Effect of regional integration agreement on foreign direct investment : A theoretical perspective

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EFFECT OF REGIONAL INTEGRATION AGREEMENT ON FOREIGN DIRECT INVESTMENT -A THEORETICAL PERSPECTIVE

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ABSTRACT

This paper looked into inter- relationships between Regional Integration Agreement (RIA) and Foreign Direct Investment (FDI) from theoretical point of view. It tried to figure out the conducts of FDI after the formation of RIA from intra- regional and inter- regional perspective. The theoretical framework was developed from the cross- section tabulation of motives and modes of FDI. It is identified that multinationals have two basic rationales for their motives of investment abroad: tariff- jumping and internalization. Further, they conduct their decision of FDI through two modes: vertical and horizontal FDI. To study the distribution of FDI in individual economy after RIA, the study of "Attractiveness matrix" was carried out. It suggested that the flow of FDI depends upon the consequences of "Environmental change" and "Locational advantage" of the host economies within the region.

Key words: Regional integration, Tariff- jumping, Internalization, Vertical FDI, Horizontal FDI, Environmental change, Locational advantage

JEL Classification: F15, F21, F23

1. INTRODUCTION

During the past three decades, an increase in the number and depth of Regional Integration Agreements (RIA) around the world has taken place quite remarkably accelerating the movement of production factors across international boundaries (OECD, 2001). The former European Economic Community has advanced into a single market European Union (EU) and has also successfully adopted a common currency, Euro. In America, a number of agreements have been either created (e.g. NAFTA, MERCOSUR) or strengthened in the 1990s. Likewise, countries in Southeast Asia have adopted the ASEAN Free Trade Area (AFTA). On a broader East Asian outlook, ASEAN plus three (Japan, China and Korea) or ASEAN plus

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three plus three (India, Australia, New Zealand) is getting prominence (ADB, 2008). However, it is to be noted that the nature of FDI and RIA that takes place between the "developed- developed" nations differs from that taking place between "developed-developing" nations and "developing-developing" nations (Blomstrom and Kokko, 1997).

Furthermore, the increasing importance of Foreign Direct Investment (FDI), relative to other forms of international capital flow has resulted in the increased production of world output (Hagen and Zhang, 2009). The world has been experiencing a dramatic surge in the flows of FDI with comparison to world trade. The surge in FDI involves flows toward both developed and developing countries and there is competition among emerging economies in attracting FDI. This is because FDI inflow brings various benefits to FDI host economies such as much needed capital, technology and international networks (Urata and Kawai, 2000).

In the light of these two developments, the role of RIA as a determinant of the location of FDI has become an increasingly relevant issue. One of the ever-argued comments is whether RIA is compliment or supplement to FDI. And this particular question arouses interests of economists and policy makers. Though there is reason to believe that effects will vary between different integration agreements and between countries and industries involved in the agreements, some of the empirical studies have showed that these two facts are interlinked in many aspects. Especially, there is a dearth of concrete theoretical underpinning on the subject of effects of RIA on FDI after the free trade agreements. This paper tries to fill in that gap by exploring the RIA as the determinant for the location of inward FDI and effects on intra- regional and inter- regional FDI. Moreover, it will also try to look into the distribution and redistribution of FDI into the host economies after RIA takes place.

Next section focuses on the literature review of the previous studies, which would be a founding step to formulate the theoretical framework. In section 3 we provide the motives and modes of FDI. Section 4 builds up the theoretical framework on the conducts of RIA on FDI, both in intra- region and inter- region level. Section 5 summarizes and concludes the paper.

