Trade Agreements and Transnational Corporations Presence in the Developing Asia

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Abstract

This paper investigates the effect of trade agreements on the transnational corporation presence in the developing Asia. This hypothesis is tested on the sample of 9 Asian developing countries for twenty one years' time period. Evidence is found that the Trade agreements had a significant impact on the FDI received by these Asian countries. Along with trade agreements other conventional FDI location pull factors also play a significant role in the attraction of FDI to the specific region. Through fixed effects panel estimation method it is found that countries with large market size, educated labour and the low trade barriers are important aspects, which MNC's consider while making investment in this region.

Key Words: *Trade Agreements, Transnational Corporations, Panel Data, FDI*
JEL Classification Codes: *C230, F130, F140, F210 and F530*

1. Introduction

Foreign direct investment (FDI) is one of the most important sources of financial flows for the economic growth of developing countries among many other financial instruments. Multinational Corporations (MNC's) by doing investment in the host countries not only provide foreign capital to the host countries, but also brings improvement in the technology, management and reinvigorate their economic progress (Shah, 2009). MNC's decision to invest in the host country is mostly based on natural resource availability and its location. FDI increases when there is more liberalisation for investment all over the world. Now a days, countries are engaged in different trade agreements to boost up commerce and business related liberalisation policies sought by multinationals (Shah & Khan, 2016). General Agreement on Tariff and Trade (GATT) had a worldwide focus (Shah, 2015). Many group of countries also developed regional trade agreement (RTA's) including European Custom Union (ECU) and North American Free Trade Agreement (NAFTA). All those agreements augmenting economic liberalisation positively affected the volume of inward FDI (Shah & Samdani, 2015).

A widespread escalation in regional trade agreements (RTAs) is witnessed in 1990's, many of them among developing countries. The RTA member countries, benefits from economies of scale, increase in efficiency and the comparative advantage with other member countries (Shah, 2011c). RTA involves the reduction of barriers, which are imposed on tariffs within the partners and implementation of a common tariff against the non-member countries (Shah, 2011d).

According to the World Trade Organization (WTO), the countries, which fully enforce their preferential trade agreements (PTAs), remove trade barriers witness increased inward FDI between them but for the non-members there aren't such benefits (Shah, 2017). The members of free trade agreements (FTAs) liberalize internal trade while for the outsiders; they maintain a common custom policy. Prominent arrangements include NAFTA, ASEAN (Association of South East Asian Nations), the ECU, Mercosur etc. It is generally accepted that PTAs, FTAs and RTAs are important trade and investment liberalisation mechanisms, hence should be preferable to attract multinational investors (Shah, 2011d). This paper attempts to answer the question that whether trade agreements play any role in multinational corporations (MNC's) presence in the developing Asia.

1.1 Purpose of the Study:

The flow of FDI into developing countries varies greatly across countries and over time. There are a number of factors which provide mechanisms for making FDI in other countries. The primary concern of this study is to examine the effect of trade agreements on transnational corporation's presence in Asian developing countries.

1.2 Objective of the Study:

- To assess the extent of trade agreements affect on multinational corporations investment in developing Asia.
- To explore different factors that enhances FDI inflows to the developing Asia.

1.3 Significance of the Study:

This research has important implications for investors interested in making FDI into Asian developing countries. Policy makers consider FDI desirable because it brings new technology, managerial knowhow and also contributes to economic growth.

1.4 Scheme of the Study:

The remaining paper is organized as follows: After introduction in part 2, review of the articles is given. Part 3 discuss the Econometric Model and explain the variables. Part 4 provides the results, whereas part 5 concludes.

2. Literature Review:

Dunning (1980) suggested that the firm should have an ownership advantage and this ownership advantage act as a competitive advantage for them. Similarly, locational advantage over another site is also very important factor to be considered. Before internalisation, a firm sees these factors and then decide whether it's beneficial for them to invest or not. According to Dunning these three factors, that are, Ownership, Location and Internalisation (OLI) act as a three legged stool and each leg is equally important to keep the balance. We can't say that one leg performs better than the other.

Blomström and Kokko (1998) states that RTA's have different effect at country and industry level. If the locational and environmental conditions of the country are stronger, then RTA will lead to more inward FDI. In case of industries, the level of investment by the MNC in host countries would not be affected by the formation of RTA. Mallampally and Sauvant (1999) said that the developing countries are becoming attractive for overseas investors. Multinational corporations make FDI to control the activities themselves. FDI usually helps in economic development; therefore the host governments are formulating policies beneficial for them. MNCs seek large markets, cost reduction etc. in the developing host.

