REGIONAL INTEGRATION AND FOREIGN DIRECT INVESTMENT: THE POTENTIAL IMPACT OF THE FTAA AND THE EU-MERCOSUR AGREEMENT ON FDI FLOWS INTO MERCOSUR COUNTRIES

Andrés López and Eugenia Orlicki[1]

Although studies on regional integration agreements (RIAs) have often been concentrated on their trade impact, it may be expected that RIAs have also consequences on other areas. One of those areas is foreign direct investment (FDI).

In fact, the interaction between RIAs and FDI has been recently examined in several studies, which, as a whole, tend to suggest that there is a positive impact of the former on the latter (see, among others, Blomström and Kokko, 1997; Dunning, 1997; Neary, 2002; Globerman, 2002; Levy Yeyati *et al*, 2003). The fact that MERCOSUR's creation in the early 90s was associated with a significant increase in FDI inflows to the region might be taken, *prima facie*, as a confirmation of the abovementioned relation between RIAs and FDI.

MERCOSUR countries received around U$S 267 billion of FDI inflows between 1990 and 2003. In a scenario of booming FDI flows in the world as a whole, MERCOSUR's share in total FDI inflows grew from 1.8 to 4.4 per cent between the second half of the 80s and the second half of the 90s, to later fall in 2001-2003 mainly due to the sharp decline in FDI to Argentina after the severe crisis suffered by that country.

Argentina and Brazil attracted almost 99% of FDI inflows to MERCOSUR. While Argentina gained a lead until 1995, from that year on Brazil was the main host country in the region, recovering the primacy it had in previous decades (which was mainly due to its larger domestic market and its higher growth rate during those decades). The different timing of privatizations in both countries contributes to explain the abovementioned sequence but other macroeconomic and institutional determinants were also in place.

At present, MERCOSUR countries are negotiating simultaneously two large regional agreements: the Free Trade Area of the Americas (FTAA) and the EU-MERCOSUR Regional Association Agreement. Although so far some studies have been made regarding the potential trade impact of those agreements, much less has been done on the FDI area. This study aims at contributing to fill that gap.

In the light of the multiple factors that may affect how RIAs impact on FDI there is a need to undertake empirical studies to examine how those factors work in different scenarios. However, at the theoretical level it is possible to suggest some hypothesis about the RIAs' impacts on intra and extra-regional FDI.

As regards intra-regional FDI, an ambiguous effect is expected. On one hand, RIAs, insofar as they involve a reduction in intra-regional trade barriers, can lead to a reduction

---

[1]. Centro de Investigaciones para la Transformación (CENIT). The able assistance of Karina Otero and Mara Pedrazzoli is acknowledged, as well as the valuable comments of Gustavo Bittencourt, Daniel Chudnovsky, Rodrigo Sabatini and Pablo Sanguinetti. As usual, any remaining errors are the sole responsibility of the authors.

in horizontal FDI[2] that is based on tariff-jumping objectives. Firms that previously supplied foreign markets through FDI could, after the integration, replace FDI with exports from their home countries. In this case, we would expect a decrease in intra-regional (horizontal) FDI (de Sousa and Lochard, 2004). On the other hand, RIAs can stimulate vertical FDI[3] among member countries when firms are able to geographically fragment production at low cost (Blomström and Kokko, 1997). This involves exporting back to the source country, so in this case FDI and trade are complements. RIAs may thus encourage intra-regional (vertical) FDI (Levy Yeyati et al., 2003).

Since the different effects of RIAs on intra-regional FDI have opposite signs, one can only learn their net impact through empirical analysis. However, we may think that, beyond the sign of that impact, a RIA can have the effect of changing the composition of intra-regional FDI from horizontal to vertical (or to "horizontal in differentiated goods"[4]).

As regards extra-regional FDI, the theory expects an unambiguous effect. In the case of horizontal or "market seeking" FDI the increase in the size of the market resulting from a RIA may generate new investment opportunities. Extra-regional horizontal FDI may also increase as a consequence of a RIA if trade barriers with the rest of the world are still high enough –i.e., "tariff-jumping" FDI does not necessarily fall after integration- (Levy Yeyati et al, 2003).

Vertical FDI from outsiders should also increase since the RIA reduces the costs of disintegrating production in different locations within the region. However, we must take into account that in the case of vertical FDI that does not involve production fragmentation among RIAs member countries, but the location of a production plant within one country to later make extra-regional exports, the existence of the RIA should normally not have any positive effect. Moreover, if as a result of the RIA trade barriers with thirds partners increase, we could have a negative impact on extra-regional vertical FDI as a result of the agreement. However, on balance, the theory predicts that, whatever the form it takes, FDI from non-member countries will increase as a result of regional integration.

