CHAPTER 4. STIMULATING INVESTMENT

Introduction: Can RIAs Help Investment?

Investment is a key component in economic development and has become one of the main objectives of countries in pursuing regional economic integration. The logic is that larger markets, greater competition and improved policy credibility will increase the incentives for investment and by that means raise incomes both directly by increasing the capital intensity of production and by encouraging technical progress. These arguments apply to investment from all sources, but they are applied particularly frequently to regionalism as a means of attracting foreign direct investment. In NAFTA, for example, stimulating foreign direct investment flows is an explicit objective. This chapter briefly describes trade blocs' policies towards investment and then asks whether the arguments advanced for their having positive effects are justified.

Section 4.1 explores explicit policies towards investment. In early RIAs this was almost always activist and interventionist, co-opting regional integration into import substitution at a regional level. Such policies almost completely failed and have now been superceded by a much more market friendly approach. Part of the latter has been a greater emphasis on policies guaranteeing the fair treatment of investment. These guarantees are often embodied in Bilateral Investment Treaties, or, where there are trade and other links, investment chapters in RIA agreements. They typically foster negative integration – i.e. precluding certain policies rather than requiring policies to actively encourage investment – but they may play an important facilitating role in investment flows.

Section 4.2 examines the common argument that RIAs add credibility to government policies other than investment rules and thus help to raise investment and attract FDI. We argue that South-South RIAs are unlikely to provide much added credibility and may, in fact, have the opposite effect, especially if they are not accompanied by trade liberalization with the rest of the world. North-South RIAs, on the other hand, can enhance a Southern country's credibility, but typically only if the RIA is likely to enhance economic performance in its own right and if the large Northern partner is willing to enforce investment-encouraging "club rules". The latter is more likely to be true if the policies on which a developing country wants to gain credibility are specified explicitly in the agreement.

Of course, investment depends on far more than just explicit policies. An RIA will stimulate investment if it raises expected returns or lowers costs. Classic economic analysis predicts that a South-South RIA should have no impact on returns to capital, but that a North-South RIA will increase the relative price of exportables in both countries, thus raising wages and decreasing the return to capital in the South, and causing investment to fall.

More recent analysis holds that the rate of return on capital (and investment) could well rise in both countries regardless of capital abundance. RIAs typically reduce the transaction costs of tradables more than those of non-tradables, so if tradables are more capital-intensive than non-tradables, RIAs will raise demand for capital—and its rate of return. Lower tariffs and trading costs for capital equipment can, also, reduce the price of investment goods, increasing the rate of return and accumulation. Integration may also result in a more efficient financial sector, especially for a Southern member of a North-South RIA, reducing lending margins and fund costs, and raising investment.

Unfortunately there are few empirical studies of the impact of RIAs on investment—most trade blocs are so new that the data are simply not there. Ex-ante simulations show, however, that increased investment is most likely in North-North RIAs, somewhat less likely in North-South RIAs, and least likely in a South-South one. Where we do have *ex post* evidence on investment, it tends to suggest mild positive effects, but there seems to be no evidence that this translates into higher economic growth. Firmer evidence is available for foreign direct investment (FDI), which seems frequently to boom after an RIA is signed. We explore this in section 4.4, and explain why it is likely that RIAs stimulate inflows of investment from non-member countries, but have ambiguous on intra-bloc flows.

Throughout the chapter we argue that general policy reforms (such as sound macroeconomic policies, well-defined property rights, and efficient financial and banking sectors) are likely to be far more important in influencing investment and FDI than merely joining an RIA. Reforms such as macroeconomic stabilization, market liberalization and privatization should raise the returns to all factors and foster investment. Regional integration will foster investment if it significantly raises policy credibility and market size only if it is accompanied by good policy overall.

The discussion of investment leads naturally to questions about the location of industry and economic growth. These topics are dealt with in Chapter 5 below.

4.1 Investment Policies

4.1.1. Investment Planning – A Dead-end

Until about 1980 theories of economic development placed great store on the stimulation of investment and on the role of the public sector in directing, and often financing, it. The prevailing theories of import substitution called for governments to plan industrial structure carefully and to ensure that the untoward effects of competition did not disrupt the search for economies of scale. Naturally, regional economic integration was seen as a potential tool for this endeavor. Recognizing that individual national markets were too small to support large-scale industries, policy-makers planned to meet regional demand by establishing one (or a few) larger regional projects instead of a greater number of smaller national ones. Thus, for example, the 1982 PTA treaty (Preferential Trade Agreement, a RIA of Eastern and Southern African countries, whose members essentially formed COMESA in 1993—see Annex to Chapter 1) called for member states to co-operate in industrial development to promote collective self-reliance and complementary industrial development, and to expand trade in industrial products.

The idea was that if countries desired a given level of industrial activity but were indifferent about its precise composition, an RIA would reduce the cost of achieving it. An RIA would allow each member to specialize on particular industries and reap the economies of scale associated with supplying the whole RIA rather than have to maintain a wider set of smaller industries to serve just their national markets (e.g. Cooper and Massell, 1965, and Johnson, 1965). As we saw above, there is nothing wrong with the logic that larger markets allow greater efficiency, but in the event its application proved top-heavy. Planners looked to intra-regional specialization to support their comprehensive regional development plans, which typically put the pursuit of scale economies above all other objectives. Thus national industrial development plans restricted entry and were coordinated across countries to avoid duplication and the under-utilization of industrial capacities. This regional "rationalization" of industry was effectively just infant industry protection and import substitution on a regional level.