Alexander (2002) concluded that for FDI, the MNC's consider human capital, infrastructure of the host country and the steps taken by the government of the country to attract FDI. Privatization schemes are also one of the important factors, which in can bring higher level of FDI. Rose (2002) concluded in his paper that the countries which belong to the WTO/GATT do not have a much different pattern of trade than the countries which aren't members of WTO/GATT.

Driemeier (2003) investigated bilateral investment treaties (BIT's) role in attracting FDI. He found that in the countries having weak property rights protection, BIT's do not serve as a substitute for them to increase investment. On the other hand the countries having good property rights protection, BIT's serves as a complement enhancing inward FDI. Jaumotte (2004) examined RTA effects FDI in 71 developing countries from 1980-1999 and concluded that the countries having different RTAs benefited more than the countries having same RTAs. According to him, market size is the main factor for FDI attraction. Other factors may include labour force, financial development etc. Yeyati, Stein and Daude (2004) examined the effect of FTAs on bilateral stock of FDI using a panel data for sixty countries. Their findings show that the host and source country effect matters and formation of an FTA positively affect inward FDI.

Baier and Jeffrey (2005) deliberated free trade agreements effect on FDI of the member countries and concluded that the countries having similar FTA's, mostly have same type of economic characteristics which results in greater integration of the international firms and higher investments. Nonetheless, some time they have to face problems because of the regulatory polices between these countries. FTA effect the member countries in different ways because of the policies mentioned in the agreement, the size of the economy and the per capita income of both members. Liu (2006) mentioned in his paper that China was the world’s largest FDI receiving country in 2003. He examined that how RTAs affects FDI in China and states that MNCs while investing in China will consider all the factors like market size, growth level, labour force and economic conditions. RTA’s encouraged trade between the member countries instead of investment from non-member countries. Khan (2007) argues that a well-educated workforce is perceived as an important incentive in overseas investment location choice. Countries that have developed human capital attract FDI. FDI positively affect growth and productivity in those countries.

Büthe and Milner (2008) using a sample of 122 developing countries found that member countries of trade agreements, have higher inward FDI. In order to attract more FDI, an economy needs to use GATT/WTO and PTAs, to create the fruitful environment for FDI. Baltagi, Egger, and Pfaffermayr (2008 investigated the role of agreements signed between EU and 10 Central and Eastern European counties. Their results show that for bilateral FDI, RTAs are important. They concluded that large volume of trade between two host countries shows that the consumers in those markets can be served at lower cost. Trade polices of RTAs, not only effect trade but also FDI, not only with in the partner countries but also with other host countries.

Easterly (2009) examined FTAs signed between different countries and their effect on inward FDI. He concluded that due to FDI, the development level of the host country increases because FDI brings foreign technology as well as skills in the host countries. Presence of human capital, low trade barriers, higher educated population increases inward FDI. Moon (2009) discussed the impact of FTA on vertical and horizontal FDI and the benefits of joining a free trade agreement. In case of vertical FDI, countries having FTA increases the trade between them but outside the region FDI remained unaffected. In case of horizontal FDI, within the countries FDI decreases but increases from outside the region. Seim (2009) argues that openness is positively associated with FDI inflows. The effect of changes in openness on FDI inflows varies according to the motivation for engaging in FDI activities. Firms that wish to expand their market might conclude that in the face of a high degree of openness little restriction and low trade costs, the market could be better served through export rather than FDI. As a result high level of openness is associated with low level of FDI. However, horizontal investment can also be made to serve adjoining markets due to greater degree of regional openness.

Ahmed, Ahmed and Sohail (2010) used different approaches to analyse Pakistan and Sri Lanka trade pattern before and after the Free Trade Agreement (FTA) and found that trade between the two nations has increased after the FTA. Still, these two countries need further cooperation in the field of textile, education, science, tourism and technology.

Gudicello (2011) analysed the regional trade agreement (RTA), tariff rates and trade pattern of 15 developing countries with USA. Except Chile, USA faces a higher tariff as compared to the 15 RTA partner countries. USA exports a number of goods to these countries but U.S imports are minimal from these developing countries which are RTA's partners, because in addition to the RTA's some other factors like tariff rate and market access preferences also create hurdles for US exports to these countries. Mughal and Akram (2011) investigated the effect of market size along with exchange rate and corporate tax on FDI inflow and found that they affect FDI in the long run whereas it has no effect in the short run.

