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FOREIGN DIRECT INVESTMENT AND REGIONAL ECONOMICS

Mohsen Heydari

Dept of Accountancy, Ardestan Branch, Islamic Azad University, Ardestan, IRAN

ABSTRACT

This paper examines the impact of the emergence of regional blocs (customs unions) on the patterns of inter-bloc and intra- bloc trade when firms have the option to engage in direct investment (FDI). The consequences of bloc formation for exogenously given external tariffs is examined first. When two regional blocs co-exist and firms have the option to engage in FDI, all inter-bloc trade may cease- complete trade diversion that is replaced by inter-bloc FDI - investment creation.In such an event the volume of world trade declines but this is more than offset by the increase in world output due to direct investment. Hence, total world output is the same as under free trade. Second, I investigate the optimal tariff that a trading bloc levies on imports from nonmember countries. The equilibrium tariffs resulting from a non cooperative game played by the trading blocs is restricted by the option to circumvent the tariff via two-way direct investment. Small setup cost associated with FDI leads to low tariffs and the outcome is almost free trade. MNEs are likely to continue to undertake FDI within the regional blocks in order to continue to benefit from regional comparative advantage and also to overcome the external tariffs that are imposed on imports into the trading block. Finally, the formation of two regional blocs enhances the welfare of all countries.

KEY WORDS
Foreign direct investment, multinational enterprise (MNE), Regional Trading Blocs (RTB).

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***Corresponding Author**
Email:
heydari138@gmail.com

INTRODUCTION

Foreign direct investment (FDI), perhaps more than all other international economic activities, has the potential to link economies, thereby integrating world markets. Baker et al. [1] indicate, for instance, that FDI allows firms to engage in international cost of capital ('cheap capital') arbitrage, and it can also enable firms to engage directly in labor cost differential arbitrage, thus furthering the integration, respectively, of worldwide capital and labor markets. In addition, FDI enables firms to conduct goods arbitrage in situations where exporting or licensing might not be possible, and it also brings about direct contact between home and host-country individuals, thus helping to integrate worldwide product markets as well as fostering the spread of international technology and best practice. This paper therefore theorizes that FDI between countries fosters stock market integration, with empirical tests supporting the paper's hypotheses that both the flow and the level of bilateral FDI between countries can explain country-pair stock market integration.

Most foreign direct investment (FDI) flows from a few developed economies into other developed economies. Flows to developing economies have recently increased but are still smaller and the world stock of FDI is very unevenly spread. The emergence of regional trading blocks and new areas for FDI has somewhat changed these flows.

Foreign direct investment (FDI) is of interest to students of the regional economy. FDI began to emerge on a significant scale in the immediate post-war period, but it was not until the 1960s that it began to spread-out from the South East of England and locate in other U K regions. This was no doubt prompted partly by the availability of loans and grants for regional development from that time. Most of this investment was from the United States, and it was given fresh impetus and created new interest in the 1980s and 1990s: first by the arrival of investment from the Far East: but then from western Europe in the run-up and completion of the Single European Market; and finally by the mergers and acquisitions 'boom' of the late 1990s. This period is unparalleled in the history of international capital flows. In 1970 the world FDI stood flows at $13 billion, but by the year 2000 they are believed to have been $1,500 billion. Virtually all the FDI has involved flows out of the developed world, and to a substantial degree it has also flowed into these areas, of which the United Kingdom (UK) is a major beneficiary over the 1990s. While FDI has fallen-back recently, there can be no doubt about the central role that FDI plays in the phenomenon of 'globalization', and the central importance of multinational enterprises to modern economic activity.

In today's global economy, foreign direct investment (FDI) has superseded trade with global sales by multinational enterprise (MNE) affiliates worth $5.2 trillion in 1992 compared with world-wide exports of goods and services of $5.0 trillion in 1992 [2]. In 1993 global trade had increased from $3.7 trillion to $4.2 trillion in 1994, and by 1995 had accelerated to $5.0 trillion [2]. Moreover an estimated one-third of world trade is intra-firm trade within MNEs. In 1995, FDI outflows increased by 38 percent over 1994 values, and this was a substantially greater increase than that of exports of goods and services, which increased by 18 percent in 1994, whilst world output increased by 5.4 percent and gross domestic capital formation (GDFCF) by 5.3 percent over 1994 [2]. Thus in 1995, FDI outflows again exceeded the increases in trade and world output. In consequence, the role and importance of MNEs in the global business environment has continued to increase.