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These policies proved almost universally to be failures. RIA members often found themselves unable to agree on industry location.[1] In one of the most notorious examples, Côte d'Ivoire, Ghana, and Togo agreed in 1976 that they could co-operate and reap economies of scale if the latter built a single cement plant to serve the region. However, the countries disagreed on how to manage the industry—and each country ended up with its own cement plant supplying its own domestic needs (Robson 1998). Agreeing to forego industrial sectors so that partner countries can establish them imposes tangible and immediate costs on governments in return for uncertain future benefits when some other project in its turn is assigned to them. Understandably, without a great deal of trust and experience of working together, and without any great confidence in the market mechanism, governments were reluctant to do this.

The sorry experience of managed industrialization, the evolution of economic orthodoxy towards using markets and the increasing mobility of international capital, have combined to move most recent RIAs (and the re-incarnations of old ones) away from outright industrial planning. Instead, they have looked at integration as means of generating investment by making the market more attractive and by improving policy credibility. In addition, many have sought to alter the environment for foreign direct investment (FDI) directly by changing the regulations governing it, either on an mfn basis or just within the bloc. In fact, many countries have signed bilateral investment treaties independently of trade agreements. The remainder of this section briefly considers these regulatory changes before moving on to consider the more general economic effects of RIAs on investment flows.

4.1.2 Bilateral Investment Treaties

[1] Such pacts can also fail because the country assigned to produce certain products lacks the capacity to do so. The Andean Pact assigned exclusive production rights to different countries by sector in 1970. The program failed when Bolivia produced only two out of the ten products assigned and Venezuela violated the agreement and started producing them (Echavarria, 1997). In other RIAs (EAC, CACM) the more industrialized member countries (Kenya, El Salvador) refused to accept constraints on the expansion of their manufacturing sectors.

Bilateral Investment Treaties (BITs) are now an important part of the regulation of worldwide investment flows.[2] There are now well over one thousand of them linking countries in all continents and at all levels of development. They are important in their own right and also as models for and precursors to regional investment treaties, most of which are part of broader RIAs. BITs are generally short agreements providing 'shallow' or 'negative' integration for investment - that is, they seek to remove barriers and uncertainty to investment rather than stipulate positive actions to encourage it.[3] They are almost always reciprocal and typically contain sections dealing with their scope of application (e.g. definitions of investment, nationality, etc), the admission of investment, general standards for the treatment of investment once it has arrived, and dispute settlement. Most also contain a number of specific provisions.

Most BITs explicitly defer to domestic law on the admission of investment, so that governments retain almost complete discretion to manage the sectors in which FDI occurs and the shares of ownership that foreigners may hold. However, the USA has generally been more progressive, insisting, in most of its BITs, on mfn and national treatment on the admission of investment (subject to explicit specific exceptions). Moreover, during the 1990s, when FDI has assumed a much more prominent role in development thinking, this approach has begun to find favor elsewhere as well.

On standards of treatment within the host country, virtually all BITs call for fair and equitable treatment, security of ownership, and freedom from unreasonable or discriminatory restrictions on the operation of investments. Nearly all guarantee mfn treatment, i.e. that no foreigner be treated more favorably than are the partner country's residents, although, as with trade, this is subject to exceptions permitting even more favorable treatment of partners in an RIA. Most BITs also specify national treatment, i.e. no less favorable treatment for the partner's residents than for domestic residents and in fact, treatment is often more favorable than for domestic residents (for example, where domestic residents face foreign exchange restrictions, but foreign firms effectively do not). Nearly all BITs contain provisions on the transfer of funds associated with FDI and on expropriation, and the USA has again led the way in introducing provisions that either restrict the imposition of performance requirements or permit the international mobility of key personnel.

Dispute settlement provisions vary, but usually define arbitration procedures, often based, in recent BITs, on international standards such those of the World Bank Group's International Center for Settlement of Investment Disputes (ICSID). The provisions are interesting in that they sometimes provide for private entities in one partner country to take action against the government of the other.

4.1.3 The Treatment of Investment in Current Regional Arrangements

At the regional level, some treaties are just multi-country extensions of BITs – i.e. freestanding investment agreements. These include, for example, the Agreement on Investment and Free Movement of Arab Capital among Arab Countries (of 1970) and the

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[2] This section draws on the discussion in WTO (1996).

[3] The terms shallow and narrow integration are discussed in Chapter 6 below ##.

Colonia Protocol on the Promotion and Reciprocal Protection of Investment within Mercosur (1994). Others, of more interest to us, however, form part of broader RIAs, which include trade and sometimes other provisions as well. Thus, for example, the EU, the Andean Pact, LAIA, NAFTA and COMESA all have investment provisions.

The most far-reaching investment provisions are those of the EU, where the objective has been to create a common market with a single market for capital and investment. Restrictions on investment and the movement of people are long-gone and the remaining frictions reside in areas such as difference in taxation, company law etc. The European Single Market Programme sought to address some of the latter, although the process is not yet complete. An important part of the integration of capital markets in the EU is its common competition policy, which restricts the worst excesses of investment incentives (known as state aids) in the EU.

Just as it has been very progressive in its BITs, the USA has been instrumental in advancing the treatment of investment in RIAs. NAFTA contained a deep and innovative investment chapter, especially considering that it is only a free trade area rather than a customs union. It has become a model for other groups such as the Group of 3 and the non-binding investment principles of APEC.

