CHAPTER TWO

THE NEW REGIONALISM AND FOREIGN DIRECT INVESTMENT IN THE AMERICAS

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Regional integration is an excellent example of the pendulum theory. Regional trade agreements (RTAs), which were popular in the 1950s and 1960s, fell out of favor in the 1970s and 1980s, only to see a resurgence in the late 1980s. The 1990s were unparalleled in terms of interest in regional integration. Between 1995 and 2002, 125 new agreements were notified to the World Trade Organization (WTO), bringing the total to 250 RTAs (WTO 2002). The explosion of RTAs has been most notable in the Americas. The new agreements are so different that policymakers now distinguish between the "old regionalism" and "new regionalism" (Devlin and Estevadeordal 2001; IDB 2002; Iglesias 2002).

Table 2.1 lists the RTAs that have been signed or are under negotiation in the Americas, as of May 2003, showing the rapid expansion in the number of agreements and their geographic breadth. There are now an amazing 45 regional trade agreements in the hemisphere (28 signed and 17 under negotiation). Most RTAs are free trade agreements (FTAs), which eliminate internal tariffs but allow countries to maintain their own external tariffs against nonmember countries, such as the 1989 Canada–U.S. Free Trade Agreement (CUSFTA) and the North American Free Trade Agreement (NAFTA). A few RTAs are customs unions (e.g., Mercosur and the Andean Pact), where a common external tariff replaces national tariffs on nonmember countries.

An important issue surrounding RTAs is their impacts on the level and direction of foreign direct investment (FDI). Politicians, policymakers, academic researchers, and the public can and do have different opinions about the economic impacts. Economists traditionally have been optimistic in their appraisals of regional integration (Rugman

Table 2.1. Regional Trade Agreements (RTAs) in the Americas: How Many? How Broad?

Part I: Signed Regional Trade Agreements

North–North or South–South RTAs	Year	North–South RTAs	Year
Central American Common Market (CACM): El Salvador, Guatemala, Honduras, Nicaragua, Costa Rica	1960[a]	NAFTA: Canada, United States, Mexico	1992
Andean Community (AC): Bolivia, Colombia, Ecuador, Peru, Venezuela	1969[a]	Chile–Canada	1996
Caribbean Community (CARICOM): Antigua and Barbuda, Barbados, Jamaica, St. Kitts and Nevis, Trinidad and Tobago, Belize, Dominica, Grenada, Monserrat, St. Lucia, St. Vincent and the Grenadines, Bahamas	1973[a]	Mexico–European Union	1999
Canada–United States (CUSFTA)	1988	Mexico–European Free Trade Area (EFTA)	2000
Southern Cone Common Market (Mercosur): Argentina, Brazil, Paraguay, Uruguay	1991	Mexico–Israel	2000
Chile–Venezuela	1993	Costa Rica–Canada	2001[b]
Colombia–Chile	1994	Chile–European Union	2002
Costa Rica–Mexico	1994	Chile–United States	2002[b]
Group of Three (G-3): Mexico, Colombia, Venezuela	1994		
Bolivia–Mexico	1994		
Chile–Mercosur	1996		
livia–Mercosur	1996		
Mexico–Nicaragua	1997		

Table 2.1. ***(continued)***

Dominican Republic–CACM	1998[b]
Chile–Peru	1998
Chile–CACM	1999
Chile–Mexico	1999
Mexico–Northern Triangle (Guatemala, Honduras, El Salvador)	2000
CARICOM–Dominican Republic	2000
Costa Rica–Trinidad and Tobago	2002[b]
El Salvador–Panama	2002[b]

Part II: Regional Trade Agreements under Negotiation

North–South RTAs	**North–South RTAs**
South–South RTAs	North–South RTAs
Mercosur–Andean Community	CACM–United States
Costa Rica–Panama	CARICOM–European Union
Mexico–Panama	Central America-4–Canada
Mexico–Peru	Chile–EFTA
Mexico–Ecuador	Chile–South Korea
Mexico–Trinidad and Tobago	Free Trade Area of the Americas (FTAA)
Brazil–China	Mercosur–European Union
Brazil–Russia	Mexico–Japan
	Uruguay–United States

Source: Updated version of IDB (2002, 26).**<<AU: DO YOU HAVE PERMISSION TO USE THIS?>>**

[a] Relaunched in the 1990s.
[b] Awaiting ratification.

1990; Globerman and Shapiro 2001; Weintraub 1993). Conversely, Canadian nationalists voiced strong warnings about the likelihood of multinational corporations (MNCs) shutting down plants and reopening them in the United States in response to CUSFTA. In the United States, politicians like Ross Perot warned of "NAFTA's giant sucking sound" that would pull U.S. investment capital and jobs to the ostensibly more profitable climes of Mexico.

The polls show similar concerns. In 1990, 57 percent of Canadians said they supported CUSFTA; in 2000, the same percentage said that they had "little or no confidence in NAFTA" (Nevitte, Anderson, and Brym 2002, 187). Warf and Kull (2002, 213), in their review of U.S. polls on free trade, found only "modest support" for NAFTA among the American public. A 2001 poll in Mexico found that, while 56 percent believed entering NAFTA was the right decision for Mexico, only 44 percent thought that the results had been good for Mexicans (Moreno 2002).

In this chapter, we examine the economic relationships between the new regionalism and FDI in the Americas, focusing on NAFTA. How have RTAs, particularly NAFTA, affected the location patterns of FDI throughout the hemisphere? Has creating two major trade agreements in the 1990s, NAFTA and Mercosur, encouraged capital inflows into member countries at the expense of nonmembers? Have the reactions of "insider MNCs" headquartered within an RTA been different from those of "outsider MNCs"? We outline the key differences between the old and new regionalisms, review the economic literature on FDI and the locational responses of multinationals to RTAs, and examine recent empirical research findings about the Americas. We end with some policy choices for deepening the relationship between FDI and regional integration in the Americas.

THE NEW REGIONALISM

In Latin America, NAFTA and Mercosur—the two subregional trade groups—dominate the field of RTAs, but they are different types of agreements. NAFTA is an FTA using rules of origin to control duty-free access to national markets. Mercosur, conversely, is a customs union with a common external tariff. Each RTA has a regional hegemon (or economic hub) at its center. Both hegemons—Brazil and the United States—are the current cochairs of the Free Trade Area of the Americas

(FTAA) negotiations, which are designed to create a hemispheric-wide RTA starting in 2005.

In North America, the old regionalism was mostly about one event: sectoral free trade for U.S. and Canadian producers under the 1965 Auto Pact, which removed cross-border trade barriers in automobiles and auto parts. The new regionalism starts with the 1989 CUSFTA, which extended the integration process to goods, business services, and investments in almost all sectors of both economies. In 1990, Mexico approached the United States about a bilateral free trade accord, which subsequently became NAFTA in 1994. Whereas the CUSFTA was a North–North agreement, adding Mexico created the first North–South RTA in the hemisphere. Canada–United States merchandise trade has been practically tariff free since January 1, 1998. The final round of tariff cuts for United States–Mexico and Canada–Mexico trade were applied on January 1, 2003, with some exceptions for agricultural products until 2008 (Canada 2003, 33, 48).

In Latin America, the old regionalism was import-substitution industrialization (ISI) "writ large." Latin American economists and policymakers, in the 1960s and 1970s, believed the growth prospects of natural resources were limited by the secular decline in the terms of trade for primary products and resource-exploiting FDI. Economic development was expected from an ISI strategy, which required protecting infant industries from import competition, strong state-owned enterprises, and controls on inward FDI. Regional integration was a complement to ISI strategies, enabling Latin American countries to lessen trade and FDI barriers among themselves while keeping (or raising) them against outsiders. Thus, the old regionalism was a substitute for taking part in the multilateral trading system (Ethier 2001).

Because of the protectionist, inward-looking motivations behind the old regionalism, the results of early RTAs in Latin America—such as the Central American Common Market, the Latin American Free Trade Area, the Andean Group, and the Caribbean Community—were limited. The underlying policies of protectionism, state intervention, and bureaucratic authoritarianism meant that governments only halfheartedly engaged in region building. Tariffs were lowered only where domestic firms were weak or nonexistent, while nontariff barriers such as licenses and quotas exploded.

The new regionalism in Latin America (Ethier 2001; Iglesias 2002) has several characteristics that distinguish it from the first wave of

RTAs.[1] First, the new regionalism arose out of crisis and was accompanied (and often preceded) by unilateral domestic policy reforms. Vernon (1994) has argued that all meaningful trade liberalization has been born from crisis. In the early 1980s, the debt crisis in Latin America caused the region's economic collapse. The subsequent entry of the International Monetary Fund and the World Bank precipitated structural adjustment policies designed to open Latin America to the world economy. Major economic reforms—liberalization, deregulation, and privatization—and democratic reforms swept through the region. Elsewhere, the rapid growth of the East Asian tigers demonstrated a successful alternative to ISI, while the collapse of the Soviet Union at the end of the 1980s meant the competition for inward FDI would become much more aggressive. This combination of world events precipitated the second wave of regional integration programs in Latin America.

Another notable difference between the old and new regionalisms is the shift from North–North and South–South agreements to North–South agreements. Historically, North–South agreements were in the form of preferential access for southern products in northern markets, often on an ex-colonial basis (e.g., the Lomé Convention between the European Community and the African, Caribbean, and Pacific countries) or organized under the General Agreement on Tariffs and Trade (GATT; e.g., the Generalized System of Preferences). NAFTA, bringing Mexico into an expanded Canada–United States FTA, was the first of the new North–South RTAs in the Americas.

NAFTA also signaled a third change: The new regionalism typically has one or more small countries linking with a large-country neighbor (Ethier 2001). Eden and Molot (1992) argued economic linkages within North America were best pictured as two dyads, a northern United States–Canada dyad and a southern United States–Mexico dyad, because Canada–Mexico trade and FDI linkages were (and remain) so small. In Mercosur, Uruguay and Paraguay are in a similar situation vis-à-vis Argentina and Brazil.

