

# **The Effects of Regional Integration Agreements on FDI**

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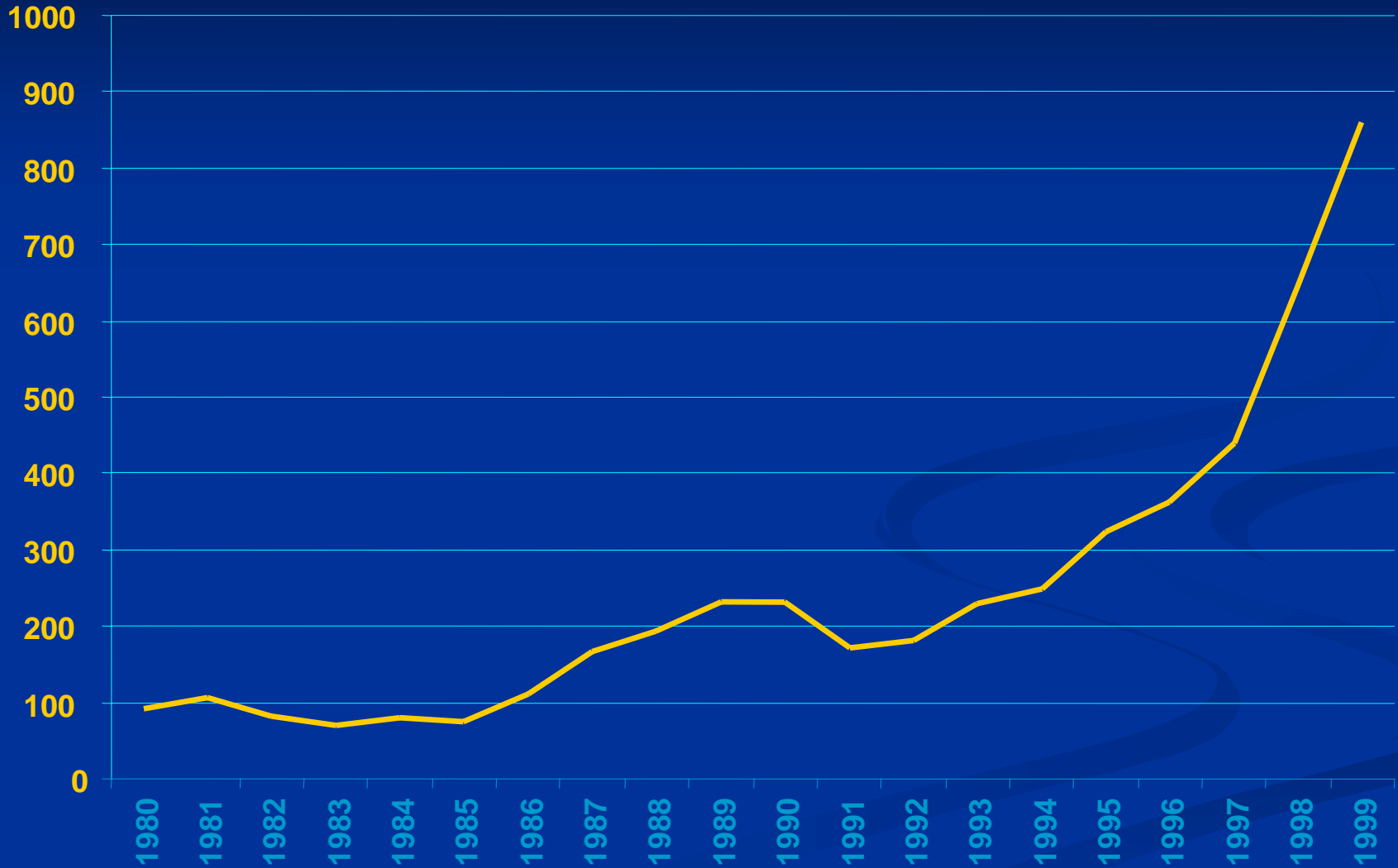
# Outline

- Motivation
- Discussion of the different channels through which RIAs can affect FDI
- Comments on empirical evidence
- Policy Issues
- Discussion based on a series of papers co-authored with Ernesto Stein and Eduardo Levy-Yeyati on the impact of RIAs on FDI (especially the FTAA)