NAFTA provides for national treatment in establishment, mfn treatment on establishment and operation, a ban on new performance requirements and a phase-out of old ones, guarantees of convertibility at market exchange rates of funds for repatriating profits, disinvestments etc., and a ban on expropriations except for public policy reasons on a non-discriminatory basis and with full compensation. This is a far-reaching menu, although the governments have made quite a number of exceptions in the Annex to the investment chapter, including general exceptions on national security grounds and sector and country specific exceptions. NAFTA also has extensive dispute settlement provisions, permitting private action against governments.

In 1994, APEC agreed an even more extensive set of principles governing investment, but were able to do so only on a non-binding basis. These basically represented a goal to which national regimes might seek to evolve in the fullness of time. They offer no concrete protections at present and so probably have only a very slight (psychological) effect on intra-APEC investment flows.

4.1.4 Multilateral Investment Agreements

As well as RIAs many bilateral and multinational agreements embody national treatment. Prominent among the latter are the OECD Codes on Liberalization of Capital Movements and Current Invisible Operations, and the National Treatment Instrument—which requires that non-resident enterprises that have been permitted to establish in host countries be treated in the same manner as domestic firms. A number of developing countries have agreed to sign these codes. Recently the OECD tried to liberalize investment further and establish binding dispute settlement procedures in the Multilateral Agreement on Investment (MAI). This initiative failed both because the OECD countries turned out not to be ready yet for such a step, and because, for a variety of reasons, the MAI aroused substantial opposition among non-governmental organizations – Henderson (1999). Investment policy has also been proposed as a subject for future WTO negotiations, although probably not in the near future in the light of the MAI's difficulties.

4.2 Integration can raise the credibility of policies – but not automatically

While a country intent on restoring or accelerating growth must improve its economic management, this may not be enough if it suffers from low credibility due, say, to a history of bad policies. Potential investors, domestic or foreign, are likely to be suspicious of the government's stated intentions if they have been burned in the past by sudden tariff changes, tax increases, or nationalization. Thus, the benefits of economic reform will be slow to arrive if credibility has to be built up over time. In fact reform may well fail without credibility: investors may not respond or respond perversely in the anticipation of reversal; they may launch speculative attacks against the reforms and interest groups that lose under the reform may attempt to reverse it.

In developing countries, low credibility can stem from a number of factors. Governments driven by interest groups or re-election pressures may be tempted to reverse reforms—or elections may bring a party opposed to the reforms into power. Kleptocratic regimes can make opportunistic raids on investors or ethnically riven societies pursue destructive redistributions. Unless governments can convince people that they will refrain from such actions, investment is likely to stay low.

But it is difficult—and takes a long time—for a country to raise its standing by itself. When reform is hampered by a lack of faith, governments must try to reduce uncertainty, and one way of doing this is to anchor reforms through a binding commitment that is credible in itself. Some countries—such as Argentina—with histories of high inflation have established currency boards that take monetary policy out of the government's hands.

4.2.1 RIAs allow bad policy to be punished

Another route might be to sign an RIA which 'locks in' reforms by changing the incentives for bad policy. Such an outcome may come about either because the RIA increases the rewards to good policy or the costs of a bad policy directly, or because it permits 'punishments' by other RIA members if the country breaks the 'club rules' (Fernandez and Portes, 1998). In the latter case the partners must have the power and commitment to enforce the necessary reforms. The partners need to be large enough, stable enough and have a sufficiently strong interest in the RIA to make it worth *their* while to discipline the target country. This is a difficult combination to achieve, for the larger and more stable a country, the less it is likely to depend on any particular RIA for its prosperity.

A partner country is likely to be more concerned—and more willing to serve as a policy anchor—for a neighbor than for a distant partner. Mexico's economic performance is more important to the United States than Argentina's, because Mexico is a more important trading partner and Mexican social and political instability can affect perceived US welfare directly, especially via migration. Francois (1997), for example, identifies strong credibility effects from Mexico's accession to GATT and NAFTA – Box 4.1.

Similarly, the EU is likely to be more concerned about Poland or Hungary than about Pakistan or Zimbabwe.

A large country can also support integration among ex-colonies. French sponsorship provided the two African monetary unions in the CFA zone, which have survived for more than 40 years, enough credibility to resist a needed devaluation for many years. Similarly, the British Colonial Office gave SACU—which goes back over 80 years—credibility for its first 50 years; later SACU became a kind of North-South RIA dominated by a hegemonic power, South Africa.

Box 4.1 NAFTA and the Credibility of Mexico's Policy Reforms

Did NAFTA raise the credibility of Mexico's policy reforms? One way to check is to compare Mexico's behavior following the 1982 and 1994 debt crises. Mexico's 1982 debt crisis led to an enormous increase in economic intervention by the government. It nationalized the banking system, and put in place foreign exchange controls, a universal regime of import-licensing requirements, and controls on foreign investment.

Mexico started to liberalize its economy around 1985, dismantling its import-licensing regime, and reforming its foreign exchange restrictions, foreign investment and intellectual property laws. It acceded to the GATT in 1986 and established formal consultation mechanisms on trade and investment with the US well before the establishment of NAFTA.

In 1985, Mexico's average tariff was 18.5% (100% for some products), and its average tariff on consumer goods 45%. After joining the GATT, its bound tariff rates fell significantly and its applied average tariffs fell to the range 4-13.1%. Tariffs were further capped at Mexico's entry into NAFTA in 1994. Thus, through NAFTA and the GATT, Mexico's government severely limited its ability to raise tariffs and dismantle its trade and investment reforms.