A fourth notable change is the shift from *shallow integration* (elimination of tariff barriers among the RTA partners) to *deep integration* (the added reduction in, or harmonization of, nontariff barriers to trade and investment within the RTA). Led by the example of the European Community's EC1992 program, which focused on internal barriers, many RTAs now liberalize trade in goods, services, investments, and technology. The motivation for deep integration is the belief that

liberalizing trade and investment policies is seen as the best way to encourage productive investment and long-run national competitiveness (Eden 1996a).

Table 2.2 provides some evidence on "how deep" are the current RTAs in the Americas by outlining the key components of each agreement. On the basis of a simple count of the possible commitments that could be made in the agreements, NAFTA and the just released U.S.–Chile FTA[2] are the deepest agreements (with 15 commitments), followed by the Group of Three (Colombia, Mexico, and Venezuela) and the Mexico–Nicaragua FTAs (13). Although economists traditionally think of customs unions as being deeper than FTAs, in fact, Mercosur is shallower than NAFTA in its provisions. The notable differences are in sanitary and phyto-sanitary measures, government procurement, and labor and environmental commitments.[3]

The new regionalism is not the only widespread policy change liberalizing trade and FDI flows. Since the late 1980s, there has been enormous growth in bilateral arrangements linking countries: bilateral investment treaties (BITs), bilateral tax treaties (BTTs), and transnational arbitration treaties (TATs). Besides signaling an "open door" policy for FDI, these two-way FDI accords are helping to create an international investment regime that extends the GATT norm of national treatment (i.e., foreign activities performed within a country's borders receive the same treatment as activities of nationals) to foreign investment, services, and intellectual property (Eden 1996a). Thus, RTAs are occurring along with multilateral commitments, helping to solidify (and acting as a backstop to) domestic policy reforms in Latin America. The key impact of these BITs, BTTs, TATs, and RTAs is not just an explosion of acronyms but also an explosion of multiple overlapping trade and investment agreements of differing degrees of breadth and depth throughout the Western Hemisphere.

RTAS AND FDI: THEORY

The literature on the effects of RTAs on FDI is considerably smaller than that on the trade effects. Research by international economists has mostly been in the form of country-level (macroeconomic) analyses, which look at the economic impacts of RTAS on trade flows and national welfare, and in which FDI is a secondary consideration. Some studies have been done at the industry (meso) level of analysis, particularly for sensitive sectors such as automobiles and agriculture. International

Table 2.2. Provisions in Selected Regional Trade Agreements in the Americas: How Deep?

Provisions	Mercosur, 1991 and 1995	NAFTA, 1994	G-3, 1994	Bolivia-Mercosur, 1996
Agriculture separate chapter	X	X	X	0
Antidumping / countervailing duties	0	X	0	X
Competition policy	0	0	0	0
General dispute settlement	X	X	X	X
Government procurement	0	X	X	0
Intellectual property	X	X	X	0
Investment	X	X	X	0
Investor-state dispute settlement	X	X	X	0
Labor/environment	0	SA	0	0
Rules of origin (HS or ALADI)	X	X	X	X
Sanitary and phyto-sanitary measures	0	X	X	X
Services	X	X	X	BE
Special and differential treatment	0	0	0	X
Special rules for auto sector	X	X	X	0
Tariff elimination	X	X	X	X
Technical barriers to trade	X	X	X	0
Temporary entry of business persons	0	X	X	0
Sum of commitments[b]	10	15	13	6

Source: IDB (2002, 65), updated to include provisions in Mercosur using OAS (1996; www.sice.oas.org/) and the United States–Chile FTA (www.mac.doc.gov/chileFTA/FTAtext.html).

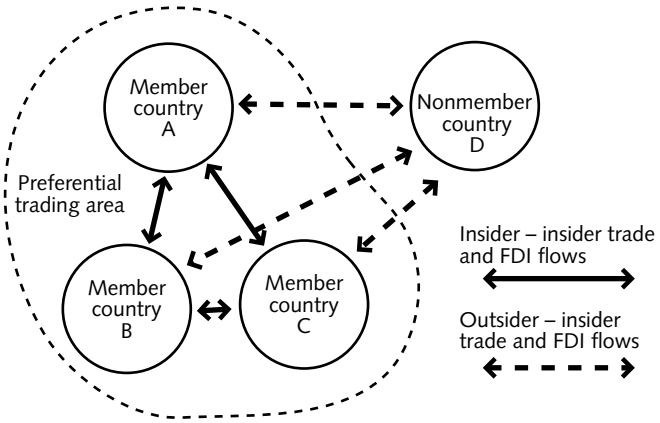
Note: CARICOM = Caribbean Community; SA = side agreement; BE = best endeavor to define in the future: the parties shall explicitly seek to develop disciplines in these areas in the future; HS = harmonization system; ALADI = Latin American Integration Association (Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela).

a The parties agreed to a reciprocal exemption from the application of anti-dumping.
b Does not include "best endeavors to define in the future".

Table 2.2. ***(continued)***

Chile-Mercosur, 1996	Canada-Chile, 1996	Mexico-Nicaragua, 1997	Chile-Central America, 1999	Mexico-North Triangle, 2000	CARICOM-Dominican Republic, 2000	Chile-United States, 2003
0	0	X	0	X	X	X
X	X[a]	X	X	X	X	X
0	X	0	X	0	0	0
X	X	X	X	X	X	X
0	0	X	X	0	BE	X
X	0	X	0	X	X	X
X	X	X	X	X	X	X
0	X	X	0	X	0	X
0	SA	0	0	0	0	X
X	X	X	X	X	X	X
X	0	X	X	X	X	X
X	X	X	X	X	X	X
X	0	0	0	0	X	0
X	X	0	0	0	0	X
X	X	X	X	X	X	X
0	0	X	X	X	X	X
0	X	X	X	X	X	X
10	10	13	11	12	12	15

Figure 2.1. Impact of Regional Trade Agreement Formation onForeign Direct Investment (FDI)—The Country-Level Perspective



business scholars, conversely, have focused specifically on firm-level (microeconomic) effects of regional integration on the production and FDI strategies of domestic and foreign firms.

Country-Level Analysis

International trade economists have long studied the welfare impacts of RTAs, generally focusing on the customs union case, where the member countries reduce internal tariffs to zero and erect a common external tariff (Baldwin and Wyplosz 2003; Bhagwati, Greenaway, and Panagariya 1998; Bhagwati and Panagariya 1996; Lipsey 1960). The general model assumes that two or three countries (members or insiders) form an RTA, leaving out the remaining countries (nonmembers or outsiders), as in figure 2.1.

The economic effects of RTAs can be separated into short-term and long-term effects (Eden 2002). First are the short-run welfare gains that come from improved specialization of resources and greater opportunities for exchange within the region. These are known as the *static gains from trade*, and they are broken into trade creation and trade diversion effects. *Trade creation* occurs when reducing trade barriers within the RTA shifts trade patterns in favor of the lowest-cost producers, improving economic efficiency within the region. Trade creation requires that

the RTA include lower-cost producers; then, the fall in internal trade barriers benefits the lower-cost members at the expense of higher cost members. *Trade diversion*, conversely, occurs when the RTA causes a shift to higher-cost internal producers from lower-cost external producers because the products of the external producers have become uncompetitive in the internal market.

At the same time, there are also short-term *transitional costs or losses* that fall on inefficient sectors and immobile factors as firms rationalize and reallocate their activities throughout the region as they respond to regional integration. These income-redistributional effects are the "Janus face" of the static gains from trade.

Because trade creation and trade diversion effects will vary by product and industry, the net impact of forming an RTA on the welfare of member and nonmember countries depends on many factors. To the extent that the member countries share similar endowments and demand conditions, economists believe that an RTA causes intraindustry trade (trade in differentiated products, e.g., small and medium-sized cars) to expand much faster than interindustry trade (trade in dissimilar products, e.g., corn and wheat) within the region. The general presumption is the more trade expands between two countries after forming an RTA and the less the negative impact on trade with nonmember countries, the more likely that trade creation effects have dominated trade diversion effects. However, Bhagwati, Greenaway, and Panagariya (1998, 1130) argue that "trade diversion is not necessarily a negligible phenomenon in current PTAs." Several empirical studies have found significant estimates of trade diversion. In addition, PTAs can lead to endogenous trade diversion as member countries raise trade barriers against nonmembers.[4]

RTAs also have long-run effects. They create welfare gains, the so-called *dynamic gains from trade*, that come from exploiting region-based economies of scale and scope, attracting FDI inflows and technology transfers, and greater competition among firms in national markets. In the long run, *greater economic interdependence* within the region is also likely to occur in response to rising interregional linkages created by trade and investment flows. Greater interdependence means more sensitivity and vulnerability to instabilities within the region (e.g., exchange rate shocks like the 1994–95 Mexican peso crisis), but it also creates added potential gains from the multiplier effects of economic linkages with other member countries.

It is this second set of effects, the dynamic impacts, that directly link RTAs to FDI. *Investment creation* occurs when the fall in trade barriers within the RTA causes a shift from lower-profitability investments to higher-profitability investments within the region.[5] In addition, investment creation occurs when the now-larger regional market attracts more FDI from outside the region as firms that had previously exported to individual countries within the region shift from exports to FDI.

Investment diversion occurs when the RTA causes a shift away from higher-profitability external investments to lower-profitability internal investments because the investments outside the region have become uncompetitive in the internal market. In other words, if investments are diverted into the region that would have been made or were previously made in a nonmember country, because of creating the RTA, this is investment diversion; a recent example is the movement of cut-and-sew garment firms from the Caribbean to Mexico after NAFTA was formed because Mexico would have preferential access to the U.S. market.

Transport costs and economies of scale at the plant level become more important as tariff barriers disappear on intraregional trade. To the extent that investments by firms in one member country were originally made in another member country for tariff-jumping reasons, their reason for existence disappears once an RTA is formed; as result, disinvestments can occur. Unless other locational attractions are more important than avoiding tariffs, the combination of initially high internal trade barriers that fall to zero coupled with large plant-level economies of scale could result in lower FDI flows, and higher trade flows, within the region (Eaton, Curtis, and Safarian 1994b). Agglomeration economies can also lead to clustering in some locations and disagglomerations in others (Dunning 2002; Eaton, Curtis, and Safarian 1994a).