With such growth continuing, it is therefore interesting to see which countries are sources of FDI outflows and which are recipients, and to see how the three main trading blocks in the world economy have so far influenced these flows, and also to speculate on future changes.

Outflows of foreign direct investment

Foreign direct investment (FDI) outflows from the United States reached $252 billion in 2004 – up from $141 billion in 2003 to hit an all-time record. While this to some extent reflected the weakness of the dollar, it also confirmed continuing strong interest among US companies in acquiring corporate assets abroad.

Of the largest 25 cross-border mergers and acquisitions in 2004, five had a US-based company as the acquirer. A recovery of M&A activity in 2004, meanwhile, has carried on into 2005. On present trends, both inward and outward FDI in OECD countries could increase by 10-15 per cent in 2005, OECD estimates suggest.

Inward FDI into Germany and France, the two largest economies of the European continent, fell sharply in 2004. In France inward investment almost halved, falling from $43 billion to $24 billion. In the case of Germany, foreign investors actually withdrew about $39 billion from the country, reversing the inflow of $27 billion recorded in 2003. (Inward FDI figures include transactions, which can involve both inflows and withdrawals, between foreign-invested enterprises and their foreign mother companies. The downturn in 2004 largely reflected repayments to recipients outside Europe of inter-company loans and other transaction between related enterprises.)

For the OECD area as a whole, according to figures newly published by the OECD in an article on “Trends and recent developments in Foreign Direct Investment”, FDI inflows continued on a downward trend, falling to $407 billion in 2004 from $459 billion in 2003. Outflows, on the other hand, rose from $593 billion in 2003 to $668 billion in 2004.

Against this background, net FDI outflows from OECD countries to the rest of the world reached record high levels in 2004: the OECD area was a net contributor of $261 billion worth of direct investment – most of which went to developing countries. In 2003, OECD countries invested a net $134 billion outside the OECD area.

Over the past decade, there has been an underlying upward trend in FDI outflows, although they have been affected by cyclical downturns in the international economy. FDI outflows in 1990 and 1991 declined but recovered in 1993 and 1994, and by 1995 FDI outflows had reached record heights of $318 billion, which was an increase of 38 percent over 1994.

Of total outflows of FDI over the period 1982-91, 94 percent came from developed countries. This percentage was to decline marginally over the 1990s, falling to 85.3 percent by 1993, and 83.0 percent in 1994; however in 1995 it recovered to 85.1 percent [3].

Over the period 1982-91, the developing economies were responsible for only just over 6 percent of total FDI outflows (a total of $16 billion compared with $188 billion from developed economies). However this absolute amount increased, as did their share, so that by 1992 they were responsible for 10.6 percent, increasing to 14.6 percent in 1993, and to 16.8 percent in 1994, although this was to decline to 14.8 percent in 1995. But the amount of FDI outflows by developing countries in 1995, at $47 billion, was also their highest ever. This indicates that developing countries are accelerating their integration into the world economy [3], although the proviso needs to be made that these outflows come from a limited number of countries, as does FDI from developed economies.

With the globalization of the international economy has come a greater interdependence between countries. This is clearly illustrated by the fact that five OECD countries --France, Germany, Japan, the U.K. and the U.S.A.-- had, during the 1980s (and before), been responsible for nearly 70 percent of all FDI outflows that came from developed countries [Table 3], while in 1995 it was to exceed this former total. The importance of these FDI outflows on the economy and prosperity of both home and host countries is well documented by Dunning [4] and other writers.

Table 1: Total FDI Outflows 1984-95 (US$ millions)

Total outflow	1984-89 Annual average	1990	1991	1992	1993	1994	1995
	121,630	240,253	210,821	203,115	225,544	230,014	317,849

Source: UNCTAD (3).

Table 2: FDI Inflows and Outflows of Developed and Developing Countries (percent of total)

	Developed countries		Developing countries	
	Inflows	Outflows	Inflows	Outflows
1982-86	69.4	93.0	30.6	7.0
1987-91	81.6	93.8	17.8	6.2
1992	67.8	89.3	30.0	10.6
1993	62.2	85.3	35.2	14.6
1994	58.8	83.0	38.5	16.8
1995	64.5	85.1	31.6	14.8

Note: The balance represents flows into and out of Central and Eastern European economies Source: UNCTAD (2, 3).

The U.S.A. had been the largest source of global outward investment and over the 1980s and 90s seldom lost that position. The dominance of the U.S.A. is illustrated by the fact that it has been the largest single source of FDI for four out of the last six years.

