

Regional Integration and Foreign Direct Investment

A Conceptual Framework and Three Cases

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How regional investment agreements affect the flows of foreign direct investment depends on location, the competitiveness of local firms, the motives for investment, and how the agreement affects the policy environment.



Summary findings

Blomström and Kokko discuss how regional investment agreements may affect the inward and outward flows of foreign direct investments in the integrating region. After describing the multidimensional character of the issue, they provide a conceptual framework for analysis as well as three case studies focused on different kinds of regional integration:

- North-North integration (Canada joining the CUSFTA).
- North-South integration (Mexico's accession to the NAFTA).
- South-South integration (MERCOSUR).

They conclude that the response to an integration agreement will, in each case, depend on the environmental change brought about by the regional investment agreements, the locational advantage of the country or region, the competitiveness of local firms in

the integrating region, and the motives for foreign direct investment in and by the country or region in question.

The creation of the Canada-U.S. Free Trade Agreement (CUSFTA), for example, had relatively little influence on direct investment patterns in Canada, since much of the trade between Canada and the United States had been liberalized long before the CUSFTA was established.

By contrast, the Mexican accession to the NAFTA brought about significant policy changes, which help to explain foreign multinationals' increasing interest in the country.

Similarly, the establishment of the MERCOSUR Common Market is likely to significantly affect the region's policy environment, which suggests that it may have a notable (although varying) impact on foreign direct investment in the four member countries.

This paper — a product of the International Trade Division, International Economics Department — is part of a larger effort in the department to study regionalism and development. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Jennifer Ngaine, room N5-060, telephone 202-473-7947, fax 202-522-1159, Internet address trade@worldbank.org. April 1997. (46 pages)

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**Regional Integration and Foreign Direct Investment:
A Conceptual Framework and Three Cases**

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Foreword

As regional trading arrangements (RTAs) have spread, enlarged and deepened over the last decade, they have posed challenges to economists on both intellectual and policy levels. On the former, do RTAs stimulate growth and investment, facilitate technology transfer, shift comparative advantage towards high value-added activities, provide credibility to reform programs, or induce political stability and cooperation? Or do they, on the other hand, divert trade in inefficient directions and undermine the multilateral trading system?

The answer is probably “all of these things, in different proportions according to the particular circumstances of each RTA.” This then poses the policy challenge of how best to manage RTAs in order to get the best balance of benefits and costs. For example, should technical standards be harmonized and, if so, how; do direct or indirect taxes need to be equalized; how should RTAs manage their international trade policies in an outward-looking fashion?

Addressing these issues is one important focus of the research program of the International Trade Division of the World Bank. It has produced a number of methodological innovations in the traditional area of trade effects of RTAs and is now starting to tackle four new areas of research: the dynamics of regionalism (e.g., convergence, growth, investment, industrial location and migration), deep integration (standards, tax harmonization), regionalism and the rest of the world (including its effects on the multilateral trading system), and certain political economy dimensions of regionalism (e.g., credibility and the use of RTAs as tools of diplomacy).

In addition to thematic work, the program includes a number of studies of specific regional arrangements, conducted in collaboration with the Regional Vice Presidencies of the Bank. Several EU-Mediterranean Association Agreements have been studied and a joint program with the staff of the Latin American and Caribbean Region entitled “**Making the Most of Mercosur**” is under way. Future work is planned on African and Asian regional integration schemes.

Regionalism and Development findings have been and will, in future, be released in a number of outlets. Recent World Bank Policy Research Working Papers concerning these issues include:

Glenn Harrison, Tom Rutherford and David Tarr, “Economic Implications for Turkey of a Customs Union with the European Union,” (No. 1599).

Maurice Schiff, “Small is Beautiful, Preferential Trade Agreements and the Impact of Country Size, Market Share, Efficiency and Trade Policy,” (No. 1668).

L. Alan Winters, “Regionalism versus Multilateralism,” (No. 1687).

Planned future issues in this series include:

Eric Bond, “An Operational Model for Assessing Preferential Trading Arrangements”

Sherry Stephenson, “Standards, Conformity Assessments and Developing Countries”

Maurice Schiff and L. Alan Winters, "Regional Integration as Diplomacy"

Magnus Blomström and Ari Kokko, "The Impact of Foreign Investment on Host Countries: A Review of the Empirical Evidence"

Anthony Venables and Diego Puga, "Trading Arrangements and Industrial Development"

L. Alan Winters and Won Chang, "Integration and Non-Member Welfare: Measuring the Price Effects"

Glenn Harrison, Thomas Rutherford and David Tarr, "Trade Policy Options for Chile: A Quantitative Evaluation"

In addition, **Making the Most of Mercosur** will be issuing papers over the next few months, including:

Alexander J. Yeats, "Does Mercosur's Trade Performance Raise Concerns About the Effects of Regional Trade Arrangements?"

Claudio Frischtak, Danny M. Leipziger and John F. Normand, "Industrial Policy in Mercosur: Issues and Lessons"

Sam Laird (WTO), "Mercosur Trade Policy: Towards Greater Integration"

Margaret Miller and Jerry Caprio, "Empirical Evidence on the Role of Credit for SME Exports in Mercosur"

Malcom Rowat, "Competition Policy within Mercosur"

For copies of these papers or information about these programs contact Maurice Schiff, The World Bank, 1818 H Street NW, Washington, D.C. 20433.

An additional major outlet for World Bank-sponsored research on regionalism will be the Annual Bank Conference on Development in Latin America, 1997, Montevideo, June 30-July 2, 1997, organized by the Office of the Chief Economist and the Technical Department for Latin America and the Caribbean Region, with the support of the International Trade Division and the Economic Development Institute.

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Regional Integration and Foreign Direct Investment: A Conceptual Framework and Three Cases^{*}

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1. Introduction

Recent years have witnessed a deepening and widening of European integration and a proliferation of new regional integration agreements (RIAs) throughout the world, with acronyms such as APEC, EU, MERCOSUR, and NAFTA attracting increasing attention. Although some integration agreements have been motivated by political considerations, it is clear that economics is generally the driving force: countries enter into RIAs because integration promises various economic benefits. In the short run, integration is expected to stimulate intra-regional trade and investment; in the longer run, it is hoped that the combination of larger markets, tougher competition, more efficient resource allocation, and various positive externalities will raise the growth rates of the participating economies. This paper focuses on the investment effects of RIAs, and discusses how such arrangements may affect inward and outward foreign direct investment (FDI) flows in the integrating region. In this context, we will interpret regional integration to mean a reduction of regional trade barriers and investment restrictions. With foreign direct investment, we refer to foreign ownership of a controlling share of a firm operating

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in a country's domestic market: FDI flows refer to changes in the foreign ownership of production factors.

The perhaps most serious problem in the study of the relation between regional integration and foreign direct investment is the multi-dimensional character of the issue. For instance, it is reasonable to expect that regional integration will have different impacts on investors from the participating economies and outside investors. The impact may vary depending on the character of existing foreign direct investment: horizontal and vertical investment, or import-substituting and export-oriented investment, are not likely to be affected in the same manner by the elimination of trade and investment barriers. The major home countries, i.e. the countries where multinational corporations (MNCs) have their home bases, may experience different effects than the countries hosting foreign MNCs. Integration between developed countries (North-North integration) may differ from integration between developing countries (South-South integration) or agreements between countries at different levels of development (North-South integration), depending on how competitive and complementary the economies are. The time dimension may be important, so that static effects differ significantly from dynamic effects. The degree of integration at the outset, and the significance and nature of the changes brought about by the RIA will also matter. In addition, the patterns of trade and investment before the RIA are important determinants of how much adjustment is necessary after the agreement. For these reasons, we will attempt to set up a conceptual framework for the analysis, and to cover several different integration cases in the empirical part of the paper.

The paper is organized as follows. The next section discusses, in broad theoretical terms, how regional integration can potentially affect investment patterns among countries. Section 3 reviews some earlier empirical studies of the relation between RIAs and FDI and presents three case studies focusing on different kinds of regional integration: North-North integration (Canada joining CUSFTA), North-South integration (Mexico's accession to NAFTA), and South-South integration (MERCOSUR). Section 4 provides a brief summary and some tentative conclusions.

2. Regional Integration Agreements and FDI: Some Theoretical Considerations

To identify and assess some theoretical linkages between RIAs and incentives to undertake FDI, it is convenient to structure the discussion according to the motives for FDI. The reason is that conclusions regarding effects of regional integration are likely to differ significantly depending on why firms invest abroad. Hence, we begin by discussing the situation where FDI is mainly a response to trade barriers, and go on to consider cases where FDI is primarily motivated by the need to internalize firm-specific intangible assets that cannot be traded efficiently in arm's-length markets. It should be noted that these categories are not mutually exclusive - in particular, all cases of import-substituting FDI necessarily involve some internalization of firm-specific intangible assets. However, the distinction is analytically convenient, both because it reflects the evolution of our understanding of the motives for FDI, and because one of the main effects of regional integration is to reduce regional trade barriers. Obviously, this classification of FDI disregards some other common characterizations of foreign investment, such as strict distinctions between import-substituting and export-oriented projects, or horizontally and vertically integrated investments, but we will touch upon some of these distinctions in the course of the analysis.

Thereafter, we consider the impact of special investment provisions and institutional changes that are sometimes connected to integration agreements. The focus in this discussion lies on the static effects of RIAs on FDI flows: the possible dynamic effects of regional integration on investment flows are discussed separately. Finally, we suggest a template for classifying entire countries and specific sectors according to the expected impact on investments. It should be noted already at the outset that the discussion will not address the welfare effects of changes in investment flows. Although the underlying assumption is that increased FDI flows are beneficial to growth and development in the integrating region, it should be recognized that the welfare effects on the region may in fact be negative if the RIA worsens the allocation of resources or adds new distortions, e.g. in the form of higher average protection of the regional market.¹ In addition, the welfare effects on the rest of the world may well be negative if the RIA diverts investment from other countries to the region in question.