Sometimes (see table 2.1 for examples), the RTA contains an investment chapter with specific rules designed to encourage FDI flows into and within the region. These investment chapters typically offer national treatment, most-favored-nation, transparency, dispute-resolution procedures, and so on (Eden and Molot 1996; Rugman and Gestrin 1993a; UNCTAD 1998). Regional agreements with investment chapters should, ceteris paribus, have stronger FDI impacts than agreements without such chapters because they offer more protection and reduce policy risks for foreign investments and investors. Because

developing countries typically have weaker FDI protections than countries that belong to the Organization for Economic Cooperation and Development (OECD), one might therefore expect South–South and South–North RTAs to generate larger FDI flows to the less developed member countries if the RTAs have investment chapters (assuming that multinational enterprises, or MNEs, see the commitments as binding and enforceable).

Economists believe static effects are short run, small, and swamped by the dynamic effects. The overall size of these four effects depends on several factors, the most important of which are the scope of the RTA in number of member countries, industries, and products covered; the degree of liberalization of tariff and nontariff barriers among the members; and the current and potential economic complementarity of member relative to nonmember countries. The relative impact on the member countries is primarily driven by size; small countries are expected to suffer most of the adjustment costs but reap most of the gains as they adjust to prices set by the larger members. Overall, whether RTAs lead to increased or decreased FDI flows probably depends on the same factors that influence general economic impacts (that is, the scope of the RTA, the degree of liberalization, and the complementarity of member relative to nonmember countries), with one additional factor: whether trade and FDI are substitutes or complements.

Industry-Level and Firm-Level Analyses

International business scholars look at the formation of an RTA as a policy shock that affects decisionmaking by multinational and domestic firms, both inside and outside the RTA (Buckley 2002; Eden 1994, 2002; Narula 2003; Rugman 1990, 1994; Rugman and Gestrin 1993b; Vernon 1994; Levy Yeyati, Stein, and Daude 2002a). The details of the agreement, the breadth and depth of preexisting trade and FDI linkages between member countries, and country-level and region-level locational advantages are key environmental and policy reasons that determine the attractiveness of the RTA to MNCs.

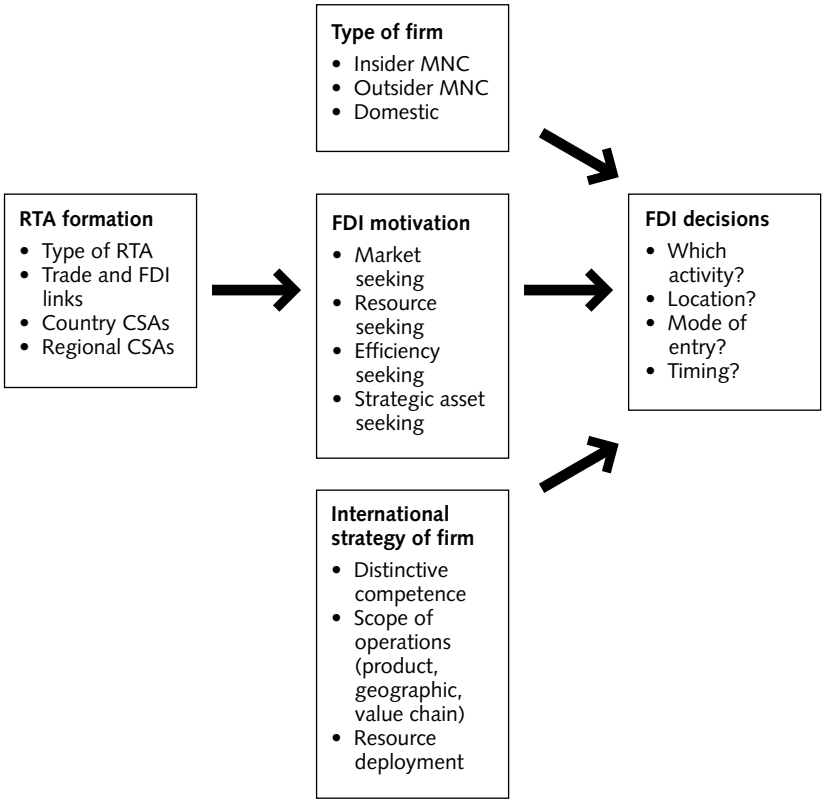
How a firm is likely to respond to the RTA depends on its motivation for investment, its particular value-adding activities, and whether the firm is an insider MNC, outsider MNC, or domestic. Firms are assumed to have four main motivations for FDI: market seeking, resource seeking, efficiency seeking, and strategic asset seeking (Dunning 1993). Each firm must decide which activity to move, how the activity is linked with

the rest of the MNC's activities, where to put the activity, and how to structure its ownership (mode of entry). Three possible types of intrafirm trade can occur with the establishment of FDI: horizontal integration in homogeneous products, horizontal integration in differentiated products, or vertical integration. The location question can be analyzed from the perspective of either macroregions (the national level) or microregions (agglomeration or clustering within regions); see Dunning (2002) and Eden (2002). Figure 2.2 outlines the theoretical framework used by most international business scholars to explore the impacts of RTAs on FDI.

International trade economists have begun to contribute to this literature, building on Dunning's eclectic paradigm of ownership, internalization, and location advantages as explanations for FDI (Dunning 1993). Their models assume product differentiation, economies of scale, and one factor that behaves as a public input (typically, technology). The MNE is assumed to consist of a headquarters and one or more production plants. Vertical specialization involves positioning specific activities in the MNC's value chain in geographically separated affiliates (Helpman 1984; Helpman and Krugman 1985). *Vertical FDI* is assumed to be resource or efficiency seeking, whereby MNEs separate their production processes so as to take advantage of factor price differentials across countries. Horizontal specialization typically involves rationalizing production across affiliates so individual affiliates have the responsibility for producing and exporting specific products. *Horizontal FDI* is assumed to be motivated by market seeking, possibly to exploit the firm's knowledge-based assets (Markusen 1994; Markusen and Venables 1998). The key difference between horizontal and vertical FDI is that, under vertical FDI, production in each affiliate is not only for the local/domestic market but also driven by the need to integrate the MNE's value chain across countries. The implementation of RTAs removes trade barriers, thus dramatically reducing the transaction costs of vertical and horizontal FDI within the region, while enlarging the overall size of the market.

The type of firm is also an important factor in predicting the impact of regional integration on FDI. Three categories of firms can be identified that are likely to have different responses to regional integration (Eden and Molot 1993; Vernon 1994). *Insiders* refer to the well-established multinationals located inside a free trade area with significant investments in the partner countries before the agreement. *Outsiders*

Figure 2.2. The Impact of Regional Trade Agreement (RTA) Formation on Foreign Direct Investment (FDI—The Firm-Level Perspective



Note: CSA - **<<Author: What does CSA stand for?>>**;
MNA - Multinational corporation.

are foreign firms outside the area, which may have been exporting into the area or may have investments inside the area. *Domestics* refer to the local firms inside the area that are mostly focused on their national market (or a subunit within that market) without significant investments in the other partner countries; they may or may not already be exporting to these countries.

Insiders should see benefits from lower intraregional barriers and then respond by rationalizing product lines (horizontal integration) and/or production processes (vertical integration) to better exploit

economies of scale and scope across the region. There is both a short-run response as MNCs engage in locational reshufflings in response to the falling trade barriers, and a long-run response where insiders locate, close, and/or expand their plants with the whole regional market in mind. Buckley and Casson (1998) break the insiders' FDI strategies into two categories: *reorganization investment* by insider firms that reorganize production within the integrated area based on regional comparative advantage; and *rationalization investment* by insiders to take advantage of the newly created returns-to-scale possibilities in the integrated area.

Outsiders are likely to also expand and rationalize their investments to take advantage of the larger market size. If rules of origin are tightened to meet North American content, transplants may be forced to upgrade production and source more inputs locally. Thus, parts plants may be induced to follow distributors and assembly plants. Outsiders that are exporting to North America may shift to FDI. They are likely to be drawn to the larger market or hub, the U.S. market, unless cost differentials make location in the smaller countries (Canada and Mexico) more attractive and/or interregional barriers are completely eliminated. Buckley and Casson (1998) call the investment reaction by outsider MNEs *defensive import-substituting investment* based on the new balance of locational advantages between the rest of the world and the region. They also discuss a fourth investment strategy called *offensive import substitution*, which is undertaken by both insiders and outsiders to take advantage of the growing intraregional market.

For domestics, firms without established links to other potential NAFTA members, a free trade area will be seen as both an opportunity (i.e., new markets, access to lower cost inputs) and a threat (i.e., more competition). Such firms, with encouragement, may start or increase their exports within North America and possibly open up distributors or offshore plants where market size or costs warrant. They will, however, have to face the difficult task of breaking into established distribution networks of domestics and MNCs in the North American markets. The key question is whether to "go regional" and branch outside the home country into other parts of North America or to stay at home and most likely be acquired by a NAFTA multinational.

In summary, the key effects of RTAs on FDI are expected to depend on the (1) the type of firm (insider MNC, outsider MNC, trader, or domestic), (2) the firm's motivation for entry, and (3) the components

of the firm's international strategy (its distinctive competence, scope of operations, and current resource deployment). The typical decisions to be made are the "who, what, where, when, why, and how" questions; that is, which activity(ies) should be moved and where, the mode of entry choice, and timing issues. "Locational shufflings" are expected as MNCs allocate production and sales on a regional basis, taking advantage of the larger, barrier-free market to achieve economies of scale and scope (efficiency-seeking FDI).

Caveats and Problems

Before we turn to the empirical work on RTAs and FDI in the Americas, it is important to spell out several caveats that should be applied to the results of these empirical studies. These include timing issues, confounding events, the spaghetti bowl effect, and data sources and problems.