Shah and Samdani (2015) studying FDI trade liberalisation effect on inward FDI in D-8 countries found it to highly influencing overseas investors. Shah (2015) got the same results. Shah (2017) exploring the significance of WTO's trade related investment measures (TRIMs) agreement for inward FDI in Sub-Saharan Africa used the aggregate trade agreements signed by a country as a proxy for TRIMs and witnessed them to have a positive sway on the multinational investment decision.

3. Model Specification

3.1 Methodology:

The purpose of this paper is to know the impact of trade agreements on the presence of transnational corporations in the Asian developing countries. A sample of nine developing economies comprising of China, India, Indonesia, Pakistan, Malaysia, Sri Lanka, Philippines, Thailand and Vietnam over the period 1990-2010 is considered. The data for the dependent variable inward FDI stock is taken from UNCTAD FDI statistics. The data for the independent variables GDP, GDPPC, Trade, Labour force are taken from the World Bank. WTO-Trade agreement gate way is used to collect data on trade agreements.

3.2 Econometric Model:

Based on the discussion in the first two sections the following empirical equation is set to gauge the effect of trade agreements on FDI:

$$\boldsymbol{LnFDISTK_{jt} = \begin{matrix} \alpha_0 + \beta_1 lnGDP_{jt} + \beta_2 lnGDPPC_{jt} + \beta_3 lnTrade_{jt} + \\ \beta_4 lnLabourforce_{jt} + \beta_5 lnTTA_{jt} + \mathcal{E}_{jt} \end{matrix} \quad \ldots\ldots\ldots 1}$$

Note that the LnFDIstock is the natural log of FDI stock. Similarly, for the market size LnGDP is the natural log of gross domestic product, for development level LnGDPPC is the natural log of gross domestic product per capita, for openness LnTrade is the natural log of trade, for human capital LnLabourForce is the log of labour force and for trade agreement

LnTTA is the natural log of total trade agreements. Total trade agreements are the sum of RTAs, FTAs and PTAs signed by each of the economies included in the research.

3.3 Explanations of the Variables Included in the Model:

3.3.1 FDI Stock:

FDI stock is the measure of existing accumulative foreign direct investment (Shah, 2010). It includes the stock of capital and reserves that originates from abroad and is invested in the host country for the purpose of long-term investment (Shah, 2011a). Nations keep track of their FDI level and include this information in their annual reports discussing their economic health and projections for the future because it provides a signal to the investors that there are opportunities of possible higher profits for multinationals.

3.3.2 Size of the Host Market:

Market size of the host nation is one of the important factors for attracting FDI. Many studies show that the size of the domestic market positively affects the inflow of FDI (Shah & Qayyum, 2015). Market size is measured by GDP and it is noticed that inward FDI is greater in those countries that has large market, high economic growth and greater purchasing power (Shah, 2013a). So by investing in those countries, the MNC's receive higher return on their investments and their expected profits are higher (Shah & Khan, 2016). Large market size is required for the efficient utilization of the resources and to take advantage of economies of scale (Shah, 2016b).

3.3.3 Development Level:

Development level is measured by using GDPPC as the proxy. Growing economies are sought by overseas investors (Shah, 2009). Therefore, it is expected to have a significant effect on inward FDI.

3.3.4 Openness:

FDI is also affected by host country degree of openness for trade and investment (Shah, 2011e). In case of horizontal FDI, the existence of a regional trade agreement positively affects FDI inflows (Shah & Ali, 2016). Moreover, in case of vertical FDI, the MNC's seeks to take advantage of natural factor endowment and for them the high degree of openness is good, because low trade barriers and lower cost is added to the total cost of products produced for the purpose of export to the other subsidiaries of the firm for value addition (Shah, 2016c). Hence for these firms greater openness has a positive impact on investment.

3.3.5 Human Capital:

Several studies demonstrate human capital vitality as an important determinant of FDI in developing countries (Shah, 2014a). FDI is discouraged by lack of skilled human capital.

Educated and trained labour force not only results in higher FDI but also affect the activities performed by MNC's in host countries (Shah, 2011f). MNC's while opening subsidiaries in the host country not only look for machinery, technology, and equipment's but also seek the presence of skilled and capable local employees (Shah, 2012c; Shah, 2013b). The degree of training given to employees vary according to the industry, mode of entry, type of operation, condition of local market and investment nature (Shah & Faiz, 2015). Presence of skilled and educated labour results in the reduction of training cost.

