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ScienceDirect
North American Journal of Economics and Finance
18 (2007) 107–116
THE NORTH AMERICAN JOURNAL OF ECONOMICS AND FINANCE

Regional trade agreement and foreign direct investment

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Received 3 May 2005; received in revised form 21 August 2006; accepted 11 September 2006
Available online 7 November 2006

Abstract

This paper investigates the relationship between regional trade agreements, such as the NAFTA, and FDI. Using a fixed-effects gravity model to estimate OECD panel data spanning 1982–1997, we learn that trade integration encourages FDI. We find specific evidence for each of the NAFTA member countries—Mexico, Canada and the United States. In addition, we find evidence that FDI will rise with host and parent country GDP and fall with distance.

JEL classification: F13; F23

Keywords: NAFTA; Regional trade agreement; Foreign direct investment; Gravity model

1. Introduction

The purpose of this study is to examine the impact of regional trade agreements on foreign direct investment. Particular attention will be given to the North American Free Trade Agreement.[1] This agreement is known for having reduced trade barriers between the three nations. While it is the trade aspect of the agreement that has received the bulk of research attention, NAFTA was innovative in its inclusion of investment issues. Just a few of the provisions with regards to investment are:

- Investors from member countries shall be treated in the same manner as domestic investors.

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[1] The United States, Canada and Mexico began negotiations in June 1991 to extend the existing Canada–U.S. Free Trade Agreement of 1988. The North American Free Trade Agreement, or NAFTA, was signed on December 17, 1992, and took effect on January 1, 1994.

1062-9408/$ – see front matter
doi:10.1016/j.najef.2006.09.004

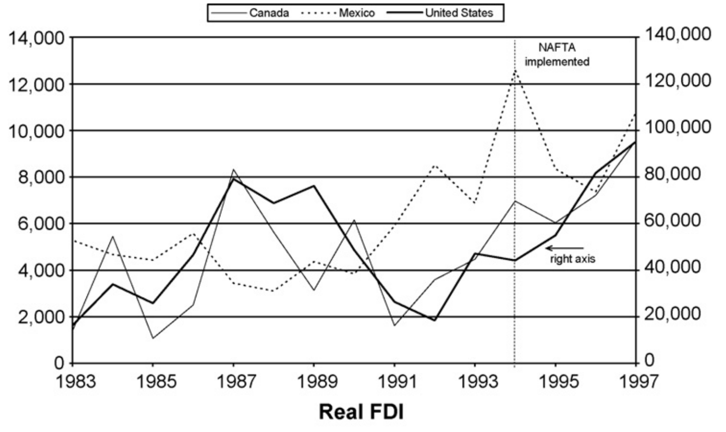

Fig. 1. Total FDI inflows to each NAFTA country.

- Most-Favored-Nation-Treatment—investors from member countries shall be treated no less favorably than those of non-member countries.
- The establishment of content requirements, export minimums or the like is prohibited.
- Dispute settlement—rather than asking the parent government to pursue a claim against the host government, investors may appeal to an international forum for binding arbitration. While these rulings cannot impose money damages or the return of property, they can be taken to courts in the member countries, which have that power.

Fig. 1 shows the evolution of FDI inflows into each of the NAFTA member countries in real U.S. dollars.[2] Through the early and mid-1980s, there is no discernable pattern to inflows of FDI into the NAFTA member countries. However, in the late 1980s, FDI into each country appears to taper off slightly before skyrocketing in the 1990s in response to negotiation and implementation of NAFTA. Further scrutiny of Fig. 1 shows evidence of the Mexican currency crisis of 1994–1995 and the decline of FDI during that period.

Although NAFTA did not go into effect until January 1994, it is readily seen that FDI increases significantly in anticipation of this event. While Freund and McLaren (1999) document the anticipatory effects on trade, similar reactions may apply to investment as well. From visual inspection it would appear at least a portion of the increase in FDI in the early 1990s can be attributed to anticipatory effects of the trade agreement.

To understand the impact of the trade agreement on FDI, we must first understand why firms invest abroad.[3] FDI may be a substitute for trade, as in horizontal FDI, where it may be motivated by the need to jump tariffs or other barriers to trade. Hence, intra-regional FDI would be expected to fall with reduced trade barriers. However, FDI from non-member countries could very well rise as a result of the discriminatory nature of the agreement.

Firm-specific assets are a motivating force for FDI. Firms must possess some asset that allows them to compete with foreign firms that possess superior knowledge of local customs, markets,

[2] The U.S. data are plotted against the secondary axis on the right and far exceed those of Canada and Mexico in magnitude.

[3] See Blomström and Kokko (1997) for a discussion of the theoretical considerations of regional trade agreements and FDI.