The U.K.-- a country which historically had been a major source of FDI-- still continues to export substantial amounts of FDI. Over the period 1982-86 the U.K.'s capital outflows amounted to $10 billion compared with the U.S.A.'s $11 billion, but over the 1980s and '90s, as world outflows of FDI grew rapidly, the U.K's volume remained relatively stable. Thus as world FDI volumes grew, the U.K.'s share fell, although in 1993, 1994 and 1995 it was to re-emerge into second position.

Table 3: FDI Outflows of Selected Countries: Shares in Total (percent)

Year	France	Germany	Japan	U.K.	U.S.A.	Total
1982-86	5.3	11.5	12.3	17.5	19.3	64.9
1978-91	10.3	9.2	17.9	14.3	12.8	64.6
1992	16.2	8.4	8.9	9.9	20.4	63.9
1993	9.5	7.7	6.3	11.7	31.1	66.2
1994	10.4	9.5	8.1	11.2	20.7	59.4
1995	5.5	11.1	6.7	11.9	30.0	65.2

Source: UNCTAD (2,3).

Recent data on FDI flows

Recent [Fig. 3] show that there has been a cyclical pattern in the volume of inward FDI flows into regions, with troughs in 1991 and 1992, and recovery coming in 1993 onwards. The EU, as already mentioned, had a greater share of these total inflows in 1990, 1991 and 1992, largely at the expense of NAFTA, and still attracts a larger proportion than either NAFTA or Asia. Flows into the newly industrializing countries of South and South East Asia remained at a relatively stable level throughout the period-- at around 7 percent of total flows. China, however, dramatically increased her share in the 1990s. From an annual average figure over the period 1984-89 of 2.0 percent, which was to fall in 1990 to 1.7 percent, China was to rapidly increase her share between 1991 and 1994, so that by that latter year she was absorbing nearly 15 percent of the total world inflows of FDI-- a truly remarkable achievement. Moreover aggregating the totals for the Asian Seven, Japan and China shows that in 1994 22.5 percent of total FDI inflows went into South and South East Asia-- a total that virtually the inflows into the EU and NAFTA.

FDI destinations within Europe

For many years, the European Union has received roughly 90 percent of all FDI coming into Europe. In the 1980s within Europe, the U.K. has been consistently the largest recipient of FDI inflows, with shares ranging from nearly 40 to 25 percent. France has also been popular, but has attracted less than half of the amount that came into the U.K., with Spain attracting nearly as much as France. These three locations attracted, on average, 62 percent in the 1990s [Table 5]. Thus a very uneven spread of inward FDI occurred within Europe.

Table 4: Distribution of Flows of Inward FDI (percent)

	1984-89 Annual average	1990	1991	1992	1993	1994	1995
World $ million	115,370	203,712	157,773	168,122	207,937	225,660	314,933
EU	32.7	47.8	49.2	47.5	35.8	28.4	35.5
NAFTA	44.3	28.6	18.7	15.8	24.3	28.3	24.9
Asian 7*	5.0	6.9	9.7	7.9	7.8	7.2	7.1
Japan	0.1	0.9	1.1	2.1	0.1	0.4	0.0
China	2.0	1.7	2.8	6.6	13.2	14.9	11.9
Latin America and Caribbean	6.7	4.4	9.7	10.5	9.4	11.2	8.4

*Korea, Singapore, Taiwan, Malaysia, Indonesia, Philippines, Thailand.Source: UNCTAD (3).

Table 5: National Shares of Western European FDI Inflows 1991-95 (percent)

	1990	1992	1993	1994	1995
France	19.5	27.4	27.7	26.8	18.0
Spain	16.1	16.6	10.9	14.6	7.4
U.K.	20.9	18.7	19.4	15.7	26.7
Germany	5.2	3.0	0.4	4.7	8.3
Total	61.8	65.7	58.6	61.8	60.4

Source: UNCTAD (3)

Types of regional trading blocks

There has been a dramatic increase in regional trading blocs over the last decade. In many cases, these trading blocs seem to have succeeded in attracting Foreign Direct Investment (FDI). According to a World Trade Organization study, total in.ows of FDI into the member countries of the European Community (EC) increased considerably from European Currency Unit (ECU) 10 billion in 1984 to ECU 63 billion in 1989, following the announcement of the Single Market Program in 1985. The Southern Cone Common Market in Latin America, better known as MERCOSUR, observed an increase in FDI in.ows from $10 billion in 1995 to $17 billion in 1997. However, traditionally when trade economists discuss trading blocs, they have looked mainly at the trading of goods and have not paid appropriate attention to the importance of FDI, largely out of habit.

