries. The degree to which a trade agreement affects these factors will determine the extent to which it affects FDI.

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