Beyond the already mentioned overall effects, RIAs impact on FDI may involve some "distributional" issues. First, regional integration might not only affect member countries but also non-members countries –insofar as the former become relatively more attractive for FDI- ("FDI diversion"). Second, FDI flows to a member country could decrease if a source partner joins a RIA with a third country ("FDI dilution"). Third, the additional FDI attracted by members of RIAs could not be (and normally would not be) "evenly" distributed. Moreover, existing FDI could be relocated among member countries. Hence, "winners" and "losers" may arise within the same RIA (Levy Yeyati et al., 2003).

---

[2]. FDI is often motivated by "market-access" reasons, rather than by differences in factor prices. This variety of FDI is termed 'horizontal', because similar types of production activities take place in different countries. Horizontal FDI may be assimilated to what Dunning (1993) calls "market-seeking" investments, which aim at exploiting the host country's market.

[3]. In vertical FDI strategies, firms separate their production processes in order to take advantage of factor price differentials across countries. Hence, Transnational Corporations (TNCs) activities are split according to their factor intensities.

[4]. Horizontal FDI may also take place with affiliates producing different varieties of a final good that are both consumed in the local market and exported. This case corresponds to what Levy Yeyati *et al.* (2003) call "horizontal FDI in differentiated goods" (which is different from the traditional kind of horizontal FDI in which affiliates make homogenous goods to attend each domestic market where they locate).

The empirical links between economic integration and FDI have been investigated extensively within a gravity framework. In this case, the "pull" forces are generally proxied by market size, while the "resistance" effect is represented by the distance between the respective countries. Following this tradition, in this study the analysis of the potential impact of the FTAA and the EU-MERCOSUR agreement on FDI flows to MERCOSUR is made on the basis of a gravity model.

We have constructed a FDI database for the period 1984-2002. In a first step, we considered the outflows from OECD countries to nearly 60 developed countries and developing countries on the basis of data extracted from the International Direct Investment Statistics Yearbook (OECD, 2004). Since that source has only information on outflows from the OECD countries to just 10 of the 34 countries that would join the FTAA, we decided to complete the database with information for the other 24 countries using UNCTAD and ECLAC's information. Thus, the database includes countries that belong and not belong to a RIA.

From our analysis it arises that there are a number of factors that contribute to attract FDI inflows: GDP growth in source countries, low inflation rates, privatizations, bilateral investment treaties (BITs) and low political risk in host countries –all of them are statistically significant and, as expected, have a positive sign-. Country pair specific and time invariant determinants of bilateral FDI flows –such as distance, common borders, colonial links, etc.- are also relevant. Additionally, we find that FDI diversion/dilution effects also exist.

Which is the effect of regional integration? After controlling for all the relevant variables mentioned above, we conclude that RIAs induce higher FDI inflows to host member countries, that result being confirmed both for the European Union as well as for most of the integration agreements in force in the American continent.

However, in the case of America's RIAs the positive impact of integration on FDI would be reflecting South-South agreements (such as MERCOSUR, CAN, CACM and CARICOM), while becoming a NAFTA partner by itself does not seem to have induced statistically significant additional FDI inflows to Mexico. In turn, Spain and Portugal's entrance to the EU only had a positive impact on extra-EU inflows, but not on intra-regional FDI inflows to those countries.

We assume that FTAA and EU-MERCOSUR agreement impacts on FDI could be to some extent similar to those generated by previous RIAs. In the case of the FTAA, its impact may be extrapolated from those of already existing RIAs in America (both North-South as well as South-South ones). For the EU-MERCOSUR agreement, the effects on FDI will be estimated on the basis of the impact of the EU enlargement after 1984 (which we deem as the best potential impact of the new agreement).

If we consider the case of the FTAA, from our econometric estimations it follows that it could foster increases in extra as well as especially in intra-regional FDI inflows to MERCOSUR[5]. Our results suggest that Latin American South-South flows could be strongly stimulated by that kind of agreement. However, we should not expect that MERCOSUR countries would become more attractive for "export-platform" FDI to the US

[5]. In fact, other Latin American countries would be more benefited than MERCOSUR in terms of FDI attraction, since its current joint market size is smaller –this is the case of countries that are members of the CAN or the CACM-

and Canada in the event the FTAA is signed, considering their geographical location and the fact that entrance into NAFTA *per se* did not seemingly have a significant effect on FDI received by Mexico. In turn, MERCOSUR countries could attract more FDI from Northern countries to take advantage of their access to other Latin American partners in the FTAA.