2. LITERATURE REVIEW

Considering the fact that the theory of FDI is not as advanced as that of trade, literature review remains the integral part of this paper in collaborating the concepts to develop the theoretical framework. Blomstrom and Kokko (1997) synthesizes that regional integration should enhance the attractiveness of investing in the region as a whole by creating a larger common market and contributing to improved overall efficiency and higher income levels in the market. The magnitude of the changes in investment will be related to the significance and nature of the trade and investment liberalization initiatives embodies in the RIA. Further, the relationship between RIA and FDI is powered by the "Environmental change" connected with regional integration and the "Locational advantages" of the individual country or industry (discussed in detail in section 4). Stronger environmental change and locational advantage will lead to inflow of FDI from the outside as well as from the rest of the integrating region. They tested their findings in three different kinds of regional integration, North-North integration (CUSFTA), North- South integration (NAFTA), and South- South integration (MERCOSUR).The first case focused on the Canadian participation in the CUSFTA, which started in January 1989, and illustrated a situation where the RIA did not appear to cause any radical changes in the inflows of FDI to the country in question. Indeed, intra- regional Investment i.e. US investment in Canada and Canadian investment in US has actually decreased with the CUSFTA agreement, however there has been some increment in investments from outside countries.

The second case examined the impact of the NAFTA agreement and suggested that this specific agreement has had a profound impact on the inflows of FDI in Mexico. The inflows of FDI have risen sharply from less than US $ 3.0 billion in 1989 to nearly US $ 8.0 billion in 1994. The agreement contributed to very significant and positive environmental change, an added bonus is that these are likely to be perceived as more permanent improvements in the investment environment than purely domestic reforms. Thanks to the increasingly market oriented economic policies, geographical proximity, and supply of cheap labor, Mexico also possesses strong locational advantages with respect to its northern neighbors. Consequently, regional integration has created new commercial opportunities for domestic and foreign investors, in the domestic Mexican market as well as in the US and Canadian markets. The Mexican experience may capture some general characteristics of North-South agreements, primarily related to the potential for improved policy credibility and gains from guaranteed access to large northern markets. The third case examined the impact of MERCOSUR involving Argentina, Brazil, Paraguay, and Uruguay. Although the Customs Union was formally established in the beginning of 1995, gradual liberalization of intra-regional trade was underway since early 1990s and most internal trade barriers had been removed by then. The available evidence, although patchy, show that a strong investment expansion has coincided with this integration process and it is reasonable to assume that the continuing integration process may stimulate further significant investment responses. Argentina and Brazil are the two countries with the strongest locational advantages, mainly because of abundant natural resources, relatively well developed industrial sectors and large domestic market. The two other members Paraguay and Uruguay seem to have relatively weak locational advantage coupled with their smaller domestic market.

It is to be noted that the three cases studied in Blomstrom and Kokko (1997) are of different variety. The integration between two developed nations US and Canada showed that there is less impact of integration process in FDI citing that the intra- regional investment has indeed decreased in both Canada and US with moderate level increment in inter- regional investment. The case of NAFTA, where a developing country joining the integration with the developed nations showed that the investment increased because it is believed that these investment from outsiders took place not only to cater the domestic market of Mexico but also in larger context to cater the larger market of US and Canada as there has been no formal barriers between these countries. The case of MERCOSUR provides us to enough evidence to support the fact that macroeconomic stability and locational advantages of the countries matter in attracting FDIs.

In another paper by Blomstrom, Kokko and Globerman (1998), the authors have compared the integration effect between EU and North America and finds contrasting results. In particular, the North American experiences suggest substantially more modest impacts of trade agreements on intra- regional trade creation and extra-regional FDI stimulation than is associated with the EU experience, particularly with the earlier stages of EU liberalization. At the same time, the North American experiences support European findings that trade and investment impacts will differ across countries within the integrating region.

Yeyati, Stein and Daude (2002) figured out the effects of RIA on the flow of FDI from the aspect of the creation of Free Trade Area of Americas (FTAA). Though the study was done to carry out the prospect of FTAA, the focus was broader covering the effects of RIA in general. The theoretical line of reasoning in this paper is to look into the effects of RIA on FDI from three different perspectives: from members of same RIA, from members outside of the RIA and from source country. The medium used for the study is a modified version of the standard gravity model that abstracts from most country and pair- specific aspects. They used dataset on bilateral outward FDI stocks from the OECD International Direct Investment Statistics which covers FDI from 20 source countries, all of them from the OECD, to 60 host countries, from 1982 through 1998. The shortcoming of this data is that it does not cover FDI between developing countries. Yet, it is the most complete source available for bilateral FDI, which is a key ingredient to the study. They conclude that the estimated effect of a common FTA membership on the bilateral FDI stock is positive and significant. Joining a FTA, on average, more than doubles the bilateral FDI between its members. The positive effect suggests that any potential loss of FDI due to the tariff- jumping argument offset by other effects that operate in the opposite direction. The formation of RIAs increases the incentives for multinational activity of the vertical variety (which takes advantage of differences in factor proportions), and reduces multinational activity of the horizontal variety, which is a substitute for trade.