While the debt crisis of 1982 resulted in nationalizations, exchange controls and a dramatic increase in protection to deal with the balance of payments crisis, this did not occur in the 1994 crisis. With the support of multilateral agencies and the USA—Mexico's principal trading partner by far—intervention was aimed at stabilizing the economy without closing it. And though protection did increase on some non-NAFTA imports, the general thrust toward openness was not heavily compromised.

What explains the different reactions to the two crises? Some have argued that the change in the prevailing intellectual climate towards liberalization was sufficient – Bhagwati and Panagariya (1997). This was clearly important – possibly necessary – but equally plausible is that Mexico had locked in its policies through accession to the GATT and to NAFTA in a way that made reversal very costly.

If reforms are clearly stipulated in an RIA treaty—and a clear and credible punishment incentive exists—a North-South RIA can provide a strong commitment mechanism and raise the credibility of these reforms. By writing the reforms into an RIA agreement, subsequent punishment is given a formal legal basis, and if the reforms also affect the partner countries' welfare, their imposing punishments is legitimized politically.[4] The obvious cases in which treaties define policies include the trade policies between the partner countries in a FTA, external trade policies in a CU, and possibly aspects of investment policy (such as national treatment). They might also include various 'deep' integration measures, and so generate credibility in these areas as well – see Box 4.2 on Europe's Single Market Programme.

Box 4.2 Credibility on Deep Integration: the European Single Market Programme

Holmes and Smith (1997) argue that one effect of the European Single Market Programmes' (SMP) removal of intra-regional trade barriers was a reduction of the risk premium on investment. They argue that trade policy commitments by EC governments reduced future uncertainty and induced additional investment and growth. Had these commitments merely been to reduce tariffs, it is not clear that they needed to be implemented regionally, rather than multilaterally. However, they actually went much deeper to issues such as standards, customs formalities and domestic regulation, in which EC institutions are critical, and over which the new power of enforcement granted to EC central bodies – the Commission and the Court – added considerable leverage. Baldwin, Francois and Portes (1997) forecast a similar reduction in risk premia for the Eastern European countries as they accede to the EU over the next decade.

What RIA treaties typically do not include is macro-economic and general domestic policy constraints. Whalley (1998a) argues that a desire to increase the credibility of domestic reforms was central to Mexico's negotiation on NAFTA. "Mexican negotiators were less concerned to secure an exchange of concessions. ... The idea was clearly to help lock in domestic policy reform through this process." But, in fact, NAFTA covered neither macroeconomic policies (which got completely out of hand in the run up to 1994) nor privatization and deregulation (which actually have moved rather slowly in Mexico). Indeed, one might argue that the intense focus on NAFTA during the early 1990s encouraged an over-optimistic view of Mexico's economic prospects, diverted attention from macro-management, and discouraged macro-stabilization for fear of puncturing the political enthusiasm for NAFTA on both sides of the border. On the other hand, the Europe Agreements between the EU and the CEE countries do cover certain domestic policy reforms (e.g. on competition policy) as do the Australia-New Zealand and the Iceland-EU RIAs.

4.2.2 RIAs can affect the incentives to have good policies

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[4] In the twenty-first century, a Northern government imposing punishments that are neither legally based nor politically imperative is likely to stir up a storm of protest about neo-colonialism and interference.

An RIA may increase the returns to investment-friendly policies because it enlarges the potential market. Similarly it may increase the costs of ‘anti-investment’ policies or fiscal laxity because the domestic market is more exposed to competition. It will be clear from this that genuinely liberal RIAs can increase the credibility of promises of good policy, whereas RIAs that do little to increase competition and exposure will do little for credibility either. That is, direct credibility effects will tend to magnify the static effects discussed in chapter 2. They are the icing on the pro-competitive cake of RIAs: but no cake means no icing.

An RIA can also help to lock in the larger partner’s trade policies. Most RIAs have dispute settlement mechanisms, which can improve the security of market access by providing a forum where disputes can be dealt with. However, such mechanisms are frequently very political and smack of managed trade. Thus a small country may have little power to resist effectively if its larger partner reneges on an agreement – e.g. applying anti-dumping measures incorrectly to help some domestic interest group. Moreover, even where the small partners can insist on addressing the problem, solutions are frequently in the form of guaranteed access for politically determined quantities rather than restoring the free rein of competition. Security of access can be particularly attractive if one fears trade wars. Thus in the early stages of negotiating NAFTA, then-President Salinas said “what we want is closer commercial ties with Canada and the United States, especially in a world of big regional markets being created. We don’t want to be left out of any of those regional markets” (cited in Perroni and Whalley 1994).

4.2.3 RIAs can signal government’s reform intentions – if they are genuine

Closely related to the incentives to pursue good policy is using an RIA to signal that a government has changed its spots. If entering an RIA entails (political) sunk costs (in terms of challenging interest groups who will lose from increased competition), and if it requires liberal or sound policies to make sense, entry provides the government with a signaling device, for only a government with genuinely liberal intentions would sign. Thus in the presence of asymmetric information about the government’s type, an RIA could improve credibility.

This argument is quite a persuasive explanation for some developing country governments’ recent interest in RIAs. There has clearly been a shift in perceptions of the policy requirements for economic growth, and after several decades of pursuing inward-looking policies governments clearly require a means of signaling genuine changes in their attitudes. Whether RIAs are the best means of such signaling, however, and whether signaling is sufficient to justify RIAs are less clear. First, there is the ‘icing on the cake’ argument above. If an RIA is genuinely liberal—i.e., if it increases domestic competition and creates trade—it is beneficial (relative to the status quo) in those terms alone, and credibility is an extra, albeit possibly of greater value than the fundamental static gains. Second, there are other means of signaling and winning credibility: for example, binding trade policy with the WTO, accepting Article VIII of the IMF, domestic rhetoric, and constitutional limitations. These do not have the trade-diverting risks of RIAs.