¹ For a classic reference, see Brecher and Díaz-Alejandro (1977).

2.1 FDI and Barriers to Trade

The early theoretical and empirical literature on foreign investment tended to regard trade and capital movements as substitutable modes of serving foreign markets.² This view of the relationship between trade and factor mobility encouraged the perspective that tariff barriers could motivate import-substituting FDI, and that general tariff reductions would reduce FDI flows or even stimulate a "repatriation" of foreign-owned assets to the home countries of MNCs. Outward direct investment would be discouraged by foreign tariff reductions, on the margin, as the cost of exporting (e.g. related to tariffs) decreased relative to the cost of establishing and operating foreign affiliates. The same relation was presumed between exporting and non-tariff barriers. Effective non-tariff barriers require firms to establish affiliates abroad, or to license foreign producers in order to supply products to foreign markets. Trade agreements which reduce or eliminate non-tariff barriers were therefore expected to make exporting a more viable international business mode and discourage FDI, other things constant.

However, although reductions in tariff and non-tariff barriers are major features of all RIAs, it is less obvious what the simple models predict when we consider regional rather than global trade liberalization. The reason is that investments made by "insiders" and "outsiders" would be affected in different ways by regional integration. Looking first at intra-regional FDI from the "tariff-jumping" perspective, we would, on the one hand, expect reduced investment flows because trade liberalization makes exporting from the home country relatively more attractive than FDI as a way to serve the regional market. On the other hand, if regional integration results in trade creation, it is likely that changes in the regional production structure are required, which would motivate a shifting of investment from one participating country to another. Hence, intra-regional FDI in some member countries might well increase in response to the emergence of these new investment opportunities. The extent of cross-border investment of course depends on the relative strength of

² See e.g. Mundell (1957), Corden (1967), Johnson (1967), Brecher and Díaz Alejandro (1977), Bhagwati and Brecher (1980), and Bhagwati and Tironi (1980). Note, however, that these authors, writing in the Heckscher-Ohlin tradition, seldom refer specifically to foreign *direct* investment: the strict distinction between FDI and foreign portfolio investment did not become essential until it was recognized that the exploitation of firm-specific intangible assets is a major motive for FDI whereas portfolio investment is mainly motivated by international differences in capital yields.

the firms in the different member countries: FDI flows would tend to be relatively small if the firms that are best positioned to exploit the situation are already based in the favored production location. This potential impact on intra-regional FDI flows has been termed "investment diversion" by Kindleberger (1966).

Turning to inter-regional FDI flows, the simple model suggest stronger reasons to expect increases. The inflows of FDI from "outsiders" into the region could obviously go up if the average level of protection increases as a result of the RIAs. The inflows of foreign capital might also increase if the volume of incoming FDI was initially restricted by the limited size of the individual national markets. Contrary to the national markets, the integrated "common" market may be large enough to bear the fixed costs for the establishment of new foreign affiliates. This surge of inward FDI would probably not be evenly distributed, but rather concentrated to the geographical areas with the strongest locational advantages. In addition, Kindleberger (1966) has pointed to "investment creation" as a likely response to the trade diversion brought about by RIAs. The term refers to the strategic investment responses by outside firms who lose export markets when their former customers turn to suppliers based in the region, because regional trade is free from tariffs.³ However, it is also possible to picture situations where RIAs could cause a reduction of FDI from outside the region. Specifically, if the initial stock of outside FDI consists of horizontally organized affiliates in several or all of the countries in the region, it is not likely that this structure would be optimal after the establishment of the RIA. A possible response to integration could then be a rationalization of the network of affiliates, so that the entire region could be supplied from a smaller number of affiliates located in the member countries with the most favorable economic conditions. In this case - which is similar to Kindleberger's (1966) investment diversion case - some countries could experience disinvestments as foreign MNCs concentrate their regional operations in other member countries. On balance, however, it appears that the arguments in favor of increased FDI inflows from outside the RIA are stronger.

The potential effects of RIA on outflows of FDI from the integrating region are rarely discussed in simple theoretical models. This is mainly related to an assumption that nothing

³ Hence, Kindleberger (1966) defines "investment diversion" as a response to "trade creation", while "investment creation" is a response to "trade diversion".

happens with trade barriers in the rest of the world. However, some changes in outward FDI are feasible even when trade policies in the rest of the world remain unchanged. For instance, it is possible that a firm's capacity to undertake new FDI projects is restricted by its administrative capability or the availability of investment capital (Stevens and Lipsey 1992; Belderbos 1992). In that case, it is likely that FDI within and outside the region are substitutes. Since integration reduces intra-regional FDI when trade and FDI are substitutes, it may also increase the scope for outflows of FDI from the integrating area to other regions..

Hence, theoretical models assuming that trade barriers are the main motive for FDI suggest that aggregate intra-regional investment flows are likely to fall following regional integration. However, investment diversion may contribute to increased intra-regional FDI in some countries. The conclusions regarding inflows of FDI from the rest of the world to the integrating region are also somewhat ambiguous, although the most likely result is an increase in FDI. Given free trade within the RIA, the location of the new investments will be determined by the comparative advantages of the countries participating in the integration agreement. It is therefore not possible to make any general conclusions regarding the net impact on individual countries in the RIA. In addition, it is possible that the outflows of FDI from the integrating area increase, in particular if foreign investments were initially restricted by some capacity constraint.

2.2 Internalizing Firm-Specific Intangible Assets

There is no doubt that significant amounts of FDI have been, and are still, motivated by tariff-jumping arguments. However, the view that avoiding trade barriers is the main reason for FDI has become increasingly questioned over time. One important theoretical development in the literature on multinational corporations and FDI is the recognition that the exploitation of intangible assets is often a major motive for foreign investment (see Caves 1996 for a review). In order to compete successfully in a foreign market - where local firms have superior knowledge of the local market, consumer preferences, and business practices - the internationally oriented company must possess some firm-specific intangible asset that gives them a competitive edge. Technological and marketing expertise are examples of such intangible assets. The effective exploitation of these assets sometimes requires firms to "internalize" their international operations by establishing

foreign affiliates, since other modes of international business, including exports and licensing of technology to foreign firms, carry relatively high transactions costs (Buckley and Casson 1976; Dunning 1977). Hence, some FDI can be expected to occur even when there are no formal trade barriers between countries. One indication of the relative importance of "internalization" and tariff-jumping as motives for FDI is that the bulk of investment flows take place between OECD countries, where both tariff and non-tariff barriers are relatively low.

Consequently, regional integration in the form of trade liberalization would not create incentives to reduce investment or repatriate capital for projects that were primarily undertaken to internalize the exploitation of intangible assets. In fact, the reduction of trade barriers could instead stimulate overall FDI flows among the relevant trading partners by enabling MNCs to operate more efficiently across international borders. This argument applies in particular for vertically integrated FDI, where the operations of the MNC's different affiliates are specialized according to the locational advantages of the host country, and where a predictable and liberal trade environment is a prerequisite for the international division of labor at the firm level.

As in the models where trade barriers motivate FDI, internalization theories imply that inflows of FDI from outsiders are likely to increase as a result of regional integration: the larger market makes the region a more attractive investment location. How large the increases FDI flows will be depends on how strong regional firms are compared to outside firms. The internalization motive for FDI does not provide any clear predictions regarding the effects of RIAs on outward FDI from the integrating region, at least not in a static context. As in the case with tariff-jumping FDI, however, it is possible that FDI within and outside the region are substitutes, in which case the most likely effect is that the increases in intra-regional investment reduce the scope for foreign investment outside the region.

Hence, recognizing that there are other motives for FDI than tariff-jumping and trade barriers, it is reasonable to abandon one of the few conclusion from simple models of FDI and integration, namely, that aggregate intra-regional FDI is likely to fall as a result of reduced trade barriers. To the extent that FDI is motivated by high transactions costs on arm's-length markets for technology and other intangible assets, regional integration is instead likely to raise regional FDI flows. Adding the expected positive effects on inflows of FDI from outsiders provides a rather

positive picture of the potential investment effects of regional integration. However, we are still not able to say anything general regarding the investment effects on individual countries - FDI can be expected to cluster to those parts of the RIA where the investment environment is most favorable, and some countries may therefore be left with less FDI than before.

2.3 Explicit Investment Provisions and Other Influences

To the extent that RIAs also liberalize capital flows, an additional stimulus is provided to the FDI process. Capital flows can be liberalized in several ways. Most directly, restrictions on inward foreign direct investment might be reduced or eliminated. Inward FDI would also presumably be encouraged by "national treatment" provisions ensuring that foreign investors are treated no less favorably than domestic investors. Obviously, the practical relevance (to the FDI process) of such provisions in integration agreements will depend upon the scope and magnitude of pre-existing barriers to inward FDI, as well as the extent and nature of host government discrimination against foreign investors.