Kim (2000) establishes three hypotheses and conducts the study on FDI determinants. First, the differences on the determinants of Japanese and US manufacturing FDI in Europe are smaller by the impacts of European Economic Integration. Second, the determinants of Japanese manufacturing FDI in Europe has been more influenced by the strategy from resource seeking to market efficiency or strategic asset seeking. And lastly, the determinants of US manufacturing FDI in Europe have been more influenced by European integration. He tested these hypotheses through generalized liner regression model. All of these hypotheses have been supported by his statistical analysis and his conclusion follows that European economic integration had influence on the determinants of Japanese and US manufacturing FDI in Europe from the first (1975-1984) to the second period (1985-1996). However, the influence of the integration compared to that of other variables is more critical in the case of US FDI rather than in the Japanese case in the second period. It could imply that because the United States has a long history of investment in Europe, European economic integration might have a greater influence on restructuring pre-existing FDI within Europe rather than on stimulating new FDI in the first period. On the contrary, because Japanese FDI in Europe began from the early 1970s and its FDI had aimed to exploit Europe as a whole from the beginning, the effect of European economic integration on Japanese manufacturing FDI was not significant in the first period, but in the second period.

On Asian studies, Kawai and Urata (2002) noted that the remarkable economic growth of East Asian economies from the mid 1980s until 1996 is the result of various factors such as sound fundamentals, including stable macroeconomic environment, human capital and limited price distortions. In addition, a large amount of FDI inflows to East Asia, together with foreign trade, contributed to the region's rapid economic growth. Economic growth in- turn generated trade and attracted FDI inflows. Indeed, in East Asia a virtuous cycle of rapid economic growth and trade- FDI expansion was behind the remarkable economic performance during 1990s. Although the crisis of 1997 disrupted the growth of these economies, FDI inflows appear to have contributed significantly to mitigating the impact of the crisis and to recovering from it. Under these circumstances, emerging East Asian economies should continue to lower and remove the barriers to trade and FDI not only through global and trans-regional liberalization processes such as WTO and APEC, but also through regional and sub regional schemes such as ASEAN+3, AFTA and bilateral FTAs.

UNCTAD (2003) in World Investment Report adjoins a page titling "Effects of regional integration agreements on FDI in Asia", in which it takes the cases of ASEAN and SAARC (South Asian Association for Regional Cooperation) countries after the signing of AFTA and SAPTA respectively. According to the page, several studies at the firm level suggest that the AFTA has influenced Trans National Corporations' decisions to invest in the region, especially in the automotive and electronics industries. A cross- sectional regression analysis of US outward FDI suggested that the major ASEAN host countries (Malaysia, the Philippines, Singapore and Thailand) received more FDI than the analysis predicted for 1994. This could imply positive effects of AFTA on FDI flows from the US. FDI flows to the ASEAN sub region have increased steadily, particularly after the signing of AFTA and until the 1997- 1998 Asian Financial Crisis. In the

SAARC Preferential Trading Arrangement sub region, FDI has seen improvements since the signing of the agreement in 1993 (Das, 2007).

3. UNDERSTANDING MOTIVES AND MODES OF FDI

A difficulty in assessing the role of RIA on FDI is that there are many different channels through which RIA could potentially have an impact on the location of FDI and not all of them go in the same direction. The motives and modes of FDI plays vital role in assessing these. Moreover, the impacts of RIA on FDI are specifically significant on the intra- regional and inter- regional level. While with the changing motives and modes, FDI can bring the change in the composition of FDI in participating countries, the scenario may look like that some country can be net winner at the cost of the loser one. Therefore, to identify and assess some theoretical linkages between RIAs and incentives to undertake FDI, it is necessary to look into the motives and modes of FDI from the perspective of intra- regional and inter- regional. Among others, we would focus our discussion on the two basic theories to explain this behavior.