Timing Issues. First, when analyzing the economic effects of RTAs, it is important to distinguish between de jure and de facto liberalization. RTA negotiations often take several years. Some firms will react to the RTA in advance of the starting date, seeking first-mover advantages to preempt the competition. Conversely, when a new RTA is announced, gains are expected quickly. However, reductions in trade barriers tend to be phased in during a transition period to give local firms time to adjust (e.g., NAFTA was phased in mostly over 10 years), many nontariff barriers are grandfathered, and some sectors (usually the most controversial, like agriculture) are excluded. In addition, RTAs sometimes resort to positive lists of products to be liberalized rather than negative lists of exceptions; negative lists are more trade promoting because they eliminate tariffs on unlisted products. Thus, the effects can be complicated.

Confounding Events. Second, confounding factors make it difficult to separate out the impacts of regional integration from other macroeconomic and policy changes. For example, the 1994 peso shock and Mexico's 1993 liberalizing FDI law are difficult to disentangle from the adoption of NAFTA. However, most scholars agree NAFTA did encourage FDI in Mexico (Globerman 2002; Krueger 2000; Levy Yeyati, Stein, and Daude 2002a). More recently, exchange rate depreciations in Brazil in 1999 and Argentina in 2002 have strained economic relationships within Mercosur. Currency devaluations lower export prices and raise import prices, causing large trade adjustments that can induce FDI reshufflings within the region. Devaluations can also provoke

more direct forms of protectionism; for example, Mexico reacted to its peso devaluation by raising tariffs against non-NAFTA countries, whereas Argentina responded to its own peso crisis by raising tariffs against Brazil. Because exchange rate swings can often be several magnitudes larger than tariff reductions, the increased trade and investment interdependencies encouraged by RTAs leave the member countries more exposed to each other's poor monetary and fiscal policies.

The Spaghetti Bowl Effect. Third, empirical work on regional integration typically focuses on one RTA at a time. However, one of the features of the new regionalism is the proliferation of bilateral accords. This considerably complicates the economic analysis of RTAs. For example, when the U.S. Congress failed to extend fast-track authority to President Bill Clinton in 1995, leaving Chile out in the cold, the U.S. withdrawal left the regional integration field wide open to other countries. Chile and other small Latin American countries responded by signing multiple RTAs. Mexico, for example, has signed bilateral RTAs with Chile, Bolivia, Costa Rica, the European Union, Nicaragua, and Israel, among others. Chile has bilateral RTAs with Canada, Mexico, the United States, Colombia, Ecuador, and associate member status within Mercosur.

Although most of these agreements have been within the region, others have not (e.g., with the European Union). This ad hoc proliferation of RTAs has been likened to a "spaghetti bowl" mixture of bilateral, trilateral, and multilateral RTAs. These political hub-and-spoke arrangements create "who is whose" problems that increase protectionism and reduce the overall welfare gains from RTAs (Bhagwati, Greenaway, and Panagariya 1998; IDB 2002; Wonnacott 1996).

In the simplest hub-and-spoke pattern, one country (the hub) has bilateral RTAs with two other countries (the spokes). Trade barriers are eliminated within each RTA but not between RTAs. Comparisons between two hub-and-spoke RTAs and one trilateral RTA demonstrate that potential static and dynamic benefits are higher under the trilateral RTA. Two bilaterals leave trade barriers in place between the spokes, whereas one trilateral eliminates these barriers.

At the same time, administrative and transport costs are higher in a hub-and-spoke system because of its greater complexity, potential for rent-seeking behavior, and inconsistencies. Instead of one tariff rate for imports, tariff schedules vary depending on which RTA applies. Different rules of origin for the same product encourage "forum shopping"

for the lowest rates, raising the cost of administering these agreements. To the extent that rules of origin are seen as transaction costs for firms, they can influence not only trade flows but also investment decisions.

The distribution of (albeit smaller) gains differs also, with the gains being distributed more unevenly in a hub-and-spoke system. The hub gains at the expense of the spokes because the hub benefits from preferences in both spoke markets and only firms in the hub can buy duty-free inputs from each spoke. The spokes, conversely, lose because they do not have duty-free access to the other spokes, face more competition in the hub market from the spokes, and are less competitive relative to hub firms because their input costs are higher.

Data Sources and Problems. The last problem that plagues empirical work on regional integration and FDI in the Americas is data availability and comparability. Most governments report their FDI data to the OECD, the UN Conference on Trade and Development (UNCTAD), and the IMF.[6] Data are reported in both flow and stock formats. UNCTAD's *World Investment Report* and the Economic Commission for Latin America and the Caribbean's *Foreign Investment in Latin America and the Caribbean* are the two annual publications with the most thorough and detailed analyses of FDI in the Western Hemisphere. Both provide extensive access to FDI studies and/or statistics on their Web sites.[7]

In the three NAFTA countries, FDI transactions (balance of payments) or flow data, both inward and outward, are reported as the sum of direct investment income (income on equity plus retained earnings plus income on debt) and direct investment financial flows (equity capital plus other capital). FDI transactions data for Mexico, however, are only available from 1994 on; before 1994, the data reflect only notifications to the Mexican government, not actual FDI. In addition, Mexican FDI flow data are only available for inward FDI because there is minimal outward FDI.

International investment position (FDI stock) data are reported as the sum of equity capital, reinvested earnings, and other capital in Canada and the United States. In Mexico, FDI position data are not reported, either for inward or outward FDI stock. For Canada, FDI position data are measured at book value, whereas in the United States, FDI position data are reported at market value (in aggregate) and at book value (historical cost) for detailed data by country and by industry. Differences between book and market value are caused by the following

factors:[8] valuation adjustments between historical cost and market value, exchange rate fluctuations, corporate reorganizations, migration of principal owners, and shifts between FDI and foreign portfolio investment where nonresidents increase their ownership to 10 percent or more of voting interest (or decrease it to less than 10 percent).

If a researcher wants to study the impact of NAFTA on FDI, he or she can use either flow or stock data, and either in aggregate (to or from all other countries) or bilateral (between pairs of countries) form. The theoretical macro and micro models we have outlined above suggest that the impact of RTAs on FDI is best studied by examining both total and bilateral FDI patterns, particularly member–member FDI and member–nonmember FDI patterns. To examine the impact of NAFTA on FDI, for example, one would need to aggregate FDI data for the three member countries, either on a stock or flow basis. There are clear problems with both approaches.

Suppose one attempts to amalgamate FDI flow data for the three countries. Bilateral FDI data by country are available in both stocks and flows for the United States (inward only), flows for Mexico, and stocks and (very limited) flows for Canada. Therefore, while Mexico and the United States publish country-level FDI flow data, Canada publishes detailed country-level data only for stocks, not for flows (Statistics Canada does this for confidentiality reasons, although why it is not a problem in Mexico and the United States but is a problem in Canada is not clear). At the flow level for Canada, only FDI flow data with the United States, the United Kingdom, and Japan are available.

Alternatively, one could amalgamate FDI stock data for the three countries. Whereas the U.S. and Canadian bilateral stock data are quite detailed, Mexican stock data before 1994 are based on notifications to the Mexican government, not on actual investments. In addition, the pre-1994 stock data for Mexico are recorded at market value, the U.S. data are at historical cost, and the Canadian data are at book value. After 1994, no stock data for Mexico are available, period. Thus, the Mexican FDI series breaks at 1994, and the pre-1994 data are not consistent with the U.S. and Canadian data.[9]

As a result, the researcher who wants to analyze the impacts of RTAs on FDI patterns are "betwixed the devil and the deep blue sea," with either approach. Most FDI researchers, but not all, are sensitive to these problems. However, one still regularly sees empirical work that ignores the data problems associated with analyzing FDI patterns in the Amer-

icas. With these caveats and problems in mind, we now turn to exploring empirical work on RTAs and FDI in the Americas.

RTAS AND FDI: EMPIRICAL WORK

In this section, we review the recent empirical studies exploring the economic effects of RTAs on FDI in the Americas, focusing primarily on CUSFTA and NAFTA, with some attention to Mercosur. We limit our review to papers published from 1998 on; readers interested in earlier work on this topic are directed to Eden (2002) and Hejazi and Safarian (1999). We start with recent statistics on FDI.

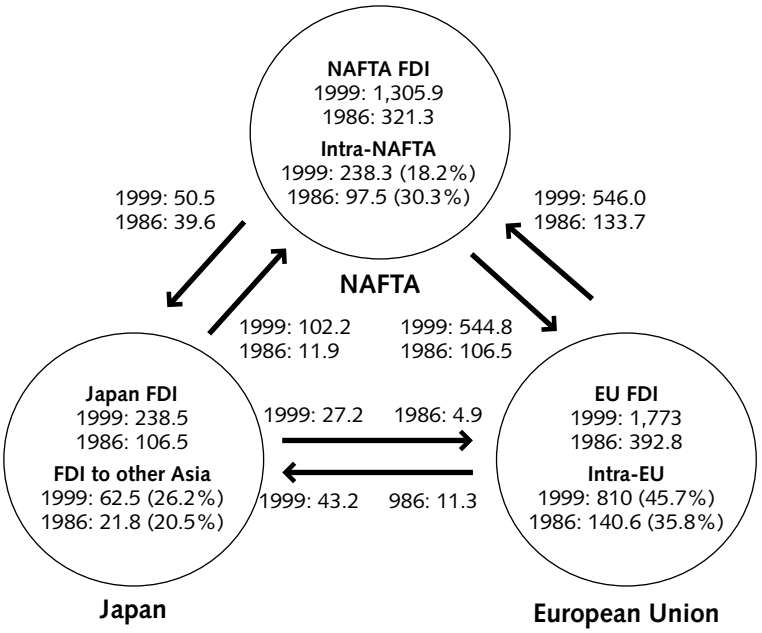
Recent FDI Patterns

Figure 2.3 shows the changing shares of intraregional and interregional outward FDI stocks between 1986 and 1999 in what Rugman and Brain (2003, 19) refer to as the "broad Triad." The enormous growth in FDI stocks in North America, Asia, and the European Union is evident. Intraregional FDI as a share of all North American FDI fell from 30.3 percent in 1986 to 18.2 percent in 1999, while the intraregional FDI share rose in both Asia and the European Union.