Inward FDI could also be stimulated by the elimination of trade-related investment measures (TRIMs), such as requirements for foreign affiliates to satisfy specific export targets, and by the presence of strong investor property rights which reduce the risk of direct or indirect expropriation. The reduction of TRIMs should make it more profitable for MNCs to establish affiliates in the host country. Stronger property rights should encourage inward direct investment by reducing non-systematic risk facing foreign investors. Both types of initiatives may be institutionalized in RIAs. In this context, it is possible that a significant effect of some RIAs may be that they "lock in" economic reforms in the participating countries. By raising reform decision from the national to the international level, the agreements may create a more predictable policy environment for foreign investors, who might otherwise fear that purely national reform efforts are temporary and that various kinds of restrictions may be reintroduced when the political regime changes. These effects are likely to be most important in connection with North-South agreements, where the southern partners may benefit both from a more credible policy environment and access to the markets of the northern partner countries, and South-South agreements, where increased policy credibility is perhaps the major benefit. In addition, it is possible that regional integration

encourages economic reform and openness by removing a source of uncertainty that would face individual countries considering reforms. The short-run political success of unilateral liberalization depends to some extent on the responses of the country's trade partners, since market-opening reforms that are not reciprocated may cause macroeconomic problems, such as trade deficits and unemployment. Regional integration entails the coordination of reforms and guarantees some degree of reciprocity.⁴

Explicit dispute resolution mechanisms are also featured in many integration agreements. To the extent that such mechanisms are effective, they should reduce trade and investment disputes between nations covered by the relevant agreement(s). Concerns about trade disputes disintegrating into "trade wars" marked by the escalating use of countervailing duties and the like are effectively non-tariff barriers, and our earlier discussion of the implications of reducing trade barriers more generally is relevant here. In response to a contentious trade environment, MNCs might favor serving foreign markets through host country affiliates rather than by exporting from the home country. In these cases, effective dispute resolution mechanisms might encourage a repatriation of capital to home countries. However, they should also encourage increased vertical specialization on the part of MNCs, since the associated inter-affiliate trade flows are less likely to be disrupted by trade disputes between host governments. The impact on any individual country of these institutional reforms depends upon pre-existing conditions. For example, if a country was much more likely to be the victim of protectionist initiatives rather than the initiator, it would likely be seen as the primary beneficiary of a more harmonious trading environment. It is therefore likely to be an above-average recipient of increased investment flows. Moreover, to the extent that "market forces" become a stronger influence on capital investment decisions compared to political risk, international differences in factor endowments should become stronger influences on investment location decisions. This strengthens the tendency for FDI to be concentrated to the most attractive investment locations in the integrating area.

Simple integration agreements ordinarily do not seek to harmonize monetary and fiscal regimes, although more ambitious forms of integration, e.g. the European Union, are quite

⁴ This may be particularly important if the countries participating in the agreements wish to avoid competing devaluations - unilateral reforms are often connected with devaluations, in order to limit the expected surge in imports and provide incentives for export oriented production.

concerned with harmonizing these broader aspects of economic and social policy. However, it is not obvious what fiscal coordination or more or less stability in exchange rate relationships imply for the FDI process. In this context, we will not discuss these types of reforms in detail, but rather define regional integration to consist mainly of trade liberalization and reforms of the investment regime. To the extent that future RIAs focus more heavily on fiscal and monetary coordination, it will of course be necessary to complement the present analysis with these issues.

2.4 Dynamic Effects of Regional Integration

The discussion has, so far, been concerned with the static effects of RIAs on FDI flows. On balance, we have concluded that RIAs are likely to make the integrating region more attractive to outside investors, and that there are arguments for expecting increases in intra-regional investments as well. These conclusions follow from the assumption that internalization of firm-specific intangible assets, rather than avoidance of trade barriers, is the dominant motive for FDI. Moreover, it is assumed that the large regional market will be a more attractive investment location for foreign MNCs than the fragmented national markets separately.

No such conclusions can be made for individual countries within the RIAs, since there is no reason to expect that the investment increases are evenly distributed across the integrating region. By reducing or eliminating trade barriers within the region, regional integration would presumably encourage a substantial reallocation of production resources to more closely reflect patterns of regional comparative advantages. That is, thanks to the easier - and guaranteed - access to the integrated market, production capacity in different activities would become more highly concentrated in those regions where each activity is most efficiently carried out.

In addition to these static effects, it is possible that the establishment of RIAs also generates various dynamic effects that affect FDI flows. For instance, analyses of the economic impact of the European Single Market have argued that this specific integration process has led to significant efficiency benefits that may raise the participating countries' growth rates over the medium or long term. These dynamic benefits might increase the attractiveness of the integrated region as a location for domestic as well as foreign investment - the quantitative impact on foreign investment depends on whether foreign or domestic firms possess the competitive assets needed to exploit the growing

market. The higher growth rates may be temporary, lasting while the economies adjust to the higher real income that comes about because of tougher competition and more efficient allocation of resources in the common market (see e.g. Emerson *et al.* 1989). It is also possible that there are permanent growth effects that occur as the initial gains in efficiency and output raise factor rewards and generate new savings and investments that contribute further to output growth (Baldwin 1989). However, the exact links between regional integration and dynamic growth effects are not well specified, and it is not uncommon that analyses and empirical estimates of dynamic benefits are considered vague or speculative (Smith 1992).

In many instances, foreign direct investment may actually be an essential catalyst for these dynamic benefits. Some of the improvements in economic efficiency associated with increased specialization, exploitation of scale economies, and greater geographical concentration of individual economic activities are likely to be driven by inter and intra-regional FDI. Increased FDI flows are also important forces behind the heavier competitive pressure that is expected to encourage local producers to adopt efficiency-enhancing strategies, such as rationalizing plant capacity or reducing slack in the production process (Smith and Venables 1989). In addition, it is likely that FDI will stimulate technology transfer and diffusion, both directly and through *spillovers* to local firms.

As noted earlier, multinationals are distinguished from already established firms in the host country because they bring with them some intangible asset - e.g. technology - that allows them to compete successfully with local firms. There is plenty of case study evidence to show that some of these intangible assets may spill over to local firms, e.g. as foreign multinationals demonstrate new products and technologies, provide technical assistance to their local suppliers and customers, and train workers and managers who are later employed by local firms (see Blomström and Kokko 1996 for a survey). Spillovers may be particularly important in the present context, because they provide a possible reason why regional integration may result in permanently higher growth rates and "dynamic" benefits. Traditional growth models predict only temporary changes in growth rates as a result of a more efficient allocation of resources, since all factors are assumed to exhibit declining marginal returns. As capital is accumulated, the rate of return declines until further investment is no longer profitable. Adding spillovers to the picture, it can be argued that the

accumulation of physical capital will coincide with increases in the stock of public knowledge. Since more knowledge is available for all investors, investments in physical capital may actually come to exhibit constant returns to scale. However, little formal work has been done on the connection between spillovers and long-run growth, which means that discussion about possible dynamic effects of regional integration on FDI flows remains rather speculative.

Furthermore, if regional integration creates a larger market, it is also conceivable that some dynamic effects occur because regional integration influences various firm characteristics, such as the stock of intangible firm-specific assets that facilitate FDI. A larger market may simply allow some firms to grow larger and stronger than what would have been possible in individual national markets. Alternatively, integration may motivate firms to seek strategic alliances or merge with former competitors in order to manage in the more competitive environment that is created when intra-regional trade barriers are removed. As firms become larger, they may be able to invest more in R&D and marketing, which may lead to the creation of new intangible assets that stimulate new FDI, within as well as outside their own region. Including this kind of dynamic considerations into the analysis, it appears clear that there is a potential for significantly stronger effects on FDI than what static models imply. The main impact of dynamic benefits of integration is to make the integrating region a more attractive investment location, which should stimulate intra-regional FDI flows as well as inflows from the rest of the world. If integration influences the regional industry's average firm size, R&D intensity, marketing investments, and other firm characteristics that are thought to have some impact on the likelihood that individual firms invest abroad, there may also be dynamic effects that stimulate outflows of FDI from the integrating region. Concurrently, it should be emphasized that foreign direct investment may be an important catalyst for several of the dynamic benefits of integration that have been discussed in the literature on regional integration.

2.5 Synthesis of the Discussion

Clearly, some FDI has been, and continues to be, motivated primarily by the desire to get behind trade barriers. Other FDI is motivated by foreign investors seeking to exploit input or output markets located abroad in activities where operating a foreign affiliate is the most efficient governance structure. Yet other investment projects are undertaken to reap economies of scale or

specialization. In the discussion above, we have noted that regional integration is not likely to have the same impact on all these types of FDI. For any individual country, the overall impact on investment will therefore reflect potentially offsetting influences.

However, a reasonable generalization is that regional integration should enhance the attractiveness of investing in the region as a whole by creating a larger common market and contributing to improved overall efficiency and higher income levels in that market. The magnitude of the changes in investment will be related to the significance and nature of the trade and investment liberalization initiatives embodied in the RIA. The impacts on investment decisions are also likely to vary across countries and industries. Countries characterized by relatively unprotected and efficient domestic markets prior to regional integration are likely to enjoy the strongest increases in foreign as well as domestic investment. The reason is that countries with low trade barriers are not very likely to host import-substituting foreign investment that might be withdrawn or diverted to other locations as a result of regional integration. Concurrently, those sectors characterized by high initial levels of trade protection combined with relatively weak locational advantages may suffer decreases in investments by both foreign and domestically owned firms. The *ex ante* structure of trade and investment flows is another determinant of the country and industry specific responses to RIAs. Countries and industries that are already closely linked to their RIA partners before the formal agreements - due to geography, historical conditions, or other reasons - are likely to face smaller changes than countries and industries with limited initial contacts with the other participants in the RIA.

In addition to the distinctions we have made regarding the motives for FDI, it may therefore be useful to specify a summary framework relating trade and investment liberalization initiatives to country and industry characteristics. Figure 1 provides an organizational template for thinking about the FDI process in the context of regional integration. The attribute labeled environmental change summarizes the degree to which trade and investment flows are liberalized by the integration agreements in question. This will, of course, depend both on the nature of the specific agreement and the initial institutional environment in the region. As one moves down the rows of Figure 1, the degree of liberalization is considered to be "weaker". The attribute labeled locational advantage summarizes the degree to which it is advantageous from a profitability standpoint to

locate an economic activity in a particular location. This characteristic refers to the availability and cost of various production factors as well as the general macroeconomic environment. As one moves across the columns (from left to right) in Figure 1, the locational advantages of a particular country - in relation to other members in the RIA and the rest of the world - are presumed to be weaker. Identifying the position of a specific country or industry in Figure 1, we will have a starting point for analyzing the investment impact of regional integration. More detailed predictions regarding FDI flows must, of course, also take into account trade and investment patterns prior to integration, the motives for pre-existing FDI, the competitive strength of domestic versus foreign firms, and so forth.