# Motivation

- Spectacular increase in FDI around the world in recent years

# World FDI Flows 1980-1999

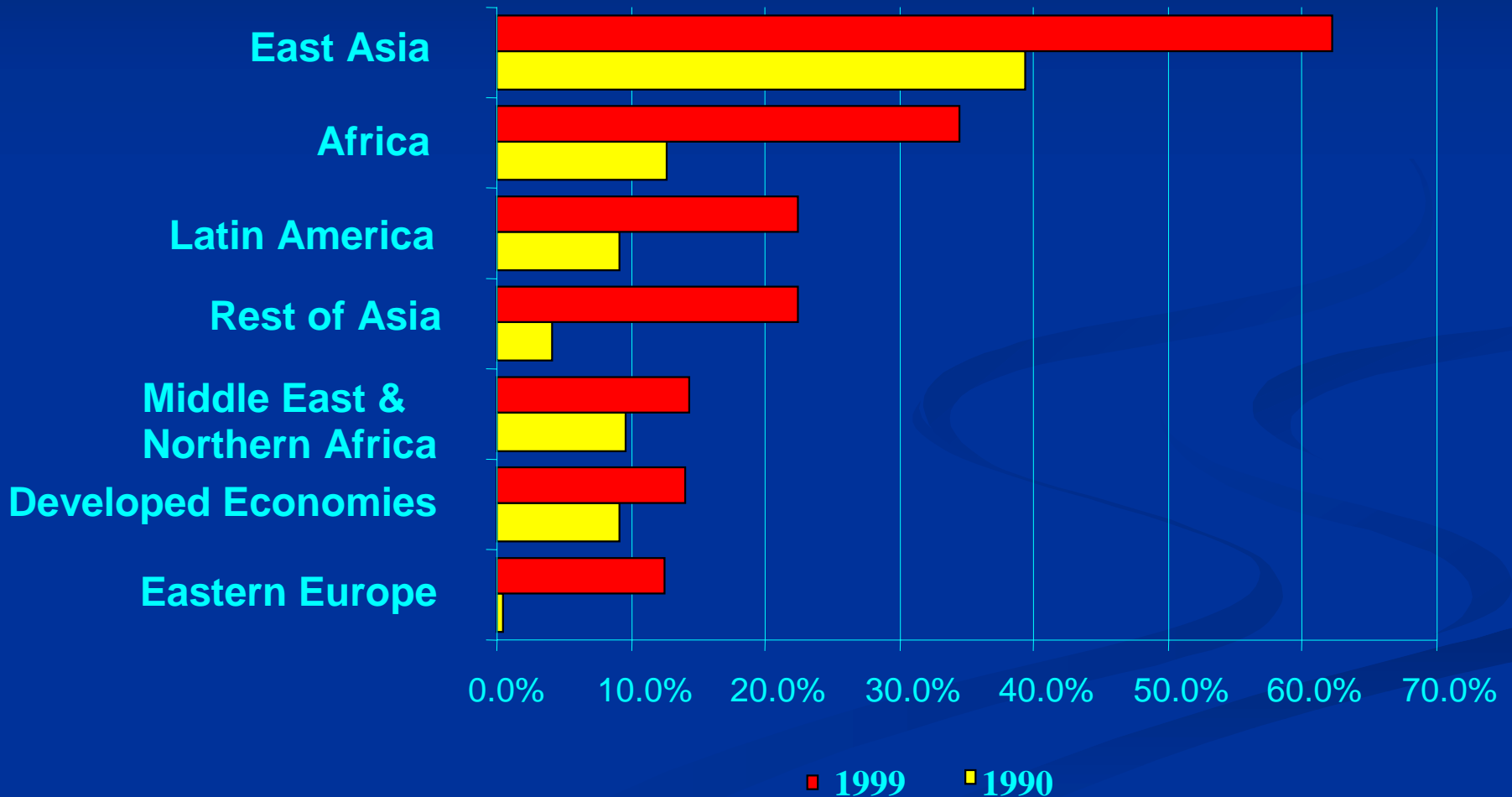


Note: Billions of Dollars, 1996 constant prices

# Motivation

- Spectacular increase in FDI around the world in recent years
- Globalization: this increasing importance of FDI is widespread through emerging economies

# FDI Stock/GDP Ratio by Region



# Motivation

- Spectacular increase in FDI around the world in recent years
- Globalization: this increasing importance of FDI is widespread through emerging economies
- At the same time, increase in number and depth of RIAs
- What are the effects in terms of the location of FDI in a region that undergoes a process of regional integration?