Table 2.3 (on pages 44 and 45) provides a long-rum view of intraregional FDI flows, focusing specifically on NAFTA. Gross FDI flows into the three NAFTA member countries declined over the 1988–93 period, from $67.5 billion in 1988 to a low of $32.0 billion in 1992, but almost doubled in 1993 and 1994. Because Mexican FDI statistics switched from reporting FDI notifications to recording actual FDI expenditures, the country's FDI data before and after 1994 are not directly comparable. However, NAFTA's FDI gains appear to come primarily from FDI into the United States, not Canada or Mexico. Since 1994, gross inflows to NAFTA have increased rapidly, peaking at $383.0 billion in 2000, before falling back to $177.2 billion in 2001. The U.S. share of inward FDI into NAFTA rose from 70.5 percent in 1994 to peak at 88.4 percent in 1999, before falling back to 70.2 percent in 2001.

Although FDI inflows rose enormously during the 1990s, that growth came to a sudden halt in 2001. FDI inflows into OECD countries and worldwide dropped precipitously in 2001. When NAFTA FDI is considered as a percentage of gross FDI inflows for all OECD countries, or worldwide, the pattern is similar. NAFTA's share fell from 48.8 percent of all OECD inflows in 1988 to a low of 25.1 percent in 1992,

Figure 2.3. Interregional and Intraregional Outward Stocks of Foreign Direct Investment (FDI), 1986 and 1999 (billions of dollars)



Source: Adapted from Rugman and Brain (2003, 9, 21). **<<Author: Do you have permission to use this figure? If not please request it.>>**

recovering to 41.1 percent in 1993, before falling again to a low of 33.1 percent in 1995. From 1996 on, NAFTA's share rose to 42 percent of all OECD FDI, before jumping to 46.7 percent in 1999. The share gains in the second half of the 1990s clearly reflect trends in U.S. inward FDI because Canada's share of world FDI has been stuck in the 4 percent range since 1995, while Mexico's share fell steadily after NAFTA was introduced to slightly less than 2 percent of OECD FDI flows in 1999. The collapse of world FDI inflows in 2001 affected Canada and the United States the most; only Mexico increased its share, rebounding from 1 to 3.4 percent of worldwide FDI inflows in 2001. More recent numbers (Evans 2002; ECLAC 2003) suggest that all three countries suffered further declines in inward FDI in 2002. These data provide the context for our presentation of empirical studies of FDI and regional integration.

Country-Level Effects

The typical model of the economic impacts of forming an RTA is based on a gravity model equation originally developed to explain bilateral trade patterns.[10] The gravity model explicitly includes income and distance measures:

$$\text{TRADE}_{IJ} = \text{GDP}_I + \text{GDP}_J + \text{DISTANCE}_{IJ} + \text{TRADE}_{IJ} + \text{RTA} + \text{Z}$$

The embedded assumption is that trade between countries *I* and *J* should be positively related to their gross domestic products (GDPs) (and/or their per capita GDPs) and negatively to the distance between them (DISTANCE). FDI is assumed to be either a substitute or complement to trade patterns (TRADE). The impact of the formation of the regional trade agreement is tested by adding a dummy variable (RTA). Z is a vector of control variables that could also potentially explain FDI patterns, such as industry mix, exchange rates, and real interest rates. The gravity model can be seen in many FDI studies, such as Krueger (2000); Levy Yeyati (2001); Levy Yeyati, Stein, and Daude (2002b); Stein and Daude (2001); Mauro (2000); Harrigan (2001); and Frankel and Rose (2000).

It is well documented in the literature that FDI is strongly attracted to countries characterized by relatively large domestic economies and by increasing levels of real per capita income (Globerman and Shapiro 2002). Levy Yeyati, Stein, and Daude (2002a) also indicate that the gains may be smaller for countries that are less developed, closed to international trade, and altogether unattractive for foreign investors. Virtually overall studies of FDI flows stress the dominating importance of the size and income level of the host country (Graham 1999). Implementing regional integration creates a common boundary for member countries (as shown in figure 2.1). The new regional economy competes with nonmember countries, and an increase in FDI into the region is expected once the RTA is launched. MacDermott (2002), for example, applies both the traditional gravity model and the knowledge-capital model to analyze the bilateral OECD FDI data from 1980 to 1997, and finds that implementing NAFTA led to an increase in FDI into member countries. This is particularly evident for Mexico, which is not surprising because NAFTA was mainly about adding Mexico to the preexisting Canada–U.S. FTA.

Table 2.3. Gross Inward Foreign Direct Investment (FDI) Flows, 1988-2001 (millions of dollars)

Host	Pre-CUSFTA	Post-CUSFTA				
	1988	1989	1990	1991	1992	1993
Canada	6,124.9	6,010.2	7,582.5	2,881.2	4,722.4	4,730.8
Mexico	2,800.8	3,881.5	3,373.7	5,704.7	8,093.7	6,715.0
U.S.	58,571.0	69,010.0	48,422.0	22,799.0	19,222.0	50,663.0
NAFTA	67,496.7	78,901.7	59,378.2	31,384.9	32,038.1	62,108.8
OECD	138,327	171,376	178,687	124,931	118,052	151,079
World	n.a.	200,612	203,812	157,773	175,841	219,421
As Percentage of FDI Flows into NAFTA						
Canada	9.1	7.6	12.8	9.2	14.7	7.6
Mexico	4.1	4.9	5.7	18.2	25.3	10.8
U.S.	86.8	87.5	81.5	72.6	60.0	81.6
As Percentage of FDI Flows into OECD						
Canada	4.4	3.5	4.2	2.3	4.0	3.1
Mexico	2.0	2.3	1.9	4.6	6.9	4.4
U.S.	42.3	40.3	27.1	18.2	16.3	33.5
NAFTA	48.8	46.0	33.2	25.1	27.1	41.1
As percentage of World FDI Inflows						
Canada		3.0	3.7	1.8	2.7	2.2
Mexico		1.9	1.7	3.6	4.6	3.1
U.S.		34.4	23.8	14.5	10.9	23.1
NAFTA		39.3	29.1	19.9	18.2	28.3
Percentage Change Year over Year						
Canada		−1.9	26.2	−62.0	63.9	0.2
Mexico		38.6	−13.1	69.1	41.9	−17.0
U.S.		17.8	−29.8	−52.9	−15.7	163.6
NAFTA		16.9	−24.7	−47.1	2.1	93.9
OECD		23.9	4.3	−30.1	−5.5	28.0

Source: Author's calculations using FDI data from appendices in UNCTAD (2001, 2002). Mexican data for 1994–2001 are from Mexican Government FDI Statistics.

Note: CUFTA = U.S.-Canada Free Trade Agreement; NAFTA = North American Free Trade Agreement; OECD = Organization for Economic Cooperation and Development; n.a. = not available.

Table 2.3. ***(continued)***

Post-NAFTA							
1994	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
8,205.7	9,255.8	9,635.0	11,525.2	22,804.1	24,436.5	66,621.3	27,458.7
10,639.8	8,324.8	7,703.6	12,125.8	8,126.9	12,856.0	15,484.4	25,334.4
45,095.0	58,772.0	84,455.0	103,398.0	174,434.0	283,376.0	300,912.0	124,435.0
63,940.5	76,352.6	101,793.6	127,049.0	205,365.0	320,668.5	383,017.7	177,228.1
164,971	230,846	248,882	299,004	509,313	683,744	n.a.	n.a.
255,988	331,844	386,140	478,082	694,457	1,088,263	1,491,934	735,146
12.8	12.1	9.5	9.1	11.1	7.6	17.4	15.5
16.6	10.9	7.6	9.5	4.0	4.0	4.0	14.3
70.5	77.0	83.0	81.4	84.9	88.4	78.6	70.2
5.0	4.0	3.9	3.9	4.5	3.6	n.a.	n.a.
6.4	3.6	3.1	4.1	1.6	1.9	n.a.	n.a.
27.3	25.5	33.9	34.6	34.2	41.4	n.a.	n.a.
38.8	33.1	40.9	42.5	40.3	46.9	n.a.	n.a.
3.2	2.8	2.5	2.4	3.3	2.2	4.5	3.7
4.2	2.5	2.0	2.5	1.2	1.2	1.0	3.4
17.6	17.7	21.9	21.6	25.1	26.0	20.2	16.9
25.0	23.0	26.4	26.6	29.6	29.5	25.7	24.1
73.5	12.8	4.1	19.6	97.9	7.2	172.6	−58.8
n.a.	−21.8	−7.5	57.4	−33.0	58.2	20.4	63.6
−11.0	30.3	43.7	22.4	68.7	62.5	6.2	−58.6
2.9	19.4	33.3	24.8	61.6	56.1	19.4	−153.7
9.2	39.9	7.8	20.1	70.3	34.2	n.a.	n.a.

One difficulty in assessing the role of RTAs on FDI—particularly for a specific country's FDI—is that there are many channels through which RTAs could potentially have impacts on FDI flows (Levy Yeyati, Stein, and Daude 2002a). The impact of RTAs will depend on characteristics of the host countries that make them more or less attractive than their RTA partners as a potential location of foreign investment (IDB 2002). It is therefore critical to take other potential explanations into account by including them as control variables in the gravity model in order to isolate the impact of the RTA on FDI patterns.

For example, *domestic economic reforms* can confound the analysis. Graham and Wada (2000) find that investment into Mexico began to speed up following the onset of policy reform in Mexico in the later 1980s, which was well before NAFTA. They cite two possible causes: bilateral trade agreements between the United States and Mexico during the period 1985–89, and policy reforms implemented unilaterally by Mexico. They infer the first explanation is not consistent with U.S. FDI patterns, but the second explanation does fit the facts. Therefore, Graham and argue that it is probable, even if not provable, that NAFTA kept FDI flows into Mexico from falling after domestic reforms had been fully implemented.

Globerman and Shapiro (2001) provide another example of the importance of domestic policies. They identify two domestic explanations for Canada's declining share of inward FDI in North America: (1) higher taxes in Canada discouraged investment by domestic and foreign investors; and (2) Canada's declining capacity to innovate and support "new economy" activities discouraged FDI inflows. Further, Blomstrom and Kokko (1997) claim both economic reforms and macroeconomic factors affect FDI. Their paper shows that the most positive impacts on FDI when regional integration coincides with domestic liberalization and macroeconomic stabilization.