FIGURE 1. Classification Dimensions

	Locational Advantages (Positive to Negative ⇒)	
Environmental Change (Strong to weak ↓)	1	2
	3	4

Source: Globerman and Schwindt (1996).

The most pronounced positive impact on investment would presumably be experienced by those economic sectors falling into area 1. These activities experience the strongest degree of integration, and the country in question enjoys a strong locational advantage. Hence, for reasons noted earlier, one would anticipate relatively strong, positive capital flows from both foreign and domestic investors in these sectors. The degree to which the bulk of the new investments are actually made by foreign investors rather than domestic investors depends, for instance, on how much foreign investment there is already at the outset and whether firm-specific advantages in the expanding industries are primarily enjoyed by foreign or domestic investors. An example of a case falling into

area 1 could be the textile sector in a developing country entering into a RIA with an industrialized country (i.e. a North-South agreement). The developing country could be expected to possess strong competitive advantages, e.g. thanks to low wages, and the RIA could be expected to constitute a significant change in the institutional environment, granting free access to the Northern trading partner's market. If the necessary production technologies, marketing skills, and other intangible assets are owned by Northern rather than Southern firms, we should expect significant inflows of FDI to the developing country.

Turning to area 3, the impact on domestic investment becomes weaker, albeit still positive. Area 3 contains those economic activities for which the country in question has a strong locational advantage, but for which the impact of the integration agreement is relatively weak. Economic integration between OECD countries (North-North integration) can be expected to provide many examples of industries falling in this category. One reason is that the formal and informal barriers to trade and investment are relatively low already at the outset, as a result of multilateral agreements such as the GATT. Another reason for expecting relatively mild investment effects from North-North integration is that several important industries, such as automobiles, are already characterized by considerable cross-investment between the major OECD countries. Moving to area 2, the expected impact on inward FDI is negative and the potential for actual disinvestment increases. Specifically, activities in area 2 can be characterized as being strongly affected by the integration agreement, but for which the country in question suffers locational disadvantages. Many countries and industries where the bulk of existing FDI has been established in order to avoid trade barriers would be classified in this area. Finally, in area 4, the potential impacts of integration on capital investment are weak and, possibly, offsetting. While the country or industry in question suffers a locational disadvantage in terms of the activities in area 4, the impacts of the integration agreement on the overall economic environment are also quite weak. In other words, area 4 contains activities where investment decisions are not likely to be affected by the RIA, either because the sector in question is excluded from the agreement (such as agriculture in the EFTA or EEA agreements) or because the market is too small to attract the attention of foreign competitors.

In summary, any systematic attempt to evaluate the potential impact of RIAs on foreign direct investment flows should acknowledge the key determinants of the "reaction functions" of

MNCs and domestic investors as broadly represented by the axes in Figure 1. For any country, the overall impact will be conditioned by the distribution of that country's economic activities across the areas in Figure 1, as well as the trade and investment pattern at the outset and the competitive strength of domestic versus foreign firms. As we have discussed above, theory offers few sharp conclusions regarding the general impact of regional integration on investment. What happens is essentially an empirical question.

3. Empirical Studies of Regional Integration and FDI

The theoretical discussion concluded that it is difficult (or even impossible) to make general predictions regarding the results of RIAs on foreign direct investment decisions. The response to an integration agreement will, in each individual case, depend on the environmental change brought about by the RIA, the competitive strength of the country in question, and the motives for foreign direct investment in and by the country in question. Consequently, effects are likely to vary between small and large countries, countries that are homes and hosts to MNCs, developed and developing countries, and different integration agreements.

In this section, we will review the empirical evidence on the investment effects of RIAs. To cover as many as different outcomes as possible, we have chosen to examine the effects of three distinct cases of regional integration:

- North-North integration, as illustrated by the impact of the CUSFTA on Canada,
- North-South integration, focusing on Mexican participation in the NAFTA, and
- South-South integration, exemplified by the establishment of the MERCOSUR.

Before doing that, however, we will briefly summarize some earlier empirical studies of RIAs and FDI.

3.1 The Early Evidence

Earlier work on regional integration and foreign direct investment have dealt mainly with the effects of European integration on the size and structure of the activities of MNCs.⁵ The period

⁵ Some exceptions to the European focus are early studies of Latin American integration, including Behrman's (1972) study of LAFTA, Mytelka's (1979) study of the Andean Group, and Bulmer-Thomas' (1982) study of The Central American Common Market.

following the formation of the European Community coincided with a considerable inflow of US direct investment, and several studies from the 1960s and 1970s asked whether the integration process was the determining factor or not (see Yannopoulos 1990 for a survey of the literature). The general conclusion of the debate was that the Common Market had attracted United States investment which might otherwise have been located in other European countries. Thus, the formation of the EC seems to have influenced the locational pattern of US direct investment abroad and lured US firms to increase their activities in the European Community. This empirical result is well in line with the theoretical hypotheses regarding effects of RIAs on inter-regional FDI flows discussed above: economic integration is likely to make the region a more attractive investment location for outside investors.⁶

Studies of later stages in European integration have been more mixed in their findings about the effects on inter-regional foreign direct investment. For example, Dunning (1992), claims that the challenges of 1992 have led to a revitalization of US investment in the EC, while Lipsey (1990) concluded that the changes in the location of fixed investment by US multinational firms after the announcement of the 1992 program were relatively small up through 1989. The upsurge in Japanese investment in Europe has also attracted much attention, and the conclusion seems to be that those investments have increased as a consequence of the 1992 program, in response to both the opportunities and threats created by the integration process (see e.g. Thomsen and Nicolaidis, 1991 and Balasubramanyam and Greenaway, 1992).

Studies of the impact of economic integration on intra-regional investment are more rare and generally constrained by data shortages. Some relatively crude studies by Franko (1976) and Pelkmans (1984), focusing on the changes in the number of foreign manufacturing subsidiaries of EC-firms established in other Community countries, found that European integration coincided with a period of clear shifts in the location of production of multinationals of EC

⁶ The conclusions of the early studies often disagreed on the reasons for the increased US investment in Europe - there was no consensus on whether the effects of integration operated through the size of the market, its rate of growth, or the degree of tariff discrimination. To some extent, the contradictory conclusions can be explained by the quality of the available data and lack of proper statistical methods, but the disagreement also mirrors the elusive character of the possible dynamic effects of regional integration. As noted in the theoretical section of this paper, there is still no consensus regarding the significance and magnitude of these effects.

parentage. In other words, these studies found signs of "investment diversion" in the Kindleberger sense. A similar picture is suggested in a later study by Molle and Morsink (1991), based on FDI flows between EC countries during the period 1975-1983. The study suggests that intra-EC trade and intra-EC investment are complementary to each other, but only above a certain level of trade intensity.

Most of the literature linking RIAs to foreign direct investment focuses on investment effects for the region as a whole. Substantially less attention has been paid to the impact of RIAs on the foreign direct investment outcomes for individual countries within the region. The few earlier works focusing on individual countries include studies of the UK (e.g. Mayes, 1983 and Grant, 1983) and Ireland (O'Farrell, 1983). The results from these studies are mixed. While no investment effects were found in the case of the UK, Ireland's membership of the EC stimulated direct investment from both EC and non-EC sources. One possible explanation could be that many foreign investors (particularly US firms) had entered the relatively open UK market already during the 1950s and 1960s, before the country's accession to the EC, so that little additional investment was necessary to respond to the new situation. In other words, the UK experience might illustrate a case that would be classified in area 3 of Figure 1. Ireland, by contrast, was not any major location for foreign investment prior to EC membership, and integration provided good opportunities for exploiting the country's locational advantages - this would be an example where area 1 dominates. Winters (1996) notes another distinction between Spain and Portugal, on the one hand, and Greece, on the other hand. Spain and Portugal benefited from significant increases in inward FDI as a result of EC membership, but Greece did not, largely because the country's macroeconomic policies did not provide an attractive environment for foreign investors. Hence, while Spain and Portugal can be classified as area 1 cases, Greece may illustrate area 2: weak locational advantages obstructed the potentially beneficial investment responses to Greek EC membership.

The studies of smaller countries integrating into larger economies are of particular interest in this context. The investment experiences of small, open economies are arguably more heavily influenced by international economic developments (e.g. regional integration) than those of relatively large economies such as the United States and the major EU member countries.

Moreover, any new members of NAFTA or EU (such as Chile or the Eastern European countries) will be relatively small economies joining a larger integrated region. Thus, the relevant historical experience for potential new members in RIAs is that of small countries rather than large ones. The choice of countries for the case studies has largely been conditioned by this consideration.

