

# Impacts of regional economic integration on industrial relocation through FDI in East Asia<sup>☆</sup>

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## Abstract

This paper examines the impacts of regional economic integration on the industrial relocation of participating countries focusing on the role of foreign direct investment. Focusing on the integrating countries' asymmetries in technology and market size, this paper demonstrates that preferential trade agreement increases intra-bloc vertical FDI flows when the integrating countries show large differences in factor costs. Moreover, when the technology gap is relatively large between the integrating countries, inter-bloc horizontal FDI tends to inflow to a county with a higher technology level even though its factor cost is higher. These results imply that Korea–China FTA might increase the inter-bloc horizontal FDI inflows into Korea when Korea has significant technological advantage while the intra-bloc vertical FDI inflows into China might be increased with increased pressure on the Korean economy to specialize in the headquarter service sectors.

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## 1. Introduction

The major driving force of the recent upsurge of regional economic integration in East Asia is the market access motivation. Especially, small open economies such as Korea have jumped

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into the Asia-wide efforts for the formation of preferential trade agreements mainly from the concerns about being left out from the preferential market access chances. In addition to the market access motivation, the expectation for the increased foreign capital inflows in terms of foreign direct investment has worked as a second driving force for preferential trade arrangements. The backgrounds for this FDI inducing motivation for preferential trade agreement is that FDI inflows will enhance national industrial efficiency and productivity in addition to the growth of domestic production.

However, these Asia-wide efforts for the formation of preferential trade agreements, which were mainly pushed forward by the concerns about alienation from the preferential market access chances, tends to produce some unintended features. The first feature observed is that FDI inflows into the PTA member countries are very asymmetric in terms of absolute volume and the increase rate. For example, after the formation of NAFTA, there has been sharp increases in the FDI inflows into Mexico, while the FDI inflows into Canada has shown quite stagnant trends comparing to the case of Mexico. That is, since 1994 when NAFTA was formed, the share of the US FDI outflows to Mexico was increased to 3.8% in 2003 from 2.8% in 1994. However, the share of US FDI outflows to Canada was reduced to 10.8% in 2003 from 18.4% in 1988 since Canada–US FTA (CUFTA) was formed in 1988. That is, from the perspective of Canada, the formation of regional integration caused negative impacts on FDI inflows from member country, the US, in terms of the ratio in the total US FDI outflows while it worked positively to Mexico.

Moreover, the recent sharp decrease in the international transaction costs in terms of communication costs and transportation costs in addition to the removal institutional transaction costs such as tariff and non-tariff trade barriers has caused an upsurge of fragmentation, especially within the member countries of preferential trade agreements. Especially in the Asia, the recent efforts for FTA formation are strongly influenced by the expectation on the FDI inflows as a result of the preferential trade agreement formation, and there have been mixed expectations on the impacts of preferential trade agreement on FDI structure in the East Asian region. For example, Korea–Japan FTA is expected to produce negative impacts to Korea in terms of trade balances and industrial production, i.e., negative static impacts on Korean economies.<sup>1</sup> Notwithstanding with these short-term negative impacts, large-scale inter-bloc FDI inflows from Japan into Korea due to FTA was expected to enhance the total factor productivity in the long-term in addition to the dynamic capital accumulation effects by the supporters of Korea–Japan FTA. However, a strong argument against Korea–Japan from the perspective of Korea goes that there will be little positive impacts on inter-bloc FDI inflows into Korea considering the little production factor cost differences between two countries. Moreover, fragmentation between two countries will be deepened pushing Korean industry to specialize in the less-value adding production process while the technology intensive headquarter service sectors are supposed to move to Japan.

Another example is the case of Korea–China FTA, which is expected to accelerate the hollowing out of Korean industries to China. The major argument is that Korea–China FTA will increase the hollowing out also in the technology intensive sector through the increased horizontal FDI. A counter-argument supporting Korea–China FTA emphasizes that the increased intra-bloc vertical FDI inflows from Korea to China after the bilateral FTA will enhance the specialization of Korean

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<sup>1</sup> Refer Yamazawa and Ippei (2001), McKibbin et al. (2004), and Lee & Park (2005) for a detailed discussion on the impacts of Korea–Japan FTA.

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