Moreover, a country's policy credibility will not benefit from entering an RIA if its government is not already heavily committed to reform. Compare Greece, which did not undertake much needed macro economic reforms after joining the EU, with Spain and Portugal, which did. Spain and Portugal gained credibility and benefited from increased FDI; Greece's credibility—and FDI performance—remained low. This example serves to prove that even strong, deep North–South RIAs are not sufficient to ensure good policy or credibility. Indeed, Alogoskoufis (1995) suggests that accession to the EC actually exacerbated Greece's policy problems by providing transfers that enabled Greece to postpone needed reforms. A further disappointment of this kind is likely to be the Regional Economic Partnership Agreements (REPAs) between the EU and the African, Caribbean and Pacific (ACP) States – see Box 4.3.

Box 4.3 Will RIAs enhance credibility in Africa?

African countries desperately need some policy credibility. An influx of investment and technology would assist the growth strategies that are absolutely fundamental to alleviating poverty successfully. Unfortunately, RIAs are unlikely to help in this regard, and if they divert attention from more important domestic issues that might produce credibility, they will be positively harmful.

We have already argued that even if combining small poor economies into a trade bloc has other attractions, enhancing credibility is not one of them. Thus it is only North-South RIAs that are of direct interest here, and, of these, only those with the EU are likely to be significant. (The EU is far more significant for Africa in terms of traditional links, location, and the depth of trading and investment flows: the USA's trade with Africa is small and dominated by oil.) In the Cotonou Agreement of 2000, the EU and the African, Caribbean and Pacific (ACP) States have recently agreed to turn their non-reciprocal trading agreement – the Lomé Convention – into fully reciprocal North-South RIAs – Regional Economic Partnership Agreements (REPAs). Prominent among the reasons for this is a desire for credibility – using the EU as an external agent of restraint (Collier, 1996). Our analysis suggests that they are unlikely to succeed in this. (Schiff and Winters, 2002, and Winters, 2000, suggests several other reservations as well.)

Even on the narrow issue of the instruments negotiated under the RIA—e.g., tariffs on intra-bloc trade—one must consider the incentives for the EU to discipline a small African country. It clearly has the necessary market power, but does it have the will? The EU's traditions on trade policy – even between its own members – are fairly pragmatic, and since the REPAs use high-level political bodies to manage intra-bloc relations, it is easy to imagine managed trade solutions and temporary derogations emerging rather than punishment. The internal politics and public relations of the EU excluding a traditional supplier from its market "just because it happened to need to raise tariffs to close a fiscal deficit" would be very difficult. The fact that most of these countries are members' ex-colonies would make it even harder. Finally, of course, ACP countries are so small and so distant that EU governments have no significant material interest in their success or their markets.

But even if the REPAs enhanced the credibility of the ACP countries' low barriers to EU imports, they will have little impact on their trade policy towards third parties, which is at least as important because of the potential losses from trade diversion. FTA members set their own trade policies, so there is no formal discipline and very little political, moral or legal case for the EU pressing ACP partners to be liberal in this respect. There are incentives such that when tariffs on imports from the EU are fixed at zero, those on the other suppliers will be lowered, but this is not guaranteed, as we saw in section 3.3 above. Similarly, while the EU is trying to induce some of its other Association partners to liberalize their mutual trade – e.g. within CEFTA and in the Mediterranean – it has not pressed for liberalizations of these partners' third country trade (this would entail a loss for the EU).

The REPAs are not strong devices for signaling African countries' liberal intents, quite simply because they generally appear to have rather few. The extended negotiations mostly hinged around ACP countries resisting having to open their markets to EU imports, demanding very long adjustment periods, and seeking to obtain a waiver in the WTO to permit the current (WTO-inconsistent) Lomé arrangements to continue indefinitely.

4.2.4 Regional versus multilateral routes to credibility

It is important to ask why RIAs might provide better or additional credibility to that available from multilateral agreements – specifically the WTO. First, many countries have bound their tariffs at the WTO at levels significantly higher than their applied tariffs, and can raise them without violating their WTO commitments. Given the weakness of the lock-in mechanism, domestic and foreign investors will be more hesitant to commit resources.

Second, RIAs also allow countries to make commitments in more areas than can be done multilaterally—including aspects of 'deep' integration, such as harmonization of investment codes— that are harder to negotiate multilaterally. Thus not only are more policies explicitly constrained, but there are more areas in which punishment can be exercised.

Third, for commitments to be credible there must be a high degree of certainty that retaliation will follow violations. More countries are affected by a country's actions at the WTO than in an RIA, which by definition has few members. Thus, RIA members internalize a larger share of the total loss from any violation—100% in a two-country RIA—and have a stronger incentive to retaliate than countries at the WTO. In addition, RIA members have less scope for free-riding on the punishment – i.e. for letting others take action – and more direct returns to making the agreement credible overall (Fernandez and Portes, 1998).

On the other hand, the WTO has proven enforcement procedures, brings major trading powers into the frame and is less subject to renegotiations and internal political pressures. Also, as noted above, only 'good' RIAs will have any credibility effects at all. Thus, even if a developing country has entered a North-South RIA, it is likely to gain by acceding to the WTO as well. Mexico used both GATT and an RIA to lock in its reforms

– Box 4.1 – as did the Eastern European countries who have sought WTO membership as well as Europe Agreements.