3.2. North-North Integration: Canada in the CUSFTA

Largely at the behest of Canada, the Canada-US Free Trade Agreement (CUSFTA) was negotiated over the 1986-1987 period. After a heated Canadian debate - including a federal election with the free trade agreement as a major dividing line - the agreement was signed in January 1988 and came into effect on January 1, 1989.⁷

The essence of the CUSFTA was the phased bilateral elimination of tariffs. In addition, a number of provisions reduced discrimination against bilateral foreign direct investment, including the extension of rights-of-establishment and national treatment. A range of prominent sectors, such as basic telecommunications, was effectively excluded from coverage under the investment liberalization provisions of the Agreement. Moreover, Canada's existing foreign investment screening procedures were left in place (Globerman and Walker 1993). Nevertheless, the thrust of the investment provisions of the CUSFTA was clearly to expand the legal scope for bilateral direct investment. Moreover, the inclusion of a relatively robust dispute resolution procedure arguably reduced the risks of either government acting in a discriminatory manner towards investors from the other country. In terms of the first classification dimension of Figure 1 (i.e., the degree of environmental change resulting from the RIA) it seems reasonable to characterize the Canadian position as an intermediate one, with moderate changes resulting from the agreement. In this context, it should be remembered that bilateral trade between Canada and

⁷ The relatively long time lag between negotiation and implementation of the CUSFTA might raise worries that large Canadian and US firms had anticipated the formal integration agreement, and adjusted their investment positions already before it was implemented. However, it should be noted that Canadian ratification of the CUSFTA was very much in doubt until the federal election was concluded. We would, therefore, expect to see some evidence of a structural break in Canadian and US direct investment data around 1988 or shortly thereafter, if the CUSFTA was a significant influence on the Canadian direct investment environment.

the US had been substantially liberalized well before the event studied here, through successive GATT rounds as well as special bilateral agreements such as the Auto Pact and the Defense Sharing Agreement. Regarding the second classification dimension of Figure 1 (the underlying locational advantages of the country) it is also reasonable to place Canada in an intermediate position, with, at best, mild locational advantages with respect to the US. Hence, we should expect relatively moderate investment effects of the agreement.

Changes in Trade and Foreign Direct Investment Patterns

To the extent that CUSFTA significantly liberalized the North American trade environment, one would expect to see bilateral trade between the United States and Canada becoming relatively more important from 1988 onward. Moreover, to the extent that trade and foreign direct investment are significantly related - either as substitutes, as suggested by models of tariff-jumping FDI, or as complements, as implied by internalization theories - one would also expect to see changes in the relative importance of bilateral direct investment between the two countries.

Both series are reported in Table 1.⁸ Bilateral exports and imports refer to Canadian imports from and exports to the US as a share of total Canadian trade, while bilateral direct investment reflects the sum of US direct investment inflows to Canada and Canadian direct investment outflows to the United States as a share of Canada's aggregate inward and outward investment flows. It can be seen that bilateral trade has increased fairly steadily since 1988, which indicates that trade liberalization has been effective. Bilateral direct investment has increased since the early 1990s. However, before that, the relative importance of bilateral direct investment changed erratically, and it is difficult to discern a consistent pattern in FDI flows that would clearly be related to the CUSFTA.⁹

⁸ The discussion in connection with Table 1 and Table 2 is based on Blomström, Globerman, and Kokko (1996).

⁹ Since the data on investment flows include reinvested earnings, it is likely that the fluctuations in these figures to some extent reflect cyclical fluctuations in profits.

Table 1
Bilateral Exports and Imports / Total Canadian Exports and Imports and
Bilateral Direct Investment / Total Canadian Inward and Outward FDI (percentages)

Year	Exports and Imports	Direct Investment
1983	72.8	30.0
1984	74.3	58.6
1985	75.4	41.9
1986	73.6	30.0
1987	72.7	60.5
1988	71.8	39.5
1989	72.0	49.3
1990	72.0	41.2
1991	72.3	40.4
1992	74.3	41.0
1993	76.7	45.1
1994	78.3	65.9
1995	77.4	62.3

Source: Statistics Canada, *Canada's Balance of International Payments*
Ottawa: Ministry of Industry, various issues.

Table 2 presents an overview of the Canadian foreign direct investment pattern between 1986 and 1995. As above, bilateral inward and outward direct investment refer to US direct investment inflows to Canada and Canadian direct investment outflows to the United States, respectively. Other inward and outward direct investment refers to non-US direct investment flows into Canada and Canadian direct investment flows to countries other than the United States. The data in Table 2 suggest no easily identifiable linkage between the CUSFTA event and subsequent changes in bilateral direct investment flows. While there are substantial changes in FDI flows for individual years, the overall magnitude of bilateral direct investment was relatively stable (decreasing slightly in nominal terms) over the period 1988-1992. Substantial increases in the nominal value of inward direct investment from the United States emerged in 1993 and continued through 1995, while the nominal value of outward direct investment to the United States increased in 1994 and 1995 - but only back to levels experienced in the mid-1980s. It is unlikely that these increases in investment flows are directly related to the CUSFTA, since they

emerged in 1993, well after the implementation of CUSFTA, and coincided with a general boom in outward FDI flows from the US at that time (see UN 1995). Furthermore, it is suggestive that a substantial decline in the value of the Canadian dollar began in 1992 following five years during which the Canadian dollar strengthened against its US counterpart. This decline in the value of the Canadian dollar may well have constituted an important motive for the increased US investments in the country (see Aliber 1978 for theoretical arguments).

Table 2
Inward and Outward Foreign Direct Investment for Canada
*(millions of Canadian dollars)**

Year	Bilateral		Other	
	Inward	Outward	Inward	Outward
1983	29	1686	2438	1558
1984	3196	3209	2960	1563
1985	-191	3144	1965	2130
1986	-743	3362	4607	1502
1987	6028	7278	4632	4044
1988	2052	2963	5899	1775
1989	2091	3510	3850	1918
1990	3246	2800	5917	2722
1991	1961	1925	1187	4553
1992	2719	1315	2673	3144
1993	5308	968	1117	6522
1994	7279	2456	960	4070
1995	10229	3570	5122	2996

Source: Statistics Canada, *Canada's Balance of International Payments*, Ottawa: Ministry of Industry, various issues

* Net flows including reinvested earnings accruing to direct investors.

Inward direct investment from countries other than the United States exhibits no consistent pattern over the period studied, although the largest inflows took place between 1988 and 1990, right after the implementation of the CUSFTA. Certainly there is no consistent evidence of any lasting diversion of foreign direct investment flows to Canada in response to CUSFTA. However, there is an interesting pattern in the development of Canadian outward

direct investment to countries other than the United States. Until 1990, Canadian outward FDI was primarily directed to the US, but the early 1990s saw a significant decrease in the relative importance of the United States as a destination for Canadian outward direct investment. This decreasing share of outward FDI destined for the US is mirrored by an increasing share (beginning in 1991) going to EU member countries other than the United Kingdom, and an even more dramatically increasing share going to regions other than the EU, the United States and Japan. The profitable opportunities encouraging a redirection of Canadian direct investment outflows presumably had nothing to do with CUSFTA. However, CUSFTA may have played an important role in that it guaranteed access to the US market, so that available FDI resources could instead be utilized to establish Canadian presence in other markets.

As a complement to the flow data on FDI, Tables 3 and 4 present some recently published data on the gross product of US foreign affiliates in Canada and Canadian affiliates in the United States. Table 3 focuses on the role of foreign affiliates in the Canadian economy. The second column of the table measures the share of US majority-owned foreign affiliates in Canadian GDP. The US share has fallen from well over 11 percent in the early 1980s to about 8 percent in the early 1990s. Coupled with the observation that bilateral trade with Canada has increased as a result of the CUSFTA, this suggests that regional integration has resulted in FDI becoming a relatively less important mode for US firms to serve the Canadian market.

*Table 3.
Foreign Firms' Shares of Canadian GDP 1977-1993 (percent).*

Year	US Affiliates in Canada/ Canadian GDP	All Foreign Firms in Canada/ Canadian GDP
1977	13.8	n.a.
1982	11.3	n.a.
1983	n.a.	16.2
1988	n.a.	15.6
1989	9.5	n.a.
1990	8.8	14.8
1991	8.0	n.a.
1992	7.9	14.3
1993	8.2	15.1

Sources: Mataloni and Goldberg (1994), Mataloni (1995), Fahim-Nader and Zeile (1995), Lipsey, Blomström, and Ramstetter (1995), and World Tables.

In other words, there is some indication that trade has substituted for inward FDI from the US. Another indication of the same development is that Canada's share of US MNCs' foreign production has fallen significantly since the implementation of the CUSFTA. The ratio of US affiliates' production in Canada to the aggregate production of all US affiliates abroad fell from 16.3 percent in 1989 to 12.6 percent in 1993.

At the same time, it appears that Canada has become a somewhat more attractive investment location for outsiders. The last column of Table 3 shows that aggregate output share of all foreign affiliates has remained roughly constant, at about 15 percent of Canadian GDP, which indicates that other foreign investors have made up for the reduction of the US share of Canadian production.

Table 4 shows the data on foreign affiliates' shares of US output since 1988. It can be seen that the share of Canadian affiliates has fallen slightly since the start of the CUSFTA, from 0.7 percent in 1988 to 0.6 percent in 1994, while the aggregate share of all foreign firms has increased from 3.9 percent in 1988 to over 4.6 percent in 1993.¹⁰ The largest increases in the GDP shares of foreign firms seem to have taken place in connection with the implementation of the agreement, in 1988 and 1989. These data suggest a similar development as in the Canadian case: regional integration seems to have reduced the motives for intra-regional FDI, but stimulated inflows of FDI from the rest of the world. Comparing the Canadian and US experiences, it also appears that the effects on FDI are not evenly distributed. For Canada, the net result appears to be close to zero, where increased inter-regional inflows barely make up for reduced intra-regional investment. In the US case, there seems to be a positive net effect, with the increases in FDI inflows from the rest of the world dominating the reduced Canadian shares.

¹⁰ Data are not available for the period before 1998, which means that any conclusions regarding the relation between these changes and the establishment of CUSFTA should be treated with caution.

Table 4
Foreign Firms' Shares of US GDP, 1988-1993 (percent).