Dunning's Eclectic Paradigm: One of the most significant theories that explain the activities of foreign firms is eclectic paradigm introduced by John H. Dunning (Dunning, 1971). According to him, the tendency of a firm to engage in foreign production depends on its OLI (Ownership, Location and Internalization) configuration in the target market. In its original form, the eclectic paradigm stated that the extent, form and pattern of international production were determined by the configuration of three sets of advantages as perceived by enterprises. First, in order for firms of one nationality to compete with those of another by producing in the latter are, they must possess certain advantages specific to the nature and/ or nationality of their Ownership. These advantages- sometimes called competitive or monopolistic advantages- must be sufficient to compensate for the costs of setting up and operating a foreign value- adding operation, in addition to those faced by indigenous producers or potential producers. The second condition for international production is that of internalization which says that it must be in the best interests of enterprises that possess ownership- specific advantages to transfer them across national boundaries within their own organizations rather than sell them, or their right of use to foreign- based enterprises.

The third strand of the eclectic paradigm deals with the location. MNEs engage in foreign production whenever they perceive it is in their best interests to combine spatially transferable intermediate products produced in the home country with at least some immobile factor endowments or other intermediate products in another country. It is then the juxtaposition of the ownership- specific advantages of firms contemplating foreign production or an increase in foreign production; the propensity to internalize the cross border markets for these; and the attractions of a foreign location for production which is the gist of the eclectic paradigm of international production. The paradigm helps to explain not only how regional integration changes location advantages but also how it affects the distribution of ownership advantages between firms of different origins and the configuration of both ownership and location specific advantages.

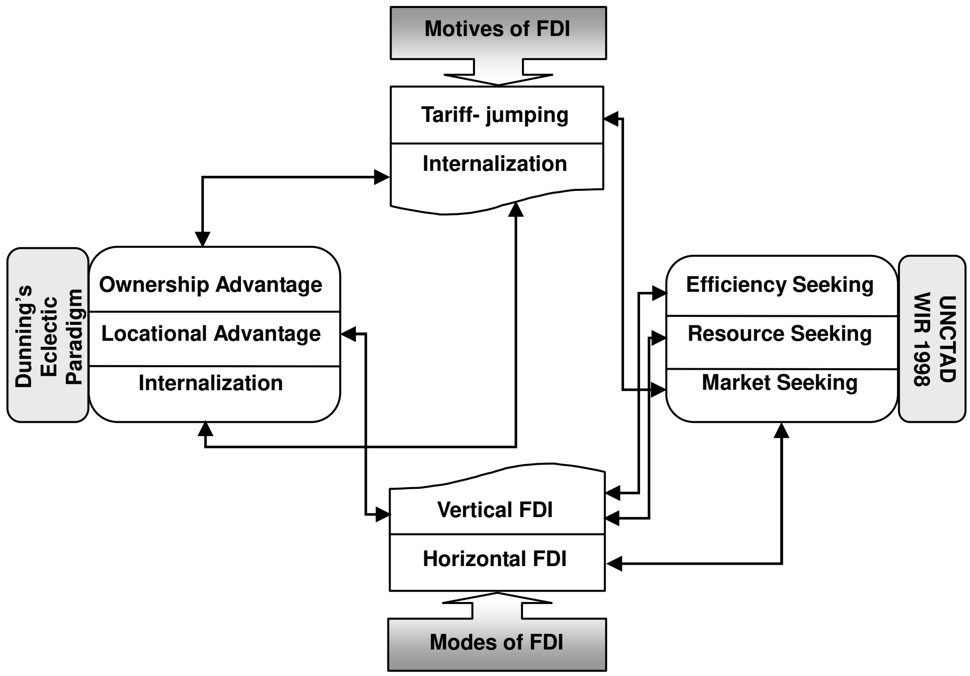
UNCTAD 1998: In a neoclassical interpretation, UNCTAD reports three host country determinants of FDI in its publication: World Investment Report, 1998: Trends and Determinants. They are Policy Framework for FDI, Economic determinants and Business Facilitation. While the Policy Framework includes the factors like economic, political and social stability, international agreements, privatization policy, etc; Business Facilitation includes the factors like Investment promotion and incentives, hassle costs and after- investment services. The economic determinant, which is more related to the study, has been described briefly below. The particular economic determinants of FDI according to the UNCTAD depend on whether the FDI falls into one of the three categories. Market seeking FDI- firms that are attempting to locate facilities near large markets for their goods and services. Resource or asset seeking FDI- firms those are in search of particular natural resources or particular human skills. Efficiency- seeking FDI- firms that can sell their products worldwide and in search of location where production costs are the lowest.