# How Do RIAs affect FDI?

Answer may depend on:

- Motives for FDI: vertical vs. horizontal FDI
- Insiders vs. Outsiders
- Host and source country characteristics

# Effects of RIAs on FDI

- ***Effects from insiders***
  - ***Vertical Integration***: Lower tariffs  $\Rightarrow$  lower transaction costs for firms to integrate vertically within the region  $\Rightarrow$  FDI Creation
  - ***Tariff-Jumping***: Lower tariffs  $\Rightarrow$  lower costs of serving markets through trade  $\Rightarrow$  FDI Destruction
- ***Extended Market Effect***: Fosters tariff jumping in activities with economies of scale  $\Rightarrow$  Higher FDI from outsiders
- ***FDI Diversion/Dilution***: Non-members or old members become relatively less attractive
- ***Redistributing Effects***: The regional effect is not evenly distributed: New and existing FDI may be relocated to more attractive countries  $\Rightarrow$  Winners and Losers

# Empirical Evidence

- Common membership in a RIA with source country increases bilateral FDI from the region and the rest of the world
- Effects are highly significant and large
- However, regional integration agreements will likely to produce winners and losers, as FDI to countries with deficient investment environment is likely to decline
  - Diversion/Dilution effects are significant
  - More open economies attract more FDI
  - Differences in factor proportions attracts more FDI

# FDI Policy in integrating countries

- FDI and welfare: In principle, there could be positive and negative effects. Empirical evidence favors relatively more the “positive” story
- Welfare effects may be higher if:
  - FDI occurs in more advanced industries (potential technological spillovers are higher)
  - Establish strong forward and backward linkages with domestic firms
  - Exports part of its production (relaxing BoP concerns and inducing domestic firms to follow suit).
  - Domestic firms have the capacity to absorb those spillovers (e.g. human capital)

# FDI Policy in integrating countries

- What kind of policies can countries adopt to insure that FDI inflows are of the beneficial kind?
- Do RIAs affect the desirability and effectiveness of those policies?
- How can countries maximize the potential benefits from RIAs?

# Performance Requirements

- Evidence suggests they have been ineffective
- Some evidence that they actually reduce technology transfer and increase capital imports (Blomström, Kokko and Zejan, 2000)
- Some of these requirements such as local content or trade balancing requirements are prohibited or being phased out under the WTO rules
- Least likely to be beneficial in the context of a RIA: firms may relocate  $\Rightarrow$  National treatment may work better than any alternative to avoid becoming a FDI loser

# FDI Policies

- Factor proportions: cannot be changed in the short-run
- Openness: amenable to policy actions. May change the composition of FDI from horizontal to vertical, reallocating resources to sectors where countries have comparative advantages
- Levy-Yeyati, Stein and Daude (2002) show that that countries that offer an overall more attractive package are likely to gain more FDI from RIAs  $\Rightarrow$  How can a country increase its attractiveness to foreign investors?

# Attractiveness as a Beauty Contest

- Improving the quality of institutions: Stein and Daude (2001) find that especially reducing excessive regulation, corruption, enforcing property rights and improving bureaucratic quality increase FDI substantially
- Education of the labor force: weaker evidence, however might be beneficial
  - May affect the type of FDI the country receives (more advanced sectors with more spillovers)
  - Improve the ability to absorb spillovers
  - Foreign firms become strong constituency in favor of further improvements in education

# Competition in incentives

- Incentives make sense if FDI brings positive spillovers
- If competition is intense and social returns across countries are similar, foreign firms will extract most of the benefits associated to the investment
- RIAs intensify competition for the location of FDI. With economies of scale, eliminating trade barriers will induce firms to produce in just one location within the bloc
- This suggests the need of coordination between RIA members
- This may be difficult in North-South integration, since source and host countries may have conflicting interests

# Conclusions

- Common membership in a RIA increases FDI between members and from outside the region
- However, RIA are likely to produce winners and losers, as FDI to countries with deficient investment environment is likely to decline
- Policies:
  - “Beauty Contests”
  - Competition in incentives

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