Year	Canadian Affiliates in the US / US GDP	All Foreign Firms in the US / US GDP
1988	0.72.	3.89
1989	0.69	4.25
1990	0.69	4.31
1991	0.69	4.50
1992	0.57	4.42
1993	0.65	4.58
1994	0.62	n.a.

Sources: See Table 3.

Summary and Conclusions from North-North Integration

Canada offers a potentially instructive case study of the impacts of a RIA on foreign direct investment flows for a small open economy. Since economic theory makes no compelling case for a strong linkage between RIAs and FDI patterns for individual countries, and since the environmental change connected with the CUSFTA was not dramatic, it is hardly surprising that the pattern of overall foreign direct investment into and out of Canada over the past years does not suggest a strong and consistent influence of the agreement. Our observations suggest a reduction in the relative importance of FDI as mode of international business between Canada and the United States, arguably caused by the liberalization of bilateral trade, and a concurrent increase in the inflows of FDI from the rest of the world, presumably because the CUSFTA made Canada a more attractive investment location for outsiders. The net impact on investment in Canada remains indeterminate.

To be sure, the foregoing observation does not permit a conclusion that trade liberalization has historically had no significant influence on direct investment patterns in Canada. As noted earlier, much of the bilateral trade between Canada and the United States had been liberalized well before the establishment of the CUSFTA. Moreover, it is possible that a more formal, multivariate analysis would identify a significant influence of CUSFTA that is obscured by the relatively simple evaluation of direct investment patterns described above.

Nevertheless, the Canadian experiences serve as a caution against anticipating substantial direct investment impacts for smaller economies joining RIAs.

3.3 North-South Integration: Mexico and NAFTA

Shortly after the establishment of the Canada-US Free Trade Agreement, Canada and the United States initiated negotiations with Mexico about a possible southern expansion of the integration agreement. In December 1992, the three countries signed the North American Free Trade Agreement (NAFTA). This agreement, which came into effect on January 1, 1994, was the first formal regional integration agreement involving both a developing and developed countries. In essence, the NAFTA is an extended version of the CUSFTA. In addition to the trade and investment liberalization measures introduced already in the CUSFTA, the new treaty includes major advances in areas such as government procurement (where coverage is extended to services and construction) and intellectual property and investor's rights (introducing binding investor-state arbitration), as well as more stringent rules of origin (see e.g. Hufbauer and Schott 1993 for details).

The overall effects on Mexico of a free trade arrangement with Canada and the United States are expected to be significant, for several reasons. One important determinant is Mexico's geographical location. In the 1970s, many Mexicans considered it to be a drawback to be "so far from heaven and so close to the United States". Today, when regional trade and investment barriers have been reduced as a result of the NAFTA, the situation is different. The North American share of Mexican exports has increased from around 70 percent in the late 1980s to over 86 percent in 1995, as shown in Table 5..

Table 5
Mexican Exports and Imports 1986-1995 (Million USD; percent of total exports and imports in parentheses.)

Year	Exports			Imports		
	Total	US + Canada	Other Western Hemisphere	Total	US + Canada	Other Western Hemisphere
1986	19,074	13,928 (73.0)	1,120 (5.9)	14,749	10,666 (72.3)	423 (2.9)
1987	20,532	13,577 (66.1)	1,589 (7.7)	12,758	8,626 (67.6)	379 (3.0)
1988	20,409	13,726 (67.3)	1,482 (7.3)	19,557	13,401 (68.5)	738 (3.8)
1989	22,975	16,364 (71.2)	1,496 (6.5)	22,789	15,911 (69.8)	930 (4.1)
1990	26,247	18,711 (71.3)	1,589 (6.1)	29,556	20,236 (68.5)	1,252 (4.2)
1991	27,101	19,523 (72.0)	1,681 (6.2)	38,121	26,825 (70.4)	1,587 (4.2)
1992	46,153	38,278 (82.9)	2,305 (5.0)	61,914	46,522 (75.1)	2,236 (3.6)
1993	51,832	44,474 (85.8)	2,554 (4.9)	65,188	49,284 (75.6)	2,320 (3.6)
1994	60,459	52,588 (87.0)	2,819 (4.7)	79,198	56,371 (71.2)	2,831 (3.6)
1995	79,324	68,388 (86.2)	4,028 (5.1)	73,938	56,344 (76.2)	2,032 (2.7)

Source: UN Trade Tapes

The value of Mexican exports more than quadrupled over the same period as a result of the increasing sales to North America, with the largest increases occurring during the last four years. The North American share of Mexican imports has also grown over this period, but not quite as dramatically

Another reason to expect positive implications of the free trade arrangement for the Mexican economy is related to the significant policy changes that have taken place in recent

years. Traditionally, Mexico has been a closed economy. In the mid-1980s, however, important market-oriented reforms were introduced in several sectors, and the economy began to open up. As a consequence of the NAFTA, the reform process has been "locked in" and extended to other sectors, such as autos, textiles and apparel, finance, telecommunications, and land transportation (see Hufbauer and Schott 1993). The coincidence of policy reforms, distinct locational advantages in the form of cheap labor, and free access to a substantial part of the Canadian and US markets, is very likely to promote economic growth in Mexico. In terms of Figure 1, it is reasonable to characterize the Mexican participation in the NAFTA as an example of a country in area 1.

It is quite clear that foreign multinationals have noted and reacted on the recent changes in Mexico. As shown in Table 6 below, the inflows of FDI have risen significantly since the late 1980s, from less than USD 3 billion to nearly USD 8 billion in 1994.

Table 6
Foreign Direct Investment Flows into Mexico (USD million)

Year	1989	1990	1991	1992	1993	1994
FDI inflows	2,785	2,549	4,742	4,393	4,389	7,978

Source: IMF, International Financial Statistics (various issues).

Since US multinationals dominate the FDI scene in Mexico it is relevant to look specifically at their responses to the NAFTA agreement. Table 7 suggest that US firms have expanded their presence in Mexico, but that much of the investment increase took place before the formal discussions about NAFTA began. The US FDI position in Mexico has not increased much since 1992, and the share of Mexico in total US investment abroad has actually declined during the past years. This indicates that outsiders account for the bulk of the recent inflows of FDI to Mexico. To some extent, these investments are probably directed to the local market, in response to the country's improving economic and institutional environment, but the investment flows are also likely to reflect some degree of investment diversion and investment creation. To the extent that Mexico has become a relatively more important supplier to the US market through

trade creation or trade diversion, foreign multinationals are likely to respond by increasing their productive capacity in Mexico.

Table 7

US Direct Investment Position in Mexico on a Historical-Cost Basis at Yearend, 1992-1995 (Million USD; percent of total US foreign direct investment position in parentheses)

Year	1987	1992	1993	1994	1995
US FDI Stock	4,900	13,730 (2.73)	15,229 (2.72)	15,714 (2.53)	14,037 (1.97)

Sources: Survey of Current Business, Vol. 75, No. 8, August 1995, and Lowe and Bargas (1996).

Moreover, the timing and character of the changes in the US investment position suggest that NAFTA has perhaps not been the main determinant of the upswing in US investments in Mexico. An equally important stimulus must have been the comprehensive reforms of the country's FDI regulation that commenced already in the mid-1980s and eventually culminated with the NAFTA. The Mexican regulatory framework for FDI, which dated back to 1973, was very restrictive and served as a disincentive for investment from abroad (Blomström 1989). In the backwash of the Mexican debt crisis, these regulations were changed dramatically in 1989 to attract foreigners to invest in Mexico. It appears that US investors responded quite strongly to this first round of reforms. A few years later, the investment regime was further liberalized through the NAFTA (see Gestrin and Rugman 1994 for details). Among others advances, the agreement established a clear, rules-based framework for the impartial treatment of FDI and placed strict limits on the use of performance requirements. It also established dispute-settlement mechanisms specifically designed to deal with investment issues. The US response was relatively mild this time, since many US firms were already in place (and because the agreement guaranteed their access to the Mexican market anyway), but investors from outside the region perceived Mexico as a much more attractive investment location than before.

When it comes to the effects of foreign investment in Mexico, there is some evidence that multinational firms have played an important role in opening up the country to foreign trade, by

converting import-substituting industries into exporting (Blomström and Lipsey, 1993). The rapid expansion of the *maquiladoras*, where foreign firms play an important role, has also speeded up the trade liberalization process (Kagami 1996). However, the main contribution of the presence of foreign firms presumably comes from technology transfer and technology spillovers (Blomström 1989). The Mexican economy seems to have reached a level of development and skills where local firms are able to absorb some of the new technology that is imported and used by foreign multinational firms (see Kokko 1994, Blomström, Lipsey and Zejan 1994, and Borensztein, De Gregorio and Lee 1995). This means that the foreign owned multinationals operating in Mexico may well act as catalysts in bringing about the kind of dynamic growth effects that have been discussed in connection with the European Single Market program.

Summary and Conclusion from North-South Integration

The experience of Mexico suggests that North-South integration may be greatly beneficial for the Southern partners, and illustrates some of the prerequisites for achieving these beneficial effects. Firstly, membership in the NAFTA coincided with other reforms that liberalized the institutional framework of the country. Hence, the RIA contributed to a very significant and positive environmental change. Secondly, Mexico possesses strong locational advantages with respect to its northern neighbors. These are made up of increasingly market oriented economic policies, geographical proximity, and cheap labor. Consequently, regional integration has been connected to significant increases in the inflows of foreign investment, in particular from countries outside the NAFTA region. In other words, Mexico is a good example of a country that would be classified in area 1 in our template of possible outcomes of regional integration.