With these two basic theories on FDI conduction, figure 1 has been developed to set up the motives and modes of FDI. It shows the association of the Dunning's eclectic paradigm and UNCTAD's interpretation on FDI with three additionally introduced variables tariff- jumping, horizontal FDI and vertical FDI. The objective of producing *motives* as tariff- jumping and internalization and *modes* as horizontal and vertical FDI is to arrange the concept of FDI Inflow in simple and explainable manner so as to have convincing analysis on the effects of RIA. It should be noted that all the characteristics of both the theories have been taken care by the motives and modes as in the figure. Rest of the analysis on the effects of RIA on FDI is based upon these motives and modes. Following sub- sections are dedicated for that purpose.

3.1 Motives of FDI: Tariff- jumping and Internalization

The motives of FDI tries to answer the "why" question, i.e. why are multinationals interested in investing and producing abroad rather than producing domestically and exporting to outside markets. The early theoretical and empirical literature on FDI tended to regard trade and capital movements as substitutable modes of serving foreign markets. This view of the relationship between trade and factor mobility suggests that tariff barriers could motivate import-substituting FDI, and that general tariff reductions would reduce FDI flows. Thus, with the argument of tariff- jumping, the formation of RIA would reduce FDI. This means that with no formal trade barriers in place, the Multinational Enterprises (MNEs) would like to produce domestically and serve the foreign market by exporting the goods. It is especially true in the scenario of intra- regional investments (investments taking place between and within the members of the integrated region) once the economies enter into formal trading agreements. On the contrary, it is also true that if the integrated region as a whole remains substantial trade barriers with outside world and free trade within members, this argument will actually give rise to inter- regional investments (investments that coming from non- member countries to integrated region).

Figure 1: Generalization of Motives and Modes of FDI



However, although much FDI is motivated by tariff-jumping arguments, there are cases when FDI have taken place with the motive of the exploitation of intangible assets. In order to compete successfully in a foreign market - where local firms have superior knowledge of the local market, consumer preferences, and business practices - the internationally oriented firm must possess some firm-specific intangible asset, such as technological and marketing expertise, brand image, etc. that gives it a competitive edge. In order to exploit these firm specific intangible assets, multinationals require to "internalizing" by establishing its affiliates or subsidiaries, since other modes of international business, including exports and licensing carry relatively high transaction costs. Therefore FDI is expected to occur even when there are no formal trade barriers between countries. And, RIA hardly matter for these types of FDIs. But, it is comprehensible from the literatures that investors prefer to have barrier free world.

As per the relationship in figure 1 is concerned, it can be noted that tariff-jumping argument holds the characteristics of the Market- seeking FDI. As discussed earlier, inter- regional investment tends to increase with enlarged market via RIA and substantial tariff barrier in place for outside world. Internalization caters to the two characteristics of eclectic paradigm- ownership and internalization.