Another factor that can influence FDI patterns is *factor costs and availability*. Love and Lage-Hidalgo (1999) conclude that U.S. FDI into Mexico is systematically influenced by relative Canadian–Mexican wage rates and demand differentials in both the short and long runs. However, there is no evidence of similar influences at work on U.S. investment into Canada. The U.S. FDI pattern in Mexico and Canada is due to the different industrial composition of U.S. FDI in these two partners. They conclude that Canadian concerns about the extent to which Canada competes with Mexico may be overstated. Also, market

size serves as an important consideration of investment location (e.g., Bertrand and Madariaga 2002).

Finally, *exchange rate changes* can also influence FDI patterns. Buckley and others (forthcoming) find the acceleration of changes in the exchange rate fostered U.S. FDI into Canada. In contrast, Mauro's (2000) empirical study of worldwide FDI patterns shows that exchange rate variability does not appear to have affected firms' decisions to invest abroad, except during the turbulent 1980s when FDI represented a means of reducing exchange rate risk.

Trade–FDI Linkages

The net impact of the trade-creating and trade-diverting effects of RTAs is typically measured by looking at the resulting changes in intraregional compared with interregional trade patterns. Table 2.4 shows estimates by the Asian Development Bank (ADB 2002) of intraregional export shares in five-year periods from 1980 to 2000. The three NAFTA member countries, for example, saw intraregional exports grow from 41.3 to 58.8 percent of their total exports. The bigger the RTA, the larger intraregional shares tend to be.

Trade intensity indices (TIIs) are better measures of relative growth than export growth rates. The TII is the ratio of the RTA's intraregional trade share divided by the RTA's share of all world trade. If the ratio is close to one, the regional agreement is seen as having a neutral impact on world trade; indexes well above (or below) 1 are associated with net trade diversion (creation). Table 2.4 shows that TIIs for NAFTA and the European Union are quite low relative to Mercosur and the Andean Pact, for example. This suggests that NAFTA has been a trade-creating RTA, whereas the impacts of Mercosur have been primarily trade diverting. North American intraregional exports of goods and services now stand at 55.7 percent of North American exports, up from 33.6 percent in 1980 and 49.19 percent in 1996 (Rugman and Brain 2003, 5, 16); similar growth patterns can be seen in the interregional export shares in table 2.4. This accords with Krueger (2000), who finds that for the United States, the impact of NAFTA has been relatively small, and that for Mexico, the results do not give much support to the view that NAFTA might be seriously trade diverting.

Eden and Molot (1992) argue that NAFTA increased the dependence of Canada and Mexico on the U.S. market. In the late 1980s, three-

Table 2.4. Changing Trade Patterns within Regional Trade Agreements, 1980-2000

Regional Trade Agreement	1980–1984	1985–1989	1990–1994	1995–1999	2000
Intraregional export shares					
NAFTA	41.3	46.7	48.2	53.2	58.8
Mercosur	9.9	8.5	15.9	24.8	22.3
Andean Community	5.0	4.8	9.1	13.2	10.8
European Union	62.0	65.1	66.5	65.1	66.9
European Free Trade Area	16.5	16.4	13.7	12.6	11.8
Asia-Pacific Economic Cooperation	66.3	72.2	73.1	74.3	75.2
Asian Free Trade Area (ASEAN)	20.8	18.9	22.5	24.8	24.5
CER (Australia-New Zealand)	8.0	8.4	9.1	10.7	9.3
Trade intensity indexes					
NAFTA	1.8	1.8	2.0	2.2	2.2
Mercosur	5.6	7.5	11.7	13.2	14.3
Andean Community	3.6	5.4	10.9	15.7	16.6
European Union	1.5	1.5	1.6	1.7	1.7
European Free Trade Area	2.3	2.1	2.0	2.1	2.2
Asia Pacific Economic Cooperation)	1.6	1.6	1.6	1.5	1.5
Asian Free Trade Area (ASEAN)	4.2	4.8	3.8	3.7	4.0
CER (Australia-New Zealand)	4.1	4.6	5.8	7.1	6.8

Source: ADB (2002, 185-86).

Note: ASEAN = Association of Southeast Asian Nations. CER = Australia–New Zealand Closer Economic Relations Trade Agreement.

quarters of Canadian and Mexican trade and FDI flows were with the United States. By 2003, the U.S. share of both countries' exports had risen above 85 percent, significantly increasing their economic dependence on the United States (Rugman and Brain 2003). A similar pattern

of increasing dependence holds for Canadian and Mexican imports from the United States.

The same pattern, however, is not true for the United States. In 1980, 17 percent of U.S. exports went to Canada and 7 percent to Mexico; by the end of the 1980s, Canada's share had risen to 20 percent, while Mexico's share of U.S. exports was unchanged. The averages for the period 1996–2001 were remarkably similar to those in 1980: 19 percent for Canada and 9 percent for Mexico (Globerman 2002, 31). The same pattern holds for the share of U.S. imports from Canada: In comparison with the late 1980s, there has been minimal change (from 17 to 18 percent). Conversely, Mexico's share in U.S. imports has increased, albeit from a low base, from 5 to 8 percent of all U.S. imports.

Whether international trade and FDI are substitutes or complements is a critical link in assessing the impacts of regional integration on FDI. The empirical evidence in the literature suggests that trade and FDI are complements, although the evidence is not definitive (Blonningen 1999; McMorriston 2000). For example, Hejazi and Safarian (2001) establish that trade and FDI are complements, using trade and FDI stock data on bilateral basis between the United States and 51 other countries over 1982–94. Specifically, U.S. outward FDI is found to have a larger predicted impact on U.S. exports than does inward FDI. Conversely, U.S. inward FDI predicts U.S. imports better than does outward FDI. An exploration of sector differences indicates that U.S. outward FDI in manufacturing has a large predicted impact on both exports and imports, whereas U.S. outward FDI in services has a large predicted impact on U.S. exports but little or no predicted impact on imports.

In the same vein, Mauro (2000), in his study of worldwide FDI patterns, finds that FDI stocks and exports are complementary at the aggregate level; a 10 percent increase in exports causes an increase in a country's FDI stock of more than 10 percent. Tariffs have no impact on FDI, implying that the "tariff-jumping" argument is not supported by empirical analysis. One possible explanation is that tariff barriers have been falling worldwide, so they can erode as an RTA mechanism. Yet Mauro finds that nontariff barriers did discourage FDI, and that a requirement for FDI to respond positively to the formation of an RTA is that internal barriers fall.

In contrast, Globerman (2002) argues that changes in intraregional trade intensity need not be mirrored by changes in intraregional FDI

intensity because RTAs encourage both intraregional trade and extraregional FDI. This is particularly so in the case of Mexico's outward FDI flows to the United States, which are quite small over the 1980–98 period (Globerman 2002). At the regional level, Feinberg, Keane, and Bognanno (1998) find that U.S. FDI in Canada, as proxied by the employment and assets of U.S. MNC affiliates in Canada, rose as Canadian tariff rates fell over the 1990s.

Specific circumstances surrounding the integration process are also important. For example, in reviewing other empirical studies, Fontagne (1999) notes that FDI into developing countries tends to have a much higher export multiplier associated with it than does FDI into industrial countries. This is because FDI into OECD member countries is more likely to be motivated by the goal of serving high-income consumers. In addition, there is likely to be greater local capability in terms of support, both in infrastructure and services, in industrial countries.

The observed variation in the trade intensity–FDI intensity relationship might also be caused by different levels of aggregation of the studies. For example, Bloningen (1999) examines product-level data and finds substantial evidence for both a substitution and a complementary effect between affiliate production and exports with Japanese auto parts for the U.S. market. He emphasizes the importance of vertical specialization as a critical determinant of the trade–FDI relationship.

Intraregional Differences in FDI Patterns

The introduction of an RTA is expected to increase FDI inflows into the region. To the extent that this occurs, the FDI statistics should show a structural break around the time that the RTA comes into force. Andresen and Pereira (2002) test this hypothesis for 63 countries using the Vogelsang SupWald test. They find clear evidence of structural breaks for Canada and the United States in 1992, and for Mexico in 1993. Both the levels of FDI (Canada, 797 percent; United States, 760 percent; Mexico 866 percent) and the ratios of inward FDI to GDP (Canada, 547 percent; United States, 505 percent; Mexico, 579 percent) rose after the structural break. The authors conclude that "regional integration is positively related to FDI levels" and that smaller countries had larger structural breaks (p. 12).

However, not all countries need benefit equally from the introduction of an RTA. Figure 2.2 shows that the intra-NAFTA FDI as a share of all outward FDI stocks fell from 30.3 percent in 1986 to 18.2 percent in

1999. The declining intra-NAFTA FDI share is one of the puzzles economists have sought to explain in their empirical work. A key explanation has been Canada's decreasing FDI intensity with the United States since the signing of CUSFTA (Eden and Monteils 2000; Globerman 2002). Both FDI flow and stock data point to the growth of inward FDI in the United States relative to Canada during the past few decades (see Buckley et al., forthcoming; Globerman and Shapiro 2001). Rugman and Brain (2003) found that the share of U.S. outward FDI stock in Canada fell from 20.9 percent in 1982, to 16.7 percent in 1989, and to 10.2 percent in 2000 (see also Hejazi and Safarian 2001; Safarian and Hejazi 2001). They argue that NAFTA caused MNEs to close plants in Canada and use U.S. exports to supply the Canadian market.

Eden and Monteils (2000) also note that Canadian share of world FDI inflow fell from 8.55 percent in 1985 to 3.97 percent in 1997 and that the U.S. share also fell from 24.40 percent in 1985 to 20.86 percent in 1997, even though for both countries the absolute amount of FDI increased. Only Mexico maintained its share (approximately 2.5 percent) of world FDI inflows. Overall, the region's share of world FDI fell from 35.43 to 27.34 percent between 1985 and 1997. Thus, NAFTA became a less attractive region, in a relative sense, for world FDI. This may reflect the reduced attractiveness of NAFTA as an investment location or, more likely, the increased attractiveness of other regions. Similar reports can be found in Swimmer (2000) and other studies. Eden and Monteils also find that the same patterns hold for NAFTA's share—and for the individual country's share—of outward FDI.