3.4 South-South Integration: MERCOSUR

Regional integration in the Western Hemisphere has a history before both CUSFTA and NAFTA. The first attempts date back to 1960, when a number of South American countries and Mexico created the Latin American Free Trade Association (LAFTA). The same year, the seven countries in Central America created the Central American Common Market, and in 1969,

Bolivia, Colombia, Ecuador, Peru, and Venezuela formed the Andean Pact. The main purpose of all these RIAs was to create a larger market, to facilitate the import substituting development policy followed during that period. However, all of these integration efforts failed, since little effort was made to liberalize trade.

Regional integration in the Southern Cone is of a later date. A bilateral agreement between Argentina and Brazil, which stipulated the elimination of all trade barriers over a ten-year period, was initiated in 1986. Five years later, this agreement was extended under the Treaty of Asuncion, with the purpose of creating a Southern Cone Common Market. The resulting agreement, known as MERCOSUR, also includes Paraguay and Uruguay as members. Intra-regional trade has gradually been liberalized since the early 1990s. A Customs Union was established on January 1, 1995, with free trade in (most) goods among the four member countries and a Common External Tariff (CET) for trade with third countries (see Laird 1995). The CET has 11 tariff levels varying from 0 to 20 percent, but some important product groups, like automobiles, telecommunications, and computer equipment, are excluded from the agreement. However, it should be noted that the integration process has not led to an across-the-board reduction of external tariffs for all countries. On the contrary, in several product groups, the CET is a compromise between countries with domestic import-substituting producers (who start out with high tariffs that are reduced as a result of integration) and countries without domestic production (where low initial trade barriers have been raised). In some cases, such as the region's automobile industry, it is even appropriate to talk about a general increase in the external trade barriers as a result of the integration process.

In addition to the trade arrangements, a partially new investment regime has also been established to promote and protect investment in the MERCOSUR region (IDB 1996b). For example, the Colonia and Buenos Aires Protocols from 1994 grant national treatment to intra-regional investments and eliminate most restrictions on capital and profit remittances. However, the most important changes in this area had occurred already before the start of multilateral liberalization under the colors of MERCOSUR, at least in the two larger member countries. In Argentina, the FDI legislation was fundamentally changed in 1976, to guarantee foreign firms essentially the same rights and obligations as national firms. The new laws also allowed

capitalization of intangible assets and unlimited capital repatriation and profit remittances abroad. As of 1993, restrictions on FDI remained only in the broadcasting and atomic energy sectors (Agosin 1995). The liberalization of the Brazilian investment legislation has not been equally far-reaching, but it should be noted that Brazil never adopted any comprehensive statute regulating foreign investment, nor established any commission or agency to screen foreign investment (Rosenn 1991). Yet, the Brazilian reforms during the 1990s include a significant liberalization of the rules for technology transfer, exports and imports, financial transactions, and other areas that affect the foreign investment climate (see Muchlinski 1995 for details).

Looking at the reforms of the trade and investment rules in the MERCOSUR region during the past decade, it is clear that there have been significant changes, although it is uncertain how much of the reforms should be credited to the formal integration agreement. As noted above, there are areas where unilateral liberalization has been important, and other field where reforms are mainly related to multilateral initiatives, such as the GATT. Yet, in terms of the classification dimensions of Figure 1, it is clear that the environmental changes connected to the MERCOSUR process have been strong. Regarding the investment environment, it can be argued that the MERCOSUR region has notable locational advantages in several industries, stemming from a large common market, abundant natural resources and relatively cheap labor. Considering the remaining barriers to inter-regional trade, these advantages apply in particular for production aiming at the regional market. Hence, in aggregate, the MERCOSUR provides another illustration of a RIA that should be classified in area 1 of Figure 1, which suggests that we should expect relatively strong investment effects for the region as a whole. The impact on individual countries may, of course, differ from this presumption, depending on the national locational advantages and the initial trade and investment structure.

Changes in Trade and Foreign Direct Investment Patterns

The effects of the trade liberalization in the Southern Cone are evident from Table 8. During the first half of the 1990s, intra-MERCOSUR exports as a share of the region's total exports more than doubled, to reach nearly 20 percent in 1994.

Table 8
External Trade of MERCOSUR, 1988-1994 (Million USD and percent)

	1988	1989	1990	1991	1992	1993	1994
Total Exports (USD million)	44,829	46,555	46,433	45,911	50,487	54,085	62,027
Intra-MERCOSUR Exports (percent)	6.5	8.2	8.9	11.1	14.3	18.6	19.3
Total Imports (USD million)	23,076	26,061	29,302	34,264	40,649	48,509	62,422
Intra-MERCOSUR Imports (percent)	13.3	15.1	14.5	15.5	18.4	19.6	19.6

Source: Laird (1995)

Intra-regional imports as a share of total imports increased significantly as well, from 13.3 percent in 1988 to 19.6 percent in 1994. It should be remembered that these changes refer to the period immediately before the establishment of the MERCOSUR Customs Union in 1995, and that the shares of intra-regional trade are likely to have increased further since then. Yet, the liberalization of intra-regional trade has been a gradual process, and most of the reforms in this area had already been completed by late 1994 (see also Behar 1996).

At an aggregate level, it does not appear that the expansion of intra-regional trade is attributable mainly to trade diversion, since the value of imports from the rest of the world more than doubled during the period. A recent study by Yeats (1996), however, suggests that trade diversion may still be significant. He finds that the most rapidly growing product groups in intra-MERCOSUR trade are capital-intensive goods that members have not been able to export competitively to outside markets. In particular, there has been a rapid increase in intra-regional trade in transport equipment, as a result of tariff increases vis-à-vis the rest of the world and regulations of the bilateral automobile trade within the MERCOSUR. We will return to this issue below.

There is also a renewed interest in the MERCOSUR on the part of foreign investors. The inflow of foreign direct investment into the region more than tripled between 1989 and 1993, as shown in Table 9. Argentina and Brazil have been the favored localizations for FDI, while

Uruguay and, particularly, Paraguay, have been lagging behind. Unfortunately, there are no aggregate data available to analyze FDI flows for the period after the establishment of the Customs Union in 1995.

Table 9
Foreign Direct Investment Flows into MERCOSUR Members (Million USD)

Year	Argentina	Brazil	Paraguay	Uruguay
1989	1,028	1,131	12.8	37.7
1990	1,836	989	76.3	38.6
1991	2,439	1,103	83.1	30.3
1992	4,179	2,061	42.0	n.a.
1993	6,305	1,292	50.0	101.5
1994	n.a.	3,072	n.a.	170.0

Source: IMF: International Financial Statistics.

However, looking at home country data for the major foreign investor in the region, the United States, it appears that the real boom of FDI did not occur until after this event. Table 10 shows that in 1995 alone, the US stock of FDI in the region increased by more than 25 percent, which is significantly higher than the growth rate of US investment in the rest of the world. It should, therefore, be noted that we risk underestimating the investment responses to the MERCOSUR by restricting the analysis to the period for which data are available.

Table 10

US Direct Investment Position in the MERCOSUR on a Historical-Cost Basis at Yearend, 1992-1995. (Million USD; shares of total US foreign direct investment position in parentheses.)

	1992	1993	1994	1995
Argentina	3,327 (0.66)	4,331 (0.77)	5,945 (0.96)	7,962 (1.12)
Brazil	16,313 (3.25)	16,822 (3.01)	18,798 (3.03)	23,590 (3.31)
MERCOSUR^{a)}	19,640 (3.91)	21,153 (3.78)	24,743 (3.99)	31,552 (4.43)

^{a)} Excluding Paraguay and Uruguay, for which no data are available.

Source: Survey of Current Business, Vol. 75, No. 8, August 1995, and Lowe and Vargas (1996).

The aggregate data do not distinguish between intra- and inter-regional investment flows, but the increases in the investment position of the United States, shown in Table 10, suggest that a significant share of the inflows come from outside the MERCOSUR. It is also obvious that the increases in FDI flows have occurred at different times in the individual countries, which may indicate that foreign capital has been attracted by other factors than regional integration. This motivates a closer look at the individual countries.

Argentina registered the largest increases in FDI inflows before 1994, and there is reason to expect that much of this was unrelated to the regional integration process. Chudnovsky, López, and Porta (1995) suggest three major explanations for the increases in foreign investment in Argentina since the early 1990s. The most important attraction for foreign investors was arguably Argentina's comprehensive privatization program, which opened several public service industries to foreign investment. Several public companies in the telecommunications and transportation sector were sold to foreign investors

Another important determinant was the country's successful macroeconomic reforms, which managed to bring down public deficits, inflation, and interest rates, and ensured the convertibility of the currency. Unlike the present situation in Europe, where the members of the EU are obliged to fulfill certain macroeconomic "convergence criteria", economic integration in the form of MERCOSUR was not a motive for Argentinean macroeconomic stabilization. A

third factor influencing foreign investors was the new wave of protectionism in the region's auto sector in the early 1990s (see Frischtak, Leipziger, and Normand 1996). In 1991, Argentina introduced a system of quotas on imports of finished automobiles, which contributed to an increase in foreign investment inflows to the sector. In this context, it is important to note that the auto sector's external trade barriers have not been reduced as a result of the RIA. On the contrary, in 1994, Brazil raised its tariffs on automobiles imported from non-MERCOSUR countries from 20 to 70 percent, and bilateral agreements between the MERCOSUR countries grant preferential treatment to companies with assembly plants in the customs union (see Chudnovsky, López, and Porta 1996).

In the short run, it is likely that the effects of increased FDI inflows on the Argentinean economy will remain limited. For instance, the impact on the diversification and expansion of exports has been relatively modest so far, since a large part of the foreign investment has taken place in the nontradable sectors, in connection with the privatization of public services. In the long run, however, we should expect positive effects of these investment, since the efficiency of public services is likely to improve and strengthen the country's international competitiveness. In the auto sector, by contrast, it is apparent that the recent FDI inflows have contributed significantly to technology transfer and modernization, but the long-run effects on the country's competitiveness and welfare remain questionable. As in other cases of import substitution, protectionism distorts the allocation of scarce resources and allows local producers to operate less efficiently than foreign competitors.