3.2 Modes of FDI: Vertical FDI and Horizontal FDI

The modes of FDI give the answer of "how", i.e. how do the multinationals expand their investments with specific motive in mind. This view provides good insight whether FDI and trade are complements or substitutes. Vertical FDI takes place when a firm geographically fragments production by stages, in order to take advantage of location-specific advantages such as lower factor prices. An implication of this model is that one would only expect to observe this type of FDI taking place between countries with sufficiently different factor endowments, so as to ensure that factor prices do not equalize (Yeyati, Stein and Daude, 2002). FDI and trade are complements if a MNE relocates part of its production chain, e.g. its labor intensive assembly plant, to a low-wage country, exports headquarter services such as blueprints and management skills, and intermediate inputs to that country, and then re-exports final goods. Imports of the 'home' country increase as it imports products made by the foreign subsidiary, while its exports increase because the foreign subsidiary requires capital and intermediate goods from home. This theory suggests that FDI tend to take place no matter of RIA's effect and locational advantage is the factor that becomes the essential concern (Caves, 1996).

Horizontal FDI takes place when a MNE produces the same goods and services in multiple countries, in order to avoid the 'trade costs' of exporting goods, but wishing to exploit its firm-specific advantages in production. Each production facility supplies the domestic market. A key assumption in the horizontal model is the presence of economies of scale at the level of the firm, which is the source of the advantage of multinational firms over domestic ones. Multinational activity in the horizontal model depends on the interplay between trade costs and plant-level economies of scale. With trade liberalization, trade costs will come down, and the incentive to produce in multiple country locations will diminish, particularly if there are significant economies of scale. In this case FDI and trade are substitutes. Therefore, in the absence of trade costs i.e. the formation of integration, there would be no reason for multinational production, since firms could concentrate their production in the home country, taking advantage of economies of scale and serving the foreign market through trade. As trade costs increase, multinational production arises as long as plant-level economies of scale are not too high (Caves, 1996).

Figure 1 provides the association of these two important concepts of FDI with that of Dunning's and UNCTAD. As mentioned above, locational advantage is the central focus for vertical FDIs to occur while Efficiency seeking and Resource seeking FDIs also fall into vertical category. On the other hand, horizontal FDIs take place when there is a motive for market seeking. As the integration makes the market of integrated market bigger, there are plenty reasons for multinationals to cater this enlarged market.

4. RIA VIS-À-VIS FDI: THEORETICAL FRAMEWORK

The effects that are discussed on motives, namely tariff- jumping and internalization and modes, namely, vertical and horizontal FDI, will lay down the basis for us to figure out the effects of RIA on the behavior of FDI. We will conduct the analysis with two aspects: intra- regional and inter- regional, which will help us in generating the rigorous behavior of FDI. A discussion will also be made regarding the distribution of FDI in individual countries later on this section.

Firstly, we will look into the conduct of FDI prior to the formation of RIA as shown in table 1. With tariff- jumping motive, there will not be any vertical type of FDI taking place however, horizontal FDI do occur in both the cases of tariff-jumping and internalization. And, the internalization effects may depend on the nature of product to vertical FDI to take place. Nevertheless, the pattern of FDI will behave differently once the countries enter into the integration agreements as the RIA will eliminate the tariff barrier (and most likely non- tariff barriers too depending upon the nature of the agreement) among the members of Integration while maintaining their tariff with the outside world, which can be common or country- specific.

Table 1: Conducts of FDI before RIA

Modes Motives	Vertical FDI	Horizontal FDI
Tariff- jumping	Does not take place	Takes place
Internalization	Depends upon nature of product	Takes place

This matrix could be effectively used for the identification of the effects of RIA that impacts FDI after the region bind into formal trading agreements. The effects are analyzed from the aspects of intra- regional and inter- regional.

4.1 Effects of RIA on Intra- regional FDI

The two views of the motives for FDI give partly contradictory predictions regarding the effects of regional integration for intra- regional investment flows. Regarding tariff-jumping FDI, we would primarily expect reduced investment flows because trade liberalization makes exporting from the home country relatively more attractive than FDI as a way to serve the regional market. However, RIA would not create incentives to reduce investment or repatriate capital for projects that were primarily undertaken to internalize the exploitation of intangible assets. In fact, the reduction of regional trade barriers could instead stimulate overall FDI flows among the relevant trading partners by enabling MNEs to operate more efficiently across international borders. This argument applies in particular for vertically integrated FDI, where the operations of the MNEs different affiliates are specialized according to the locational advantages of the host country, and where a predictable and liberal trade environment is a prerequisite for the international division of labor at the firm level. Table 2 gives the framework of the mechanism of intra- regional FDI that takes place after RIA.