Globerman (2002) observed that European investors almost disappeared as a source of inward FDI to Canada in the latter part of the 1990s. Investors based in the "NAFTA zone," essentially U.S. investors, became increasingly dominant sources of inward FDI for Canada in the 1990s. Meanwhile, European investors became the dominant investors in the United States. According to Globerman (2002), one possible reason for Canada's declining attractiveness to European FDI was that favored "new economy" acquisition targets were more heavily represented in the United States.[11]

Horizontal and Vertical FDI

The key difference between horizontal and vertical FDI is that, under vertical FDI, the production in each affiliate is linked through the value chain to MNC affiliates in other countries; but horizontal integration

is primarily driven by domestic market seeking. Whether regional integration primarily stimulates vertical or horizontal FDI is not clear from the literature.

One of the major advantages of regional integration is the economies of scale gains that come from replacing small, national markets with a larger, regional market; this suggests that horizontal FDI (locational shufflings for efficiency reasons) should be the primary response to RTAs. Empirical analysis of FDI patterns worldwide suggests that horizontal FDI is the primary explanation (Markusen and Maskus 1999). Mauro (2000), in analyzing the impacts of tariff and nontariff barrier reductions on bilateral FDI patterns in 1988, 1993, and 1996, finds that FDI is primarily market seeking.

However, Levy Yeyati, Stein, and Daude (2002b), examine bilateral FDI patterns between 20 OECD countries and 60 host countries from 1982 through 1998, finding that RTAs tend to promote vertical over horizontal FDI. They find that vertical FDI for differentiated products does not substitute for trade, while the conclusion on horizontal FDI is not definitive. Waldkirch (2001) also finds that vertical integration is the likely explanation for the large increase in Mexico's FDI from Canada and the United States after NAFTA. Similar results are reported by other studies (e.g., Aizenman and Marion 2001; Hanson, Mataloni, and Slaughter 2001).

Moreover, MNCs display strategy preference patterns according to their origins, which affects the linkages between RTAs and FDI. For instance, Makhija and Williamson (2000) argue that U.S. industries are mostly multidomestic in comparison to other nations. That is, U.S. firms tend to duplicate production activities across the different countries in which they operate and to be less vertically specialized than MNCs from other OECD countries. This, according to Makhija and Williamson, implies the NAFTA experience might differ from that of the European Union.

When interpreting intraregional FDI data, differences in sectoral performance should also be taken into account (Rugman and Brain 2003). However, there are few econometric studies focusing on individual sectors and regional integration, probably because of FDI data limitations. The most important sector in terms of bilateral trade flows within NAFTA is automobiles and auto parts, which represents between one-third and one-half of NAFTA trade, depending on how broadly the sector is defined (Eden and Molot 1992, 1993; Hunter,

Markusen, and Rutherford 1995a, 1995b; Molot 1993). The Canadian and U.S. auto industries were not expected to see major MNE location shifts after CUSFTA and NAFTA because of bilateral producer free trade since the 1965 Auto Pact. NAFTA, in terms of autos and auto parts, was primarily about the opening and integration of the Mexican auto industry into an already deeply integrated North American auto sector (Weintraub and Sands 1998).[12]

Insiders versus Outsiders

A body of empirical work on the impact of RTAs on FDI inflows finds that RTAs benefit member countries (insiders) and have no impact or negative effects on nonmember countries (outsiders), as the executors of RTAs expected. Bertrand and Madariaga (2002) use the panel data on U.S. FDI in NAFTA and Mercosur from 1989 to 1998 and find that economic integration certainly plays a major role in U.S. firms' location patterns. The U.S. position regarding the two agreements—an insider in NAFTA, an outsider in Mercosur—seems to matter. Their regression results indicate significant positive relationship between U.S. (insider) FDI and NAFTA dummy variables, while no relationship is detected between U.S. (outsider) FDI and Mercosur dummies.

Monge-Naranjo (2002) compares the effect of NAFTA on flows of FDI received by Mexico (an insider) and the countries in the region excluded from NAFTA (outsiders). He finds that, with the exception of Costa Rica, all other Central American countries lagged behind Mexico after 1994. The most severe bias occurred in textile and apparel sectors, which represented most of the FDI flows in Honduras, El Salvador, and Guatemala, but not Costa Rica. For Costa Rica, what attracts FDI was the production of electronic components, medical equipment, and so on. Unlike other outsiders, Costa Rica, after the launching of NAFTA, still remained its attractiveness for FDI inflows. The "secret" lies in its production of electronic components, medical equipment, and so on.

The Bottom Line: Empirical Studies of Regional Integration and FDI in the Americas

In this section, we have reviewed dozens of empirical studies, done over the past five years, which have analyzed the relationships between regional integration and foreign investment. The gravity model has been

the preferred method of analysis, more recently supplemented by variables that distinguish between horizontal and vertical integration, and between insider and outsider investments. Although there have been many studies, the one *definitive* study of the impacts of regional integration on FDI in the Americas has not yet been done. In addition, most of the empirical work focuses on NAFTA, with little attention to the rest of the hemisphere.

The implications of RTAs for policymakers, as a result, are not obvious. Though there is a clear presumption that regional integration benefits member economies, a solid economic explanation for why some members lose FDI (e.g., Canada in NAFTA) and how this can be prevented is still in its infancy. Linking the micro-level locational strategies of individual firms to the macro-level shifts in FDI flows and stocks in response to regional integration also remains a challenge. Statistical agencies in the Americas are clearly one culprit here. Until FDI flow and stock data, at the bilateral and industry level, are harmonized in terms of definitions and collection practices, and the data are made freely available to researchers, the empirical studies of FDI and regional integration will continue to be piecemeal and problematic. We view this as an essential prerequisite to better econometric work on hemispheric issues.

POLICY OPTIONS

The new regionalism in the Americas is very much at a crossroads. The renewal of fast-track authority in the United States in the fall of 2002 gave the U.S. president a key precondition for the executive branch's successful negotiation of new trade accords. President Bush has announced U.S. interest in pursuing bilateral (e.g., Chile and Singapore), plurilateral (Central America), regional (FTAA), and multilateral (WTO) agreements. At the same time, the long recession in the Americas, depression in stock prices, collapse of FDI flows and unstable currency markets could hardly provide a less propitious time to be negotiating these accords. Worldwide FDI flows dropped in both 2001 and 2002, with predictions of similar declines in 2003; FDI inflows into North America, Latin America, and the Caribbean experienced similar declines (Evans 2002; ECLAC 2003).

Still, the question of how and where to deepen regional integration is important if the momentum for RTAs is to continue, and thoughtful suggestions for new policy directions continue to be made (Harris

2001; Dobson 2002). Here, we explore a few options linking regional integration in the Americas to foreign direct investment.

Our first option is *deepening the current agreements*. For shallow RTAs, this primarily involves the removal of remaining internal tariff barriers and the dismantling or harmonization of nontariff barriers such as quotas. Most Latin American customs unions, including Mercosur, are incomplete. Tariffs are not zero among members, and differences exist in the level and variety of barriers against nonmembers. This creates exactly the type of costs that RTAs were expected to eliminate.

For already deep agreements like NAFTA, further deepening would involve greater liberalization of services, devising consistent regulatory provisions, harmonizing policies that affect trade and FDI flows, opening up grandfathered sectors (e.g., agriculture), and strengthening regional institutions. For example, the Inter-American Development Bank (IDB 2002, 81) estimates that mean agricultural tariff rates within NAFTA were still quite high in 2000 (Mexico, 23.3 percent; Canada, 20.8 percent; and the United States, 11.4 percent), although median rates were lower (Mexico, 15.0 percent; Canada, 3.0 percent; and the United States, 3.7 percent). These rates suggest there is considerable room for reducing internal barriers to agricultural trade.

Tariff reductions, however, may not be politically feasible given the (externally perceived) aggressive subsidies in the 2002 U.S. Farm Bill, recent protests against NAFTA by Mexican farmers, and the new trade dispute over U.S. tariffs on Canadian wheat exports (Canada 2003; Morton 2003; Rosenberg 2003; Taylor 2003). At least the 1998 Canada–U.S. Record of Understanding provides an institutional forum for exchange of information and discussing the future harmonization of agricultural policies (Canada 2003, 40).

Another example where potential deepening would have positive benefits for FDI is the never-ending problem of antidumping and countervailing duties, which had recently become more serious as a result of the Byrd Amendment (Canada 2003, 43–44). This amendment, becoming U.S. law in October 2000, encouraged U.S. firms to file antidumping and countervailing duty complaints by making it possible for the firms to share in the collected duties. Canada and Mexico, along with several other countries, challenged the Byrd Amendment at the WTO. Both the 2002 interim and 2003 final WTO reports concluded that the amendment violated GATT principles. The U.S. government is expected to comply with this ruling. It may also be possible, within the

context of the current Doha Round of trade negotiations, for the administrative trade policies of the three NAFTA countries to be brought closer together, for example, by treating NAFTA as a single entity with respect to research and development subsidies and developing a common methodology for measuring costs (Harris 2001, 25–26). A much more difficult proposal would be to scrap national trade remedy laws and replace them with a NAFTA-wide competition policy; as advocated by Graham and Warner (1994).

A second possibility would be the *harmonization of external tariffs* in the major FTAs, such as NAFTA (Wonnacott 1996), in effect, replacing complex rules of origin with a common external tariff. While some argue that this is likely to raise tariff rates to the "highest common denominator," in many sectors tariffs are close enough to zero such that harmonization would be feasible. In addition, given the unequal bargaining power among the three NAFTA members, the most likely political outcome is that tariffs would converge to the U.S. level, typically the lowest of the three rates. A second major gain from moving to a common external tariff would be the reduction of transaction costs in cross-border trade as rules of origin were eliminated and border processes expedited.