4.3 RIAs might boost investment

4.3.1 Integration affects the incentives to invest

For policy changes to have a positive impact on investment they must raise expected returns or lower costs. Recent analysis (e.g. Baldwin, Forslid and Haaland, 1996, Baldwin and Seghezza 1996b, and Baldwin and Forslid 1996) suggests that the rate of return on capital (and investment) can rise in all integrating countries regardless of capital abundance.[5] They note that regional integration typically reduces the transaction costs of tradables more than those of non-tradables, shifting both demand and supply toward tradables. If, as is commonly believed, tradables are more capital intensive than non-tradables, trade liberalization will raise the relative demand for capital and, hence, its rate of return. The latter increases the amount of capital that people wish to hold/use and so increases investment. (Extra investment is required to boost the capital stock to desired levels, but even after it reaches these, investment will not fall back to its original level because the higher stock requires more servicing and replacement.) Moreover, increased competition in tradable goods sectors may induce improvements in efficiency, lower markups, and an increased demand for inputs in those sectors, further increasing the relative demand of capital. Integration may also affect the prices of capital goods. Lower tariffs and trading costs on imports of capital equipment may reduce the price of investment goods, increasing the rate of return and accumulation. Increased competition from capital goods imports could also stimulate the domestic capital goods industry to greater efficiency.

However, these arguments are less forceful in low than in middle income countries, because the former's capital goods already generally enter with low or zero tariffs and there is no indigenous capital goods industry before integration. Developing countries have often given their industries high rates of effective protection by imposing zero or low tariffs on capital goods and high tariffs on final goods. This gave capital-intensive industries the highest effective protection, so that if those industries lost most with integration (as they well might in a North-South RIA), the result will be a reduction in the demand for capital and in investment. Additionally, of course, for a small country continuing to import capital goods from the rest of the world, prices will not change – see section 2.2 above.

Regional integration that goes beyond tariff reduction may raise the efficiency of the financial sector, reducing lending margins and the cost of funds, leading to higher investment. This is likely to provide some benefits for developing countries. Two small developing countries may gain by integrating their financial sectors through increased competitiveness and because it may allow them to better diversify their portfolios and reduce their risk premia, though these benefits will be small if the countries have similar

[5] These studies were developed mainly with the European Single Market Programme in mind, but may also apply to RIAs including developing countries.

endowments and production structures and thus highly correlated shocks. The benefits of increased competitiveness are likely to be more important in an RIA with a large partner with a well developed financial sector than in an RIA between developing countries, and even larger from non-discriminatory liberalization. Financial integration is, however, difficult; even the EU needed several decades to achieve it. And, as discussed in Chapter 6, the deeper integration needed to capture these benefits has been mostly absent in South-South RIAs. Finally, note that the benefits of a more efficient financial sector may also be obtained through non-discriminatory liberalization.

Overall, these theoretical arguments that an RIA will raise returns and investment in developing countries are more persuasive for North-South RIAs than for South-South ones. And one must not equate increased investment with increased economic welfare: if it is not well-conceived, investment can cut welfare. Also one needs to recall the conditional nature of the arguments made. RIAs may raise investment, but one needs to consider the starting points quite carefully to be sure. Whether a RIA will raise the return to capital depends on the capital intensities in the various sectors and on the initial tariff structure. And opening up the financial sector under unstable macroeconomic (fiscal, exchange rate) policies is likely to hurt more than help. Finally, RIAs are not necessary to induce investment. General reforms, such as stabilization, market liberalization, and privatization should raise the returns to all factors and are likely to be more than sufficient to increase private investment. In the mid-1970s Chile began a profound process of unilateral economic reforms that led to a significant increase in its savings and investment rates, approaching those of the East Asian tigers. In fact, Chile *left* the Andean Pact to have more freedom to undertake its reforms.

And neither is an RIA sufficient to induce investment as we saw above with Greece. Thus, RIAs are neither necessary (Chile) nor sufficient (Greece) to raise investment. What seems to matter most is the quality of domestic policies. A country suffering from low credibility, say, due to a long history of illiberal policies and failed reforms, may be able to use a North-South RIA to raise its investment level if it first undertakes serious reforms and then uses the RIA to give them credibility.

4.3.2 But investment does not necessarily mean growth in RIAs

A major ex-ante analytical study of investment effects in an RIA is Baldwin (1989, 1992), who postulates a positive investment effect from the European Single Market Programme (SMP). Early estimates placed the static gains from the SMP at around 5% of GDP (CEC, 1988). Treating these as pure gains in productivity which raise rates of return, Baldwin argues that investment will also increase as a result. Applying the latter increases in a Solow (1956) growth model, in which the steady-state (long-term) growth rate of the economy is given exogenously and is independent of government policy, he argues that, as capital accumulates, growth will increase temporarily, allowing income to increase to its new levels. Baldwin terms this additional medium-term income effect, which adds perhaps a further 5% of GDP, the "medium-term growth bonus." However, while the static income effect of SMP is essentially free (setting aside temporary adjustment costs) - a pure welfare gain - the medium-term income effect must be paid for by increasing investment—sacrificing present consumption for higher future consumption. Thus the welfare gain associated with the medium-term income effect is only about 0.5 percent of GNP, or one tenth of the income effect (Baldwin 1993). The static effect would be spread over, say, five to seven years following completion of the internal EC market, while it would take about ten years for half the medium-term effect to be realized.