Table 2: Conducts of Intra- regional FDI after RIA

Modes Motives	Vertical FDI	Horizontal FDI
Tariff- jumping	No effect	Decrease
Internalization	Increase	Mixed effects-most likely increase

There will not be any effect in the vertical FDI with tariff- jumping motive. New investments will hardly take place and the pre- existent investments will also have no impact because these investments are not concerned with changes in tariff. However, pre- existent horizontal FDIs may tend to decrease, or even disinvestments may take place, with barrier free region as the firms now find themselves better in serving the region by domestic production. The cross-section of internalization argument and vertical FDI will give rise to FDI and much more depends upon the locational advantage of host country. As the firms no more face any barrier, MNEs will be happier than before to invest utilizing its available resources. On the other hand, the cross- section of internalization and horizontal FDI will have the mixed effect but most likely to increase. Reasons for it being that the pre- existent investments will not change however, if the firms internalization advantage is strong enough, the investments do take place.

Hence, the static effects on intra- regional FDI flows are subject to partially off-setting influences, and the net impact on any specific RIA or individual member country would tend to be determined by the structure of and motives for pre-existing investment. A reasonable generalization, however, is that countries with low initial trade restrictions are more likely to benefit from increased intra-regional FDI flows as trade barriers are reduced, since they are not very likely to host import-substituting FDI projects that might be withdrawn.

4.2 Effects of RIA on Inter- regional FDI

Turning to inter- regional FDI flows, both the tariff- jumping and internalization suggests increased investment flows in both vertical and horizontal modes. The inflows of FDI from “outsiders” into the region would go up if the average level of protection increases as a result of the RIAs, or if the establishment of a RIA raises fears about future protection. Another strong reason for this situation is because of the enlarged market. The inflows of foreign capital would increase if the volume of incoming FDI were initially restricted by the limited size of the individual national markets. Contrary to the national markets, the integrated "common market" may be large enough to bear the fixed costs for the establishment of new foreign affiliates. This surge of inward FDI would probably not be evenly distributed, but rather concentrated to the geographical areas with the strongest locational advantages. Table 3 outlines the mechanism of inter-regional FDI that takes place after RIA.

Table 3: Conducts of Inter- regional FDI after RIA

Modes Motives	Vertical FDI	Horizontal FDI
Tariff- jumping	Increase	Increase
Internalization	Increase	Increase

Vertical FDIs will increase with tariff- jumping motive because the outside investors can take advantage of country- specific resource, which was initially not catered due to limited market. As for horizontal FDI, the average protection level of the region as a whole will encourage multinationals to invest in the region, more importantly dealing with large market. Moreover, companies with internalization advantage would be willing to invest with both modes of vertical and horizontal FDI. Hence, in contrast to intra- regional effects, it is easy to determine in the case of inter- regional investment, that with the formulation of integration agreement, the region will enjoy the increase in FDI.

4.3 Effects of RIA on Total FDI

With the analysis of these two perspective of FDI effects on hand, we can reach to the generalization that the total FDI in the region will depend upon the intensity and the mix of investment coming from inside and outside of region. Clearly, if the inter- regional investment has domination over intra- regional investment, comprehending the effects on inter- regional FDI after RIA, we can make a rational assertion that the total FDI in the integrated region will increase. On the other hand, if the intra- regional FDI was far higher than inter- regional FDI, the effect could be negative.

4.4 Distribution and Redistribution of FDI

As discussed above, not all the countries would benefit from the increase in FDI. Even participating in the same RIA, some economies may entertain more FDI flowing in while some may have to satisfy with less FDI or even disinvestments. For any individual country, the overall impact on investment will therefore reflect potentially offsetting influences. However, a reasonable generalization is that regional integration should enhance the attractiveness of investing in the region as a whole by creating a larger common market and contributing to improved overall efficiency and higher income levels in that market. The magnitude of the changes in investment will be related to the significance and nature of the trade and investment liberalization initiatives embodied in the RIA.