There are problems with the common external tariff policy option, however (Dobson 2002; Harris 2001; Weintraub 2003). For example, Dobson (2002, 21) notes that "Canadians would still have to face capricious U.S. trade-remedy laws authorizing the use of [countervailing duties] and [antidumping] penalties," national sovereignty in trade policy would be compromised, and the three countries would have to adopt common negotiating policies at the WTO. In addition, each country now has one or more RTAs with a non-NAFTA country and Mexico has several; this suggests that complex negotiations with outsider countries would be required to deepen NAFTA into a customs union. For example, Weintraub (2003, 2) argues that Mexico would have to terminate its FTA with the European Union in order to enter a North American customs union.

If moving to a customs union proves impossible, three simpler possibilities suggest themselves. First, all three countries now have an FTA with Chile. A short quadrilateral negotiation should be sufficient to bring Chile in as a full member of NAFTA, fulfilling its request for entry first submitted in 1994. Second, common external tariffs could be nego-

tiated on a sectoral basis, following the example of computers in NAFTA. Dobson (2002) suggests that a NAFTA commission be set up that would regularly examine country tariffs by commodity and propose sectoral common external tariffs. Third, the member countries could liberalize rules of origin on a sector-by-sector basis. There is some precedent for this. In January 2003, at the request of industry associations, Canada and the United States liberalized rules of origin for seven products, including alcoholic beverages and petroleum/topped crude oil; Mexico was to follow later during 2003 (Canada, 2003: 39). This liberalization should encourage intra-NAFTA exports.

A third major initiative could be *ending the proliferation of bilateral RTAs*. For example, Canada, Mexico, and the United States now all have bilateral RTAs with Chile (the U.S. one must still be ratified). Harmonizing these three bilaterals would reduce administrative costs for firms; if it were done consistently, Chile could be brought in as a full member of NAFTA. A broader alternative would be to sweep many of the smaller RTAs into the FTAA commitments, removing many of the hub-and-spoke distortions that have crippled the potential economies of scale and scope gains from regional integration. The FTAA talks are apparently entering their "last stage" of negotiations and are on track for January 2005 (*International Trade Reporter* 2003), although Brazilian officials may attempt to slow the pace of negotiations (*International Trade Daily* 2003). At present, it looks as if the FTAA will coexist with other RTAs, with preexisting arrangements taking precedence except where all member countries agree to substitute the FTAA rules for the specific RTA's rules (Canada 2003, 50). This suggests that the FTAA will not end the proliferation of RTAs unless national governments push for harmonization under the FTAA umbrella.

In addition to trade policy changes, more attention should be paid to the *proliferation of bilateral FDI agreements*—particularly BITs and BTTs—within the Western Hemisphere. These also create hub-and-spoke arrangements that offer fewer benefits and higher costs than a comparable multilateral FDI accord. The failure of the Multilateral Agreement on Investment should not prevent the adoption of regional approaches to investment policy. Replacing the three bilateral tax treaties with one trilateral tax treaty with common withholding tax rates would be a relatively simple way to deepen NAFTA (Eden 1996a; Harris 2001). This is one more example where regionalism can precede multilateralism.

It is clear from the empirical work above that the formation of an RTA advantages certain countries over others in terms of attracting inward FDI flows. Not all countries benefit equally from regional integration in terms of FDI, and some may well lose. For countries that have suffered disinvestments and a declining share of intraregional FDI (e.g., Canada within NAFTA), a key policy issue is how to reverse the situation and attract inward FDI. Deepening regional integration may well worsen the situation, causing a vicious circle and disagglomerations as capital flows to areas with higher returns. This suggests that *domestic policy reforms must accompany the RTA process.*

Levy Yeyati, Stein, and Daude (2002a) discuss two polar strategies to attract FDI. The first strategy, "competition in incentives," entails the aggressive use of fiscal and financial incentives to attract foreign investors. Blomstrom and Kokko (2002) suggest that the use of investment incentives focusing exclusively on foreign firms, although motivated in some cases from a theoretical point of view, is generally not an efficient way to raise national welfare. The main reason is that the strongest theoretical motive for financial subsidies to inward FDI spillovers of foreign technology and skills to local industry is not an automatic consequence of foreign investment. The potential spillover benefits are realized only if local firms have the ability and motivation to invest in absorbing foreign technologies and skills. To motivate the subsidization of foreign investment, it is therefore necessary, at the same time, to also support learning and investment in local firms.

Incentives competition has been a real problem between Canada and the United States during the past 15 years, with state and local governments in both countries engaging in bidding wars to attract businesses. The Buy America initiative and small business set-aside provisions in U.S. government procurement contracts have also negatively affected export sales by Canadian and Mexican firms in the U.S. market (Canada 2003, 44–45). Regional integration in North America would benefit if these tax incentives and subsidies were either curtailed or applied uniformly to firms in all three countries. Carrying this one step further, with the removal of tariffs and the curtailment of nontariff barriers, corporate income taxes assume more importance in FDI location decisions. Deepening regional integration might also involve some harmonization of corporate income tax policies in North America (Eden 1996a; Harris 2001).

The second strategy, the "beauty contest," involves improving the quality of institutions, educating the labor force, and developing the

country's infrastructure. The advantage of this strategy is beyond the effects on FDI; it can benefit society as a whole. In particular, domestic firms will clearly benefit from improvements in infrastructure, education, or the quality of the institutional environment. The results reported in Stein and Daude (2001) suggest that, beyond these general benefits, improving the quality of institutions can have a major impact on FDI inflows. In terms of institutional policy changes in Latin America, better governance would clearly have positive effects on FDI. Globerman and Shapiro (2002) show that good governance has positive impacts on both inward and outward FDI flows. More specifically, a reduction of public sector corruption in Latin America could lead to sharply increased inward FDI flows because corruption acts as a tax on firms, encouraging less stable bank borrowing at the expense of FDI (Wei 2001).

In North America, a focus on improving and coordinating infrastructures, particularly in transportation and telecommunications across the three NAFTA countries, would reduce transaction costs within the region, facilitating both trade and FDI (Canada 2003; Harris 2001). The call to improve cross-border transportation within North America is an old argument, and the common example was Mexican trucking—but no longer. Since September 11, 2001, it has become abundantly clear that borders open for "goods" (trade, FDI) are also open for "bads" (illegal immigration, drugs, terrorists). As a result, national security demands now conflict with just-in-time delivery systems predicated on rapid border crossings. The Smart Border action plan is a necessary first step in rebuilding borders that are "open for business but closed to terrorists" (Canada 2003, 37).

CONCLUSIONS

Pendulums swing in both directions. Regional trade agreements were highly popular in the 1960s and the 1990s but fell out of favor in the 1970s and 1980s. In this chapter, we have examined the economic relationships between the new regionalism and foreign direct investment in the Americas. We reviewed the literature on differences between the old and new regionalisms, linked this work to the literature on FDI and locational responses by multinationals to regional integration, and compared it with the recent empirical research findings on the Americas. We concluded by examining several policy options for deepening the relationship between FDI and regional integration in the Americas.

Given the macroeconomic recession that now plagues the Americas, the focus on terrorism and national security after September 11, 2001, rising budgetary and balance of payments deficits, and the public's resentment of multinational corporations and globalization, policymakers must be sensitive to the conditions that could set the pendulum swinging again. Could it be possible that the United States, having finally opened the door with fast track to new regional agreements after years of sitting on the sidelines while other countries filled their "dance cards" with RTAs, could be met by Latin American countries closing the door due to macroeconomic and political crises at home? The key test of the new regionalism in the Americas will be the Free Trade Area of the Americas, which is due for implementation two years from now—NAFTA at 10, and the FTAA waiting in the wings.

Notes

1. ECLAC (1994) first used the term "open regionalism" to describe the difference between old and new regionalisms in Latin America. We are indebted to Enrique Dussel Peters for this point.

2. We coded the United States–Chile provisions based on the draft text, released on April 2, 2003, and posted at www.mac.doc.gov/chileFTA/FTAtext.html.

3. Most economists would argue that the elimination of antidumping and countervailing duties within a regional agreement is an improvement, leading to deeper regional integration. In this case, Mercosur is an improvement over NAFTA; customs unions typically eliminate these policies on internal trade, whereas FTAs continue to use them to protect domestic producers. In fact, one of the principal (and unmet) goals of the Canadian negotiators in the Canada–United States and NAFTA agreements was the removal of U.S. antidumping and countervailing duties against Canadian exports.

4. E.g., Mexico responded to the peso crisis in 1995 by raising more than 500 tariffs against nonmember countries while leaving those against its NAFTA partners unchanged.

5. This is the investment equivalent of trade creation; similarly, investment diversion is the equivalent of trade diversion.

6. Information on each country's practices can be found, using the search engine for "international investment position," at http://dsbb.imf.org/Applications/web/keyconceptfiscalsec/.

7. UNCTAD's FDI data is accessible at http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm; while ECLAC's statistics can be found at www.eclac.cl/estadisticas/default.asp?idioma=IN.

8. See, e.g., Landefeld and Lawson (1991), Statistics Canada (2002, chap. 16, "Direct Investment Position") and Gray and Rugman (1994).

9. Blomstrom, Kokko, and Globerman (1998) argue that total FDI flows into Mexico should have been overstated prior to 1995 because they were based on notifications, not actual investments; although it is less clear that the overstatement was biased in favor or against intraregional FDI flows. Their data indicate that U.S. FDI flows into Mexico were relatively little changed (in absolute value) in the immediate post-NAFTA period compared with the pre-NAFTA period.

10. See Deardorff (1998) for a history and analysis of gravity models in international trade.

11. Globerman and Shapiro (2001) caution that year-to-year changes in FDI values may be heavily influenced by a small number of very large mergers and acquisition (M&A) activities. The examples provided by Globerman and Shapiro are two specific acquisitions in 2000 that accounted for virtually all of the inward FDI to Canada through the M&A channel: Vivendi's acquisition of Seagrams and Alcatel's purchase of Newbridge.

12. Regional integration in automobiles had an interesting policy spillover. As a result of Japan taking Canada to the WTO, Canada was forced in 2002 to end the 1965 Canada–U.S. Auto Pact and replace it with a uniform Canadian tariff on motor vehicle imports from non-NAFTA countries, ending the differentiation between the Big Three and Asian assemblers (Eden and Molot 2002).

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