Multilateral Trade Liberalization and FDI: An Analytical Framework for the Implications on Trading Blocs

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Pascal L. Ghazalian, University of Lethbridge
Ryan Cardwell, University of Manitoba
1. INTRODUCTION

- RIAs → trade creation, trade diversion

- theoretically ambiguous welfare effects for RIA member countries
• value of US FDI activity eclipses US merchandise exports and imports

• FDI must be considered in analysing effects of trade agreements

• how are incentives to conduct FDI affected by RIAs?

• will subsequent multilateral liberalisation (DDA) change/undo these incentives?
2. **INCENTIVES TO CONDUCT FDI**

- FDI is an alternative method (to exporting) of accessing foreign markets
- firms will conduct FDI if it is a cost-effective alternative
- incentives to conduct FDI can be analysed through OLI paradigm (Dunning, 1981, 1997)

  **Ownership**
  **Location**
  **Internalisation**

- **Vertical FDI**
  - separation of supply chain across countries
  - function of factor costs

- **Horizontal FDI**
  - replication of production across countries
  - function of trade barriers, transport costs, corporate-level fixed costs

- incentives to conduct FDI are affected by trade liberalisation
3. **REGIONAL INTEGRATION AGREEMENTS AND FDI - THEORY**

- Regional Integration Agreements (RIA) → trade *creation*, trade *diversion* (Viner, 1950)

- RIAs → investment *creation*, investment *diversion* (Kindleberger, 1966)

- RIA’s effects on incentives to conduct FDI depend on:
  1. Type of FDI (horizontal vs. vertical)
  2. relative degree of liberalisation between trade and FDI in new RIA

- RIAs can generate three permutations of creation/diversion
  1. trade creation + investment diversion (between member countries)
  2. trade creation + investment creation (between member countries)
  3. trade diversion + investment creation (non-member to member countries)
3. **Regional Integration Agreements and FDI - Empirical Evidence**

**Trade**

- CUSFTA $\rightarrow$ trade creation, no trade diversion *(Clausing, 2001)*  
  - positive welfare effects for US

- CUSFTA/NAFTA $\rightarrow$ small positive welfare effects *(Romalis, 2005)*  
  - (+) effects of trade creation offset by (-) effects of trade diversion

**FDI**

- ESMP $\rightarrow$ investment creation in EU members, investment diversion in EFTA members  
  *(Baldwin, Forslid and Haaland, 1996)*

- CUSFTA did not generate expected FDI flows *(Blomstrom and Kokko, 1997)*

- CUSFTA $\rightarrow$ increased responsiveness of FDI flows from US to Canada *(Buckley, et al; 2007)*
4. **Multilateral Integration Agreements and FDI - Trading Blocs**

- Multilateral integration reduces the significance of preferential market access of RIA member countries.
- New trading environment may alter incentive structures for firms to conduct FDI.
- Insignificant direct effects between RIA member countries (confirm TC+ID effects of existing RIA).
- Potentially significant indirect effect for member countries: defensive import-substituting → investment creation.
- Significant effects for RIA non-member countries:
  - Incentives for hurdling borders via FDI are reduced.
  - Undo trade diversion and investment creation initiated by existing RIA.
  - Relative importance of input costs and geographic proximity are magnified in location decision.
  - Generate trade creation and investment diversion.
4. **Multilateral Integration Agreements and FDI - Food Processing**

- RIAs distort firms’ decisions to obtain cheap inputs across countries via FDI
- Firms of RIA non-member countries will have lower incentives to maintain FDI in RIA countries with higher input and production costs.

- Liberalised trade in primary products will reduce distortions and change relative international commodity prices
  - change firms’ incentives to conduct FDI across markets (input prices are emphasised over trade barriers)
    - firms will have reduced incentives to conduct FDI in high-cost RIA member countries (undo RIA-induced trade diversion and investment creation)

- Liberalisation → higher agricultural commodity prices, change in relative international prices
  - % price increase may be smaller in protected RIA regions
  - incentives to pull FDI out of these RIA regions may be muted
5. **Concluding Remarks**

- Proliferation of RIAs has changed incentives to trade and conduct FDI, and has altered the international trade and investment landscape.

- High prevalence of FDI necessitates analysis of investment activity in *ex ante* evaluations of trade agreements.

- Multilateral liberalisation (DDA) will further alter FDI incentives.

- The trade and investment creation/diversion effects of existing RIAs will be strengthened in some cases, undone in others:
  - RIA member countries vs. non-member countries
  - Primary commodity liberalisation and food processing FDI