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

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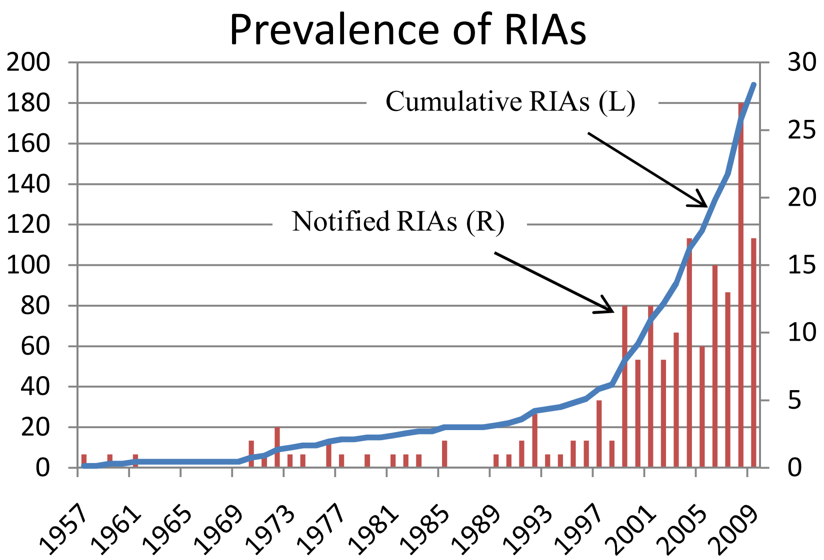
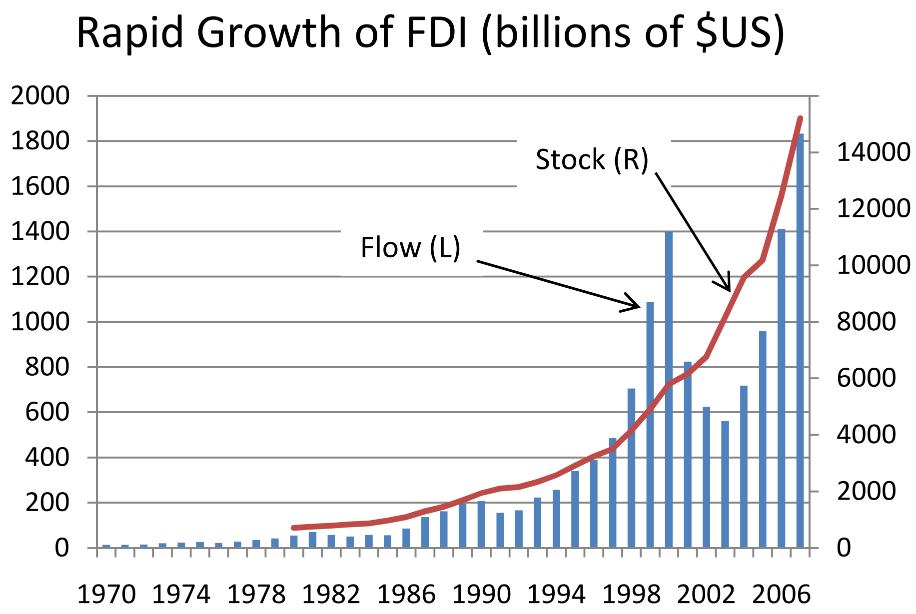
1. INTRODUCTION



Source: WTO

- RIAs → trade creation, trade diversion
- theoretically ambiguous welfare effects for RIA member countries

1. INTRODUCTION



Source: UNCTAD

- value of US FDI activity eclipses US merchandise exports and imports
- FDI must be considered in analysing effects of trade agreements

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- 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 → trade creation, no trade diversion (Clausing, 2001)
  - positive welfare effects for US
- CUSFTA/NAFTA → small positive welfare effects (Romalis, 2005)
  - (+) effects of trade creation offset by (-) effects of trade diversion

FDI

- ESMP → 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 → 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

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- 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

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