Economic integration within members of regional trading blocks (RTBs) can take a variety of forms. Of the three RTBs that have emerged so far, the EU has developed furthest along the continuum since the creation of the Single Market. Since 1992 all trade and non-trade barriers to trade have been abolished, thus allowing the free movement of goods, people and money within this single market. The degree of intra-European trade, and economic integration, will be further assisted by monetary union that will occur if, and when, the single currency is introduced within Europe at, or soon after, 1999. Thus Europe will move further along the continuum.

Table 6: National Shares of Western European FDI Inflows 1991-95 (percent)

Home country	1980	1985	1990	1994	1995
France	4.6	5.4	6.5	7.6	7.4
Germany	8.4	8.7	8.0	8.2	8.6
Japan	3.7	6.5	12.2	11.8	11.2
U.K.	15.7	14.6	13.7	11.7	11.7
Germany	42.9	36.6	25.8	25.3	25.8
As s percentage of total	75.3	71.8	67.2	64.6	64.7

Source: UNCTAD (3)

NAFTA does allow the free movement of goods between member countries but this does not extend to people and thus is a very different extent of economic integration. However, NAFTA does allow firms to profit from different factor endowments between countries within this RTB, and so prompt a more efficient use of most but not all factors of production (not labor) within this RTB.

The Asia Pacific Economic Cooperation (APEC) block is a much looser form of economic co-operation and is more, at present, 'a consensus to achieve certain goals', although there is a binding commitment to achieve those goals. APEC has agreed to become operational for developed countries within the region by the year 2010, and by 2020 for developing countries, although much co-operation does already take place. There is an agreement to establish free trade within the region by 2020 at the latest, whilst much FDI has and will continue within the region as MNEs of members undertake FDI within the regional block.

That a country may be a member of more than one RTB is illustrated by the U.S.A. and Canada which are members of both NAFTA and APEC. Within an RTB, governments of member countries agree to harmonize their macro-economic policies in the cause of regional economic stability. Thus having these two RTBs as 'overlapping sets' will mean that, as they are responsible for such a large percentage of world trade and world FDI, such regional economic stabilization between such a large number of countries will greatly assist global economic stabilization.

FDI between regional trading blocks

RTBs between FDI between is still occurring and seems likely to remain and even increase as MNEs in North America view Europe as the most important location for expansion in the future, especially in consumer goods industries while European MNEs view the U.S.A. with similar favor [3].

The developing countries in Asia-- the core of the APEC block--form the most significant developing region in terms of FDI [5].

FDI inflows into developing Asia reached $59 billion in 1994, an increase of 84 percent on the 1992 figure. The result of these recent large FDI inflows into the region is shown in that between 1988 and

1993, developing Asia almost doubled its total stock of inward FDI-- an increase that no other developing region achieved. Now almost half of the total stock of FDI in developing countries is located within this region. Japan, the U.S.A. and the EU are the predominant sources of these FDI inflows. However the EU has the smallest stock amongst the Triad of FDI in developing Asia. In 1993 this was 12.9 percent of the total stock, lower than that of the U.S.A. and half of Japan's share of the region's FDI stock. Japan's share of inward FDI into developing Asian countries amounted to 21.0 percent of the region's total stock as Japan relocated some of its industries to lower-cost locations within Asia [5].

Table 7: FDI Inflows by the Triad into Developing Asia ($ million and percent)

	1985-87		1990-93	
	Value	Share of total FDI	Value	Share of total FDI
EU	697	11.9	3,501	10.5
Japan	1,558	27.2	5,316	15.9
U.S.A.	1,299	22.7	3,686	11.0
Triad total	3,536	61.7	12,502	37.4
All countries	5,731	100.0	33,473	100.0

Source: UNCTAD and EC (5).

Annual average FDI inflow figures into the U.S.A., Canada and Mexico--the countries that were to become founder members of NAFTA--in the late 1980s averaged 44.3 percent of total world FDI inflows (see Table 3.6). But of this total inflow into the region the U.S.A. took 86.0 percent. Over the 1990s this proportion was to fall steadily, reaching its lowest level in 1993 when only 66.4 percent of the FDI inflows went into the U.S.A., but the U.S.A.'s share recovered in 1994 to 77.9 percent and in 1995 was 76.8 percent. Inflows into Mexico started from a low base point in the late 1980s being only 4.8 percent of the total. But in 1991 its share dramatically increased to 16.1 percent, and increased still further in 1992 to 16.6 percent. Indeed, from 1991 onwards, FDI inflows into Mexico were to become double the amounts that flowed in during the late 1980s, whilst by 1994 the value of Mexican FDI inflows was to double again. This indicates that, whilst the U.S.A. always attracts the vast majority of FDI going into this region, Mexico has become a more attractive location and is now rivaling Canada as a host for FDI inflows. Thus there has been some slight diversion effect on FDI inflows, although not strong. Moreover some of the inflows may well have gone in irrespective of NAFTA membership. FDI inflows into Mexico, however, are likely to increase still further in the future due to its lower-cost advantages compared with the other existing members of NAFTA, although any enlargement will again influence the choice of host country location within this RTB.