In this regard, the results of our econometric estimations suggest that a Latin American and Caribbean RIA would have roughly the same effects on FDI received by MERCOSUR countries that the FTAA[6], while signing bilateral RIAs with the US would not foster more FDI inflows.

What could happen in the event the EU-MERCOSUR agreement is signed? It would encourage more FDI inflows from non-EU countries than from EU countries. In fact, if we assume that the impact of an agreement with the EU for MERCOSUR countries would be similar to that observed in Spain and Portugal after their entrance in the Union in 1984, the EU-MERCOSUR agreement would only foster non-EU FDI inflows[7].

This result implies that MERCOSUR countries would attract export-platform FDI aimed at serving European markets. However, this could only be the case if the agreement includes better market access for agricultural goods produced by MERCOSUR countries –MERCOSUR countries are not well located as to serve as an export-platform to the EU on the basis of labor costs-. Furthermore, MERCOSUR countries would receive neither full EU-member status nor the amount of funds available for backward countries joining the EU. Hence, there is the possibility that the EU-MERCOSUR agreement might fail to foster increases in FDI inflows received by MERCOSUR countries.

Finally, as bilateral investment treaties have a positive impact on FDI attraction it is probable that, insofar both RIAs under analysis may include investment chapters, for countries that have already signed BITs with the U.S. and EU countries the increase in FDI inflows could be lower than for the other countries –in MERCOSUR, Argentina is the only country belonging to the first group-.

Summing up, while it seems reasonable to foresee a positive impact on FDI received by MERCOSUR countries in case one or both RIAs are signed, caution is needed when forecasting its probable magnitude as well as the origins and nature of additional FDI inflows to be received. In particular, our study confirms the argument of Vallejo and Aguilar (2002) that the impact of regional integration on FDI may differ according to the nature of the regional agreement, the countries involved, etc. Hence, clearly more research is required on the subject.

Additionally, there is a need to study which could be the impact of both agreements in terms of FDI inflows in each MERCOSUR member country (i.e. the “winners and losers” issue), as well as which sectors would be more attractive for foreign investors. More generally, we have not discussed “FDI quality” aspects when analyzing the potential impacts of the FTAA and the EU-MERCOSUR agreement, an issue that is highly relevant when discussing the effects of FDI on economic development objectives in host countries.

[6]. Naturally, the same conclusion does not necessarily apply to other Latin American countries that could be more apt to serve as an export-platform to the US.

[7]. This assumption is based on the fact that Spain and Portugal were relatively more backward than other countries joining the EU during the period under analysis (for our analysis, we are not considering the recent entrance in the EU of Eastern Europe countries).

References

Blomström M. and A. Kokko (1997). “Regional Integration and FDI”, Working Paper 6019, National Bureau of Economic Research (NBER).

De Sousa J. and J. Lochard (2004). “Foreign Direct Investment and Integration: Lessons for CEECs”, preliminary draft, University of Paris, France.

Dunning J. (1993). Multinational Enterprises and the Global Economy, Wokingham: Addison-Wesley Publishing Company.

Dunning J. (1997). “The European Internal Market Programme and Inbound Foreign Direct Investment”, Journal of Common Market Studies, 35, 1–30.

Globerman, S. (2002). “Trade, FDI and Regional Economic Integration: Cases of North America and Europe”, presented at the Conference Enhancing Investment Cooperation in Northeast Asia, Honolulu, Hawaii, August 7-9.

Levy Yeyati E., E. Stein and C. Daude (2003). “Regional Integration and the Location of FDI”. Inter-American Development Bank, Research Department Working Paper 492, Washington D.C.

Neary P. (2002). “Foreign Direct Investment and the Single Market”, The Manchester School, June, 291-314.

Organisation for Economic Co-operation and Development OECD (2004). International Direct Investment Statistics Yearbook, Paris, OECD.

Vallejo H. and C. Aguilar (2002). “Economic Integration and the Attraction of Foreign Direct Investment: The Case of Latin America”, paper prepared for the Seventh Annual Meeting of the Latin American and Caribbean Economic Association, Madrid, Spain, October.