Integration in the European Community seems likely to have a greater impact on investment and growth than will RIAs involving only developing countries. The SMP deals not only with border measures such as tariffs and non-tariff barriers but entails "deep integration", which aims to eliminate all barriers to the movement of goods, services, people and capital and pertains to a much larger market. Thus it should have a greater impact on contestability of markets and competitiveness of firms than simply removing trade barriers within a smaller block which is the situation in most South-South RIAs.

The evidence on the impact of RIAs involving developing countries on investment is scarce and ambiguous. Brada and Mendez (1988) estimate the effects of integration on capital formation in RIAs involving developed and developing countries (EFTA, EEC, CMEA, LAFTA, and EAC). They find that, with the exception of CMEA, investment increased, but that the effect on growth was very small. They conclude that "dynamic effects of integration can neither explain the rapid growth of West European countries in the 1960s nor serve as a strong justification for encouraging non-member countries to join existing schemes or to organize new ones."

De Melo et al. (1992), on the other hand, report that African RIAs such as CEAO and UDEAC experienced increased investment rates following integration. In CEAO (created in 1974), the investment rate increased from 6.8% of GDP in 1960-72 to 8.6% in 1973-85. The corresponding numbers for UDEAC (created in 1973) are 15.9% and 18.3%. And in the Andean Pact, created in 1969, investment increased slightly from 18.3% in 1960-72 to 19% in 1973-85.

However, such stimuli are not unambiguously desirable when external trade barriers are high, for investment is likely to go to the highly protected capital-intensive sector where the *private* rate of return on capital is high—but the *social* rate of return lower or negative. Hence the higher rate of investment need not raise economic growth or welfare. De Melo et al. (1992) find no significant differences in growth rates for members of RIAs compared with other countries. Also, in a multivariate regression analysis, they find no effect of membership in an RIA on growth for developing countries. Despite rising investment rates in CEAO, UDEAC and the Andean Pact, income growth fell in all three. One should not necessarily attribute the declines in growth rates to the formation of the RIAs, however, as the growth rates of both developing countries as a whole (78 countries) and OECD countries also fell in this period, probably because of the 1973 oil shock. However, they certainly do not support the view that regionalism boosts growth. We return to growth in Chapter 5 below.

An important lesson from these results is that the current sacrifice that additional investment entails need not result in additional future benefits if investment occurs in a distorted environment. In a liberal policy environment where domestic relative prices reflect world prices and private rates of return approximate social ones, additional investment is likely to be productive. This is another reason for lowering external trade barriers as countries form RIAs.

4.4 Regional Integration can attract Foreign Direct Investment (FDI)

4.4.1 Motives for FDI

While FDI is subject to the same forces that influence total investment, it also responds to various specific determinants. One common motive for FDI is the importance of local sales and market access. Access to large or rich markets can be important factors in attracting FDI into a country. In a survey conducted by Japan's MITI on the motives behind Japanese manufacturing FDI in Asia, North America and Europe, 70% of respondents assign local sales as a major factor (Kawai and Urata, 1996). Similarly, the spurt of FDI in ASEAN countries in the late 1980s is usually attributed to the rapid growth of the ASEAN economies (Alburo, Bautista and Gochoco, 1992).[6] A necessary condition for this sort of investment to occur is that the market not be as readily accessible from outside the bloc. That is, FDI motivated by market access is of the 'tariff-jumping' variety. FDI for automobiles and automobile parts in ASEAN economies rose partly because of the fact that these were highly protected sectors, and FDI was the only way to gain a foothold (Bhalla and Bhalla, 1997). The same happened in Mercosur. It is important to note that tariff-jumping FDI can be immizerising – i.e. it can reduce domestic economic welfare. The tariff directs capital into sectors in which the RIA does not have comparative advantage, and by causing other factors of production to flow into those sectors, it reduces output in those where it does [7].

These factors are much more likely to stimulate FDI flows from outside the RIA than between members. Firms originally located in a member country receive access to the whole market without relocation and so have less incentive to invest in other members. Firms located in third countries, on the other hand, will have more incentive to locate new production facilities in a member country and service the other members of the bloc through intra-RIA (preferential) exports – so called platform investment. This is particularly likely if there are increasing returns to scale in production, making for "lumpy" investments that are only viable above a certain size. The integrated market may become large enough to bear the fixed costs for the establishment of new foreign affiliates. Thus RIAs might attract more foreign investment (such as for the production of consumer durables) into developing regions as a whole than can fragmented national markets. However, whether these effects are more likely for RIAs between larger countries or smaller ones depends on the relative sizes of the blocs' demands for a product and the minimum efficient scale of production. Combining several small

[6] The share of ASEAN in world inward FDI increased from 2.5 percent in 1985 to 4.3 percent in 1990.

[7] Bhagwati (1987) has proposed another trade-oriented explanation for FDI, which is grounded in the political economy of protection: so-called "quid pro quo" FDI takes place not to circumvent tariff but to defuse the threat of protection. Unlike the tariff-jumping kind, this type of investment occurs in anticipation of the imposition of protection, in which case FDI which transfers technology and promotes employment is in the nature of a bribe paid to the host country in return for allowing free access to the investor country's exports. This may be significant in the EU.

economies may make new FDI attractive in low-scale industries, but these same industries may already be present in larger countries even without an RIA. On the other hand, no developing country RIA is likely to be able to stimulate FDI in, say, the production of large airliners.