Table 8: FDI Stocks by the Triad in Developing Asia ($ millions and percent)

	1980		1985		1993	
	Value	Share of total FDI	Value	Share of total FDI	Value	Share of total FDI
EU	4,779	16.4	9,058	17.2	29,846	12.9
Japan	7,313	25.1	13,090	24.9	48,607	21.0
U.S.A.	4,657	16.0	11,099	21.1	32,617	14.1
Triad total	16,748	57.5	33,248	63.2	111,070	48.1
All countries	29,115	100.0	52,645	100.0	230,933	100.0

A recent change in FDI flows has been the growing importance of South, East and South East Asia. Very significant amounts of FDI are now flowing into this region-- the ASEAN group have attracted some inflows.

Table 9: FDI Inflows into Countries in NAFTA ($ millions and percent)

	1984-89 Annual average	1990	1991	1992	1993	1994	1995
U.S.A.	86.0	82.2	76.4	66.4	81.4	77.9	76.8
$ million	43,938	47,918	22,020	17,580	41,125	49,760	60,236
Mexico	4.8	4.4	16.1	16.6	8.7	12.5	8.9
$ million	2,436	2,549	4,742	4,393	4,389	7,978	6,984
Canada	9.2	13.4	7.5	17.0	9.9	9.6	14.3
$ million	4,718	7,855	2,740	4,517	4,997	6,043	11,182

The planned enlargement of the EU by the incorporation of new members (e.g. Poland and the Czech Republic) is also likely to affect FDI flows. Whilst current flows of FDI into Central and Eastern Europe are small, they are also concentrated into a few countries, some of which are the most developed and stable, and are due to join the EU shortly. So the surges going into Poland can be viewed in part as a strategy to establish a local market share and a cheaper EU location from which to service other parts of the EU. This is particularly true for Volkswagen which is faced at home by the highest European labor costs in Europe, while Fiat have decided to use Poland, rather than Italy, as a location to implement their new strategy of achieving a greater degree of globalization of their business activities.

The planned expansion of NAFTA is to include Chile. In 1994, out of a total FDI inflow into Chile of $2,533 million, 59 percent ($1,502 million) came from NAFTA, with the remainder coming from APEC.

Future enlargement of both blocks is also likely. The EU will soon probably include most of Central and Eastern Europe and Turkey, and perhaps some of the North African countries bordering on the Mediterranean (e.g. Egypt which is an emerging industrial country in certain industrial sectors). FDI is already flowing into several of these countries, especially Turkey, which is the fastest growing economy in the region. Moreover Turkey, from lst January 1996, has a Customs Union with the EU and has adopted its common external tariffs from this date, so has effectively become part of the Single Market. Further inflows of FDI into Turkey and other Mediterranean countries are likely to lead to a diversion effect of FDI from Western Europe and the U.K. to these areas. Further expansion of the EU may occur if the discussions between the EU and the representatives of the Mediterranean and Middle Eastern countries, held in November 1995, led to the successful introduction of a free trade block by the year 2000. The Middle Eastern countries are not at present members of the current regional trading blocks and, while geography might dictate a link withEurope, history and religion would push them more towards APEC.

NAFTA may well also expand to incorporate much of Central and South America over a longer time horizon, whilst APEC will surely quickly aim to accept India as a member. Enlargement of all three regional trading blocks will inevitably increase the FDI flows within blocks as each becomes bigger, whilst FDI flows between blocks will also increase--again at the expense of trade.

CONCLUSIONS

FDI flows are likely to continue to flow between the regional trading blocks, although the countries which provide this investment and the countries to which it goes are likely to change over time. FDI outflows from South East Asia are starting now. Very soon this area will become a major source of FDI, and the ascendancy of those mature OECD countries which in the past provided most of the FDI will soon be over. MNEs are likely to continue to undertake FDI within the regional blocks in order to continue to benefit from regional comparative advantage and also to overcome the external tariffs that are imposed on imports into the trading block.

CONFLICT OF INTEREST
There is no conflict of interest

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