The foreign investment in Brazil has fluctuated widely during the past years, and the inflows of FDI have fallen well short of those to Argentina, although the Brazilian market is about four times larger. One reason is that market-oriented reforms were introduced later and macroeconomic stabilization was achieved later in Brazil than in the other countries in the region. Consequently, the positive prospects connected with regional integration were tempered by an unpredictable macroeconomic environment. However, the recent years have witnessed successful reforms and stabilization in Brazil as well and the inflows of FDI have increased markedly. For instance, Brazil replaced Argentina as the favored MERCOSUR location for US direct investment in 1994 and 1995 (see Table 10). The strong locational advantages of Brazil -

in terms of its large market and supply of labor and natural resources - suggest that we should expect substantial inflows of foreign investment in the medium run, assuming that the country's macroeconomic environment remains stable.

The experiences of the two smaller countries in the region, Paraguay and Uruguay, are mixed. While the flows of FDI to Uruguay seem to have increased, there is no clear trend for Paraguay. Uruguay is arguably more attractive for foreign investors because of its geographical location between Brazil and Argentina, while the locational advantages of Paraguay are weaker. In both cases, foreign investment can be expected to be directed to industries where economies of scale are not important - industries relying on scale economies are more likely to locate in either Argentina or Brazil, where they can benefit from proximity to larger consumer markets.

However, neither Uruguay nor Paraguay is likely to be influenced greatly by static investment effects. Instead, their benefits of economic integration are likely to derive from possible dynamic effects, that lead to growth and increased demand for their exports in the entire MERCOSUR region. It is also possible that economic integration will have a stabilizing impact on the political and macroeconomic environment in both countries, in the sense that radical policy changes are less likely because of the commitments to the neighboring countries.

Summary and Conclusions from South-South Integration

Given that the MERCOSUR Customs Union was not established until 1995, it is obvious that it is too early to detect even the static effects of that specific RIA on foreign investment. Yet, less ambitious forms of regional integration have been pursued by the MERCOSUR countries since the mid-1980s, so that much of the intra-regional trade had been liberalized in 1994, and it is possible to draw some tentative conclusions from the region's experience to date. The following generalizations are suggested by the analysis above.

First, macroeconomic stability appears to be a more important determinant of FDI inflows than is regional integration. Both the Argentinean and Brazilian experiences illustrate that foreign investors have responded stronger to successful stabilization programs than to the early stages of the MERCOSUR project. Second, comprehensive integration, as in the case of the MERCOSUR Customs Union, may stimulate significant investment responses. In our data, this

has mainly been illustrated by the changes in the US investment position in the region between 1994 and 1995, but there are indications that investors from other countries have also reacted strongly, as discussed above. Third, the inflows of FDI to the region are not likely to be distributed equally to all participating countries. It is reasonable to assume that Argentina and Brazil possess relatively strong locational advantages and will be the main beneficiaries of increased FDI inflows in the short to medium run. Finally, as illustrated by the development in the MERCOSUR auto sector, it is not evident that the welfare effects of all FDI increases will be positive. To the extent that regional integration contributes to increased distortions, e.g. in the form of higher tariff barriers or market sharing agreements between oligopolistic producers, it is possible that the resulting inefficient allocation of resources outweighs the various benefits of FDI inflows, such as technology spillovers.

4. Summary and Conclusions

The relation between regional integration agreements and foreign direct investment is neither self-evident nor straightforward, as illustrated by the first part of this paper. In our attempt to set up a conceptual framework for thinking about the impact of RIAs on FDI flows, we touched upon several characteristics of countries and investors that contribute to the confusion surrounding the issue. For instance, the effects of agreements between developed countries (North-North RIAs) may differ from integration between developing countries (South-South RIAs) or agreements between countries at different levels of development (North-South RIAs), depending on how competitive and complementary the economies are, and how much integrating there is at the outset. Regional integration is likely to have different effects on investors from the participating economies and outside investors, particularly if the agreements are discriminatory in the sense that significant trade barriers against the rest of the world remain after regional trade is opened up. Sectors and industries where national firms are relatively weak may experience larger inflows of FDI than sectors where strong local firms are well positioned to exploit new investment opportunities. The impact may also vary depending on the character of FDI projects. Horizontal and vertical investment, or import-substituting and export-oriented investment, are

not likely to be affected in the same manner by the elimination of regional trade and investment restrictions.

A host of other distinctions between countries, investors, and integration agreements could be added to the discussion. However, a more detailed list would hardly change the conclusion from our theoretical discussion, namely, that economic theory does not provide any general prediction regarding the impact of RIAs on foreign investment decision. For this reason, we proposed an eclectic approach for examining the impact of regional integration on individual countries or industries. A first step should be an assessment of how significant is the environmental change brought about by the RIA, and how strong are the locational advantages of the industry or country in question. The stronger the environmental change and the stronger the locational advantages of the individual industry, the more likely it is that the RIA will lead to inflows of FDI from the outside as well as from the rest of the integrating region (see Figure 1). This first estimation should then be complemented with a closer analysis of trade and investment patterns before the RIA (to identify the reasons for existing FDI and to determine how much adjustment would be needed to reach the new equilibrium) and the competitive strength of local and foreign firms (to determine who is most likely to exploit the opportunities presented by the enlarged regional market). Hence, specifying the exact relation between RIAs and FDI is essentially an empirical question.

The three cases presented in the second part of the paper highlighted some of the cross-country differences in the investment effects of regional integration. The first case focused on the Canadian participation in the CUSFTA, and illustrated a situation where the RIA did not appear to cause any radical changes in the inflows of FDI to the country in question. The main reasons for the moderate impact of the CUSFTA are probably that the environmental change connected with the agreement was not dramatic (since trade between Canada and the US was already relatively free due to GATT commitments and various bilateral treaties) and that there was already considerable cross-investment between the two countries. Yet, there were some indications of a reduction in the relative importance of FDI in the bilateral relation between Canada and the United States, because of the reduction of remaining trade barriers, and a concurrent increase in the inflows of FDI to Canada from the rest of the world, presumably because the RIA made Canada a more

attractive investment location for outsiders. The relatively modest investment response to this specific RIA may well be a general characteristic of many North-North agreements, where the trade and investment regimes are relatively open and markets are *de facto* integrated already before the formal RIA.

The second case examined the impact of the NAFTA agreement on foreign investment in Mexico, and suggested that this specific RIA has had a profound impact on the inflows of FDI. There are several reasons for this impact. Firstly, the establishment of the NAFTA coincided with and deepened other reforms that liberalized the institutional framework of the country. Hence, the agreement contributed to very significant and positive environmental changes: an added bonus is that these are likely to be perceived as more permanent improvements in the investment environment than purely domestic reforms. Secondly, due to its increasingly market oriented economic policies, geographical proximity, and supply of cheap labor, Mexico possesses strong locational advantages in labor-intensive industries with respect to its northern neighbors. Consequently, regional integration has created an abundance of new commercial opportunities for domestic and foreign investors, in the domestic Mexican market as well as in the US and Canadian markets. The response has been a significant increase in the inflows of foreign investment, in particular from countries outside the NAFTA region. The Mexican experience is likely to capture some general characteristics of North-South agreements, primarily related to the potential for improved policy credibility and gains from guaranteed access to large northern markets.

The third case examined the impact of regional integration in the Southern Cone, involving Argentina, Brazil, Paraguay, and Uruguay. Although the MERCOSUR Customs Union was not formally established until the beginning of 1995, we argued that it should be possible to discern some effects of integration in this region: a gradual liberalization of intra-regional trade commenced in 1991, and most internal trade barriers had been removed by 1994. The available evidence, although patchy, show that a strong investment expansion has coincided with this integration process, and it is reasonable to assume that comprehensive integration, as in the case of the MERCOSUR Customs Union, may stimulate further significant investment responses. However, the inflows of FDI to the integrating region are not likely to be distributed equally to

all participating countries. In the case of the MERCOSUR, it is reasonable to assume that Argentina and Brazil possess relatively strong locational advantages and will be the main beneficiaries of increased FDI inflows in the short to medium run. There is also an important caveat that may be relevant for many other instances of South-South RIAs. Macroeconomic stability appears to have been a more important determinant of FDI inflows to countries like Argentina and Brazil than is regional integration: both the Argentinean and Brazilian experiences illustrate that foreign investors have responded stronger to successful stabilization programs than to the early stages of the MERCOSUR project. Finally, the structure of the MERCOSUR agreement - with some sectors like autos and telecommunication, where controls and trade barriers have been raised rather than reduced - suggests another important caveat. It is not evident that the welfare effects of all FDI increases stimulated by regional integration agreements will be positive. To the extent that regional integration contributes to increased distortions, e.g. in the form of higher external trade barriers or market sharing agreements between oligopolistic producers, it is possible that the resulting inefficiencies will outweigh the various potential benefits of increased FDI inflows.

This brings us to some of the limitations of the present paper. The analysis has focused on the impact of RIAs on FDI flows, but the more general welfare effects have not been discussed in detail, neither for the integrating region nor for the world at large. Moreover, we have concentrated on ownership issues, interpreting FDI flows as changes in the ownership of production factors. Future research should of course consider welfare effects in closer detail, and also take into account factors that determine production location rather than ownership issues alone. Regarding the empirical cases, the discussion has mainly concerned the effects on entire countries, and developments in individual sectors and industries have not been addressed in sufficient detail. However, the conceptual framework presented in the paper suggests that the impact of RIAs is likely to differ between countries and industries, and more detailed sectoral studies are clearly called for.

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