A second important set of motives behind FDI is to take advantage of local factors of production (e.g., local labor) and set up export platforms. In the MITI survey mentioned above, 44 percent of the Japanese firms surveyed indicated that the use of local labor was one of their motives. These motives can be enhanced if a developing country forms an RIA with a developed country, as a firm located in the developing country can then take advantage of cheap inputs while obtaining free access to the large developed economy. Although Mexico has long been used as an export platform to the USA, NAFTA had a profound impact on FDI into Mexico after 1994 from countries outside NAFTA, as it became a way to guarantee market access into its Northern neighbors (Blomstrom and Kokko 1997, Fernandez and Portes, 1998). About 80 percent of the vehicles produced by US auto manufacturers in Mexico in 1997 were for export, compared with 48 percent in 1994 (USITC, 1997). Following the creation of NAFTA, Japan redirected part of its FDI from the US and Canada toward Mexico. While Japanese investments in the US are geared primarily for the local market (mainly directed towards manufacturing, commerce, and banking and finance), those in Mexico particularly in the automobile industry are intended more for the NAFTA continental market.

A third factor may be that the removal of internal barriers in the RIA allows firms to allocate different operations across member countries more efficiently. Thus if RIA members differ in their endowments, the RIA may stimulate vertical FDI. This potentially important aspect of North-South arrangements lies at the heart of Ethier's (1998) theoretical exploration of the benefits of regionalism. With guaranteed preferential access to the Northern market, the Southern country becomes an attractive location for labor intensive activities. Knowing this, it is more confident of receiving inflows of investment, and hence more comfortable with liberalizing, than it would be under multilateral liberalization where it would face fiercer competition for inflows. This argument is equally applicable to intra-bloc FDI as to that from outside.

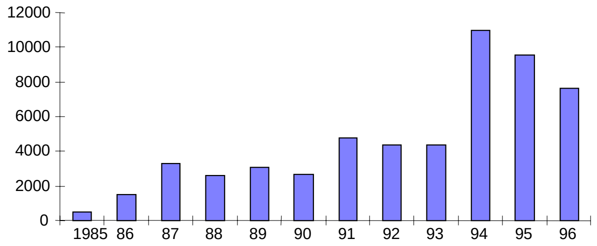
4.2.2 Evidence of the positive effects of integration

There is quite strong circumstantial evidence that creating or deepening an RIA stimulates FDI. For example, on intra-member flows, the number of manufacturing subsidiaries of EC-6 multinationals located in other EC countries increased over six-fold from 68 to 434 over 1946-70, while those located in non-EC European countries increased only from 95 to 311 (Yannopoulos, 1990). Similarly, the European Commission (1998) finds that intra-EU FDI has risen more rapidly than investment outside the EU following the SMP, with Germany and the UK, in particular, switching their investment from the US to the EU since the late 1980s.

It has also been widely documented that European integration has made the member countries more attractive to US, Japanese and other third country firms. The creation of the single market in the EU in 1992 had a significant impact on Japanese, Korean and Taiwanese company decisions to establish operations in the union (Motta and

Norman, 1996)[8]. Total inflows of FDI into the member countries expanded from ECU10 billion in 1984 to ECU63 billion in 1989. During this period, inflows into the US also increased but at a significantly lower rate (WTO Secretariat, 1995). The European Commission (1998) finds that the EU's share of worldwide inward FDI flows increased from 28 to 33% over 1982-93.

Figure 3.1. Mexico: Foreign Direct Investment, Net Inflows (Current US$, Million)



For North-South RIAs, the data show that FDI to Mexico rose sharply following the announcement of NAFTA in 1990 (Figure 3.1): from $4.3 billion in 1993 to $11 billion in 1994, the year NAFTA came into force. Likewise, for RIAs between middle income countries such as Mercosur: following the signature of the Asuncion Treaty, FDI into Mercosur member countries increased, from $3.5 billion in 1991 to $18 billion in 1996 and $38 billion in 1998. With nearly $11 billion, Brazil surpassed Mexico as the largest FDI recipient in Latin America in 1996 (compared with $1.1 billion in 1991) (Table 4.1*)*. A qualification to these figures is that one can not know for sure that it was the RIA *per se* rather than better policy in general that boosted FDI. Particularly in the case of Mercosur, the two were more or less contemporary. And the welfare implications are ambiguous because some of the boost in FDI, as in the automobile sector, was caused by trade and industrial policy distortions such as very high tariffs.

Although we have some evidence of the impact on investment of North-North and North-South RIAs and for South-South RIAs among large middle-income countries, no such evidence is available for South-South RIAs among small low-income countries. Note also that all of these examples entailed anticipation of the RIA followed by something of a decline. This strongly suggests that RIAs change the firms' views of the optimal stock of investment in the RIA; thus we observe a big step up of during the adjustment period, but only a small permanent increase in the flow commensurate with

[8] Although Motta and Norman also argue that this may have been due to the stricter application of anti-dumping legislation in the EU from about 1985.

maintaining the higher stock. There is no evidence to date that steady-state flows of FDI increase.

One area not examined here is the potential of FDI to generate technological knowledge spillovers. This examined in Chapter 5.

Table 4.1 Mercosur: Net Inflows of Foreign Direct Investment
(Current $ Million)

	1991	1992	1993	1994	1995	1996	1997	1998
Argentina	2,439	4,384	2,763	3,432	5,279	6,513	8,094	6,150
Brazil	1,103	2,061	1,292	3,072	4,859	11,200	19,652	31,913
Paraguay	84	137	111	180	184	246	270	256
Uruguay	0	1	102	155	157	137	126	164

Source: WDI.

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