Attractiveness Matrix in following figure (Adopted from Blomstrom and Kokko, 1997. Original source: Globerman and Schwindt, 1996) provides an organizational template for thinking about the FDI process in the context of regional integration and it will help explain us why the economies involved in the integration attracts more FDI than other.

Figure 2: Attractiveness Matrix

	Locational Advantage (Positive to Negative →)	
Environmental Change	1	2
(Strong to weak ↓)	3	4

Environmental change is the degree to which trade and investment barriers are liberalized by the integration agreements in question. The simplest way to understand this feature is that it is the impact of integration agreement that the change in openness brought in by. In other words, environmental change is the degree of openness or the degree of trade and investment liberalization resulted due to agreement for individual countries. This implies that countries which had higher barriers before the agreement will benefit the most after the barriers would be liberalized via agreement. This depends both on the nature of the specific agreement and the initial institutional environment in the region. Up to down means liberated environment to restricted environment. Locational advantage is the degree to which it is advantageous from a profitability standpoint to locate an economic activity in a particular location. This characteristic refers to overall advantage of specific country, such as the availability and cost of various production factors as well as the country's geographic location with respect to major consumer markets and the general macroeconomic environment. Left to right means more advantageous with compared to other countries in integration to less advantageous.

Examining the figure, the most pronounced positive impact on investment would presumably be experienced by those economic sectors falling into area 1. These activities experience the strongest degree of integration, and the country in question enjoys a strong locational advantage. Hence, for reasons noted earlier, one would anticipate relatively strong, positive capital flows from both foreign and domestic investors in these sectors. In area 3, the hypothesized impact on domestic investment is weaker, although still positive. This area contains those economic activities for which the country in question has a strong locational advantage, but for which the impact of the integration agreement is relatively weak. Economic integration between OECD countries, where the formal and informal barriers to trade and investment are relatively low already at the outset, can be expected to provide many examples of industries falling into this category. Moving to area 2, the expected impact on inward FDI is negative and the potential for actual disinvestment increases. Specifically, the activities in area 2 are strongly affected by the integration agreement, but the country in question suffers locational disadvantages. Many countries and industries where the bulk of existing FDI has been established in order to avoid trade barriers would be classified in this area. Finally, the impact of integration on activities in area 4 is likely to be small in which the country suffers a locational disadvantage and weak agreement influences. In other words, area 4 contains activities where investment decisions are not likely to be affected by the RIA.

5. CONCLUSION

The relation between RIA and FDI is neither self- evident nor straightforward, as the decision for foreign investment depends upon lots of factors including economic, social and political. This study focused on whether the formation of RIA brings into increased inflow of FDI in the integrated region from theoretical perspective. To generate the conceptual framework, we carried out two means. Firstly, available empirical studies on the subject matter were reviewed. And secondly, theoretical arguments were reviewed based on available literatures and papers. These reviews paved the road for the development of theoretical argument on motives- tariff- jumping and internalization; and modes- vertical and horizontal FDI. The cross section effects of these motives and modes were analyzed from intra- regional and inter- regional distribution of FDI. By this way, we developed a theoretical framework by examining the conducts of FDI after the formation of RIA from four different perspectives- motives, modes, intra- regional and inter- regional. Moreover, we borrowed a theoretical template as Attractiveness Matrix to study the distribution pattern of FDI Inflow in individual participating countries after RIA. We concluded following three major effects of RIA on FDI.

- The formation of Regional Integration Agreement will give rise to inflow of FDI in integrated region in general.
- The effect of intra- regional FDI Inflow will have mixed effect depending upon previously existent FDI while inter- regional FDI will increase after RIA.
- FDI allocation will not be even in the participating countries after the formation of RIA. The benefits depend upon the environmental change brought in by openness on trade and locational advantage of the country's geographic position to the consumer market.

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