Chapter 6

The role of investment

The discussion so far has largely focussed on India's market access to the EU. The other dimension is the reverse trade flow, which assumes much significance in the context of a possible EU–India agreement and its impact on excluded low-income developing countries. The EU's strategic interests in most developing country markets are in Mode 3 and here it would be interesting to see if a possible EU–India agreement has separate provisions on investment in addition to coverage of Mode 3. In either case, given that European firms complain about being unaware of general conditions in the Indian market and the plethora of horizontal barriers plaguing investment in India, a possible agreement covering such issues could go a long way in switching the portfolio of EU investment in favour of India and possibly away from other low-income developing countries. In view of the well known positive effects of such investment in the recipient countries, such possible shifts in the flow of capital to India could be quite detrimental to the excluded low-income developing countries. The positive spill-over effects of economic integration on investment are documented in the literature (for example, see Brenton et al. 1999, Gao, 2005 and Feils and Rahman, 2008) and the excluded countries would be bereft of these as well.

As Schiff and Winters (2003) point out, integration has an impact on the overall investment climate within the PTA and this may in turn have a favourable effect on investment. Regional integration typically reduces the transaction costs of tradables more than those of non-tradables and if the former are more capital-intensive than the latter, trade liberalisation will increase the relative demand for capital and its rate of return. This in turn induces investment in the PTA. Moreover, deep integration may raise the efficiency of the financial sector, reducing lending margins and the cost of funds, thereby leading to higher investment, although, in truth, such financial integration is not easy to attain.

Since PTAs encompass reductions in regional trade barriers and investment restrictions, their impact on investment flows will ultimately reflect the impact of trade and investment liberalisation on location and firm-specific advantages. As Blomstrom et al. (1998) note, changes in location-specific advantages are potentially associated with liberalisation-induced changes in relative costs among member and non-member countries, changes in relative economic growth rates, altered investor perceptions about country-specific political risk, agglomeration economies, etc. Some of these changes will be the direct result of liberalisation initiatives while others will indirectly reflect the consequences of economic integration – economic integration will affect relative and absolute growth rates which, in turn, may have an impact on investment.

Motta and Norman (1996) show that economic integration, by improving market accessibility, induces outside firms to invest in the integrated regional bloc. Most of this invest-

ment is likely to take the form of intra-regional export platform FDI[66], including that emanating from excluded countries, with the investing firm supplying the majority of the countries in the PTA by intra-regional exports. They also show, however, that a net increase in inward investment in the PTA, from members and non-members, is not necessary. If there is intra-regional FDI prior to integration, increased market accessibility post-integration would lead to the rationalisation of intra-regional FDI through an investment replacement effect of FDI by outside firms. Intra-regional firms will switch increasingly to intra-regional exports.

The purpose of FDI may also be to take advantage of the local factors of production and these motives can be enhanced if a developing country forms an agreement with a developed country. For instance, the NAFTA, after 1994, had a profound impact on FDI into Mexico from countries outside the bloc, as this investment became a way to guarantee market access to Mexico's northern partners (Blomstrom and Kokko, 1997; Fernandes and Portes, 1998).

Finally, the removal of internal barriers within a PTA may stimulate vertical FDI, especially if the partner countries differ in their endowments. This aspect of North-South PTAs lies at the heart of Ethier's (1998a) theoretical exploration of the benefits of regionalism. With guaranteed preferential access to the northern market, the southern partner becomes an attractive destination for labour-intensive activities and thus attracts more investment, both from within and outside the PTA.

Ethier (1998b) further adds that the credibility of a government to announced reform can be crucial in attracting FDI – 'even a regional arrangement with only modest big-country preferences for the small country establishes an external commitment to reform that (weakly) binds future governments, thereby making the future preservation of reform (slightly) more credible'[67]. Moreover, even marginal preferences in trade agreements lead to investment re-orientation in favour of the partner country to the detriment of the excluded countries – 'suppose one country that would undertake reform anyway enters into a regional arrangement. Then direct investment producing intermediate goods for that country's partner will all be diverted there, and the country still remains a potential host for other direct investment. Less direct investment remains for other reforming countries, reducing their prospects for success and perhaps deterring some of them even from embarking upon reform'[68].

The empirical results in this area are somewhat ambiguous. The general conclusion is that the first phase of European integration was accompanied by a substantial net increase in both EC-related intra and extra-FDI and trade flows. Studies of the later stages of European integration have been more mixed in their findings. Pain and Lansbury (1997) cited some evidence that the Internal Market process of the EU may have diverted investment into the EU at the expense of other locations. Specifically, the level of inward investment in Europe by U.S. and Japanese firms was significantly higher since 1987 than might otherwise have been expected. Pain (1997) focused on the determinants of intra-EU FDI from the United Kingdom to investigate the diversion of British investment into the EU at the expense of the United States. His results suggested that the internal market pro-

gramme had a significant positive impact on the stock of UK FDI within the EU, especially in the services sectors. Barrell and Pain (1997) also found clear evidence that the EU Single Market Programme had raised the level of intra-EU FDI significantly. Brenton et al. (1999), on the other hand, found no evidence of FDI diversion perhaps because, as opposed to the studies above, the results from their gravity model was based on flows of FDI and not their stock.

In terms of the impact on individual PTA members, while no investment effects were found in the case of the UK (e.g. Mayes, 1983 and Grant, 1983), Ireland's membership in the EC stimulated direct investment from both EC and non-EC sources (O'Farrell, 1983). Similarly, Spain and Portugal benefited from significant increases in inward FDI as a result of EC membership (Baldwin et al., 1995) but Greece did not (Winters, 1996). However, Brenton et al. (1999) found no evidence that this increased investment in Spain and Portugal in the late 1980s significantly reduced investment flows to other European destinations. Further, FDI flows to CEECs in the 1990s did not have a clear negative impact on overseas investment in Spain and Portugal.

The North American experience of Mexico after NAFTA too suggests substantially more modest impact of PTA on extra-regional FDI stimulation than is associated with the earlier stages of EU integration (Blomstrom et al. 1998). At the same time, there is support for the European findings that trade and investment impacts will differ across countries within the integrating region. These empirical results thus serve as a caution against generalising from earlier experiences. As Blomstrom et al. note, 'the consequences of regional economic integration are sufficiently conditioned by inherited policies, as well as by existing macroeconomic conditions, to make extrapolation from historical experience very risky and potentially misleading.'

To summarise, there are certainly theoretical reasons to believe that the EU–India FTA will stimulate investment in India and that this will be strongly beneficial for the Indian economy. There are also some reasons to believe that investment elsewhere might contract and that this could be harmful for excluded countries. On the other hand, empirical evidence for such effects, especially the losses to excluded countries, is far from conclusive. Thus, while there is reason to consider these effects, there is little reason to expect them to be very harmful.

Notes

66 As Schiff and Winters (pp. 118, op.cit, 2003) point out, 'such platform investment is particularly likely if there are increasing returns to scale in production, making for lumpy investments that are viable only above a certain size'. Many services exhibit these characteristics.

67 Ethier (1998b) op. cit. pp. 1157.

68 Ethier (1998b) op. cit. pp. 1158.