FDI also effect the tertiary education of the host country. MNC's provides opportunities to the skilled students in the field of engineering, business and natural sciences and this helps the graduates to complete their tertiary training and in return the local governments also invest in education because of MNC's demand for skilled labour (Shah & Afridi, 2015).

3.3.6 Trade Agreements:

Trade agreement is one of the best ways to open market for MNC's to do FDI in the host country. Trade agreements remove barriers, protect interest and enhance efficiency of the multinational firms in host country (Shah, 2012a). Removal of trade barriers and creating a more stable trading and investment environment make it easier for the MNC's to do investment in the host country. The common trade agreements are regional trade agreements (RTAs) and the preferential trade agreements (PTAs).

3.3.6.1 Regional Trade Agreements:

More than half of the international trade is covered by RTA's. They operate alongside global multilateral agreements under WTO. RTA's are basically the regional grouping of countries formed with the objective of reducing trade barriers between member countries (Shah, 2014b). These unions or grouping are between countries belonging to the same geographical region. European Union (EU), North American Free Trade Agreement (NAFTA) are the examples of regional trade agreements signed between the neighbouring member countries.

3.3.6.2 Preferential Trade Agreement:

It is a trade agreement signed between countries that reduces tariff for certain products for the member countries. It is a form of an economic integration. Countries engaging in PTA's also intend to increase mutual FDI. PTA leads to the replacement of high-cost domestic production by the low-cost imports from other members (Shah, 2011b). Similarly Custom Union (CU) requires common external trade policies towards non-members e.g. European Custom Union (EU) being a fully functional custom union.

3.4 Hypothesis:

The following hypothesis is set to answer the research question

H_0: Trade agreements are not an important factor attracting FDI to developing Asia.

H_1: Trade agreements are one of the important factors attracting FDI to developing Asia. .

4. Results and Interpretations:

The results and findings as well as the diagnostic tests are discussed over here.

4.1 Statistical Techniques:

Having data from nine economies for twenty years the first task is to choose the appropriate panel method.

4.1.1 Hausman Specification Test:

The Hausman (1978) specification test is used to test whether random effect or fixed effect is the suitable panel method to be used for the regression analysis (Shah, 2012d). The probability of 0.0000 shows that the coefficients estimated with both the methods are significantly different than each other. Therefore, we have to reject the null and apply fixed effects.

4.1.2 Descriptive Statistics:

It is the representation of the different basic statistics regarding the research study that includes the information regarding the number of observations, highest value, lowest value, mean, variance and median (Shah, 2016a). Table one represents the descriptive statistics of all the variables included in the research study.

4.1.3 Correlation Matrix:

Correlation is used to check how much the variables are related with each other. The value ranges from +1 to –1. The correlation of a variable with itself is 1.00, showing a perfect correlation. If the correlation between two variables is one, it means they are perfectly correlated. If the correlation is negative, it shows that the variables move in the opposite direction. If it is positive, the variables move in the same direction. If the correlation is 0, it means that they are completely unrelated.

If the independent variables are highly correlated it is a sign of extreme multicollinearity (Shah, 2012b). Table two represents the correlation matrix. As evident the degree of association between them is not alarmingly high. Therefore, multicollinearity should not be a problem in the analysis.

Table 1: Descriptive Statistics

Variables	Proxy	Obs	Maximum	Minimum	Median	Variance	Mean
Foreign Direct Investment Stock	lnfdistk	189	27.09	19.30	23.52	2.27	23.54
Market Size	Lngdp	189	29.41	22.59	25.47	1.89	25.57
Development Level	lngdppc	189	9.07	4.59	6.88	0.75	6.95
Openness	Lntrade	189	5.40	2.78	4.27	0.36	4.24
Human Capital	Lnlbrfrc	189	20.49	15.70	17.46	2.09	17.80
	Lnterredu		0.711	0.53	0.17	0.02	0.22
Trade Agreement	Lntta	189	3.17	2.19	2.48	0.06	2.50

Table 2: Correlation Matrix

Sr. No	Variables	Proxy	1	2	3	4	5	6	7
1	**Foreign Direct Investment Stock**	Lnfdistk	1.000						
2	**Market Size**	Lngdp	0.820	1.000					
3	**Development Level**	Lntgdppc	0.544	0.288	1.000				
4	**Openness**	Lntrade	0.185	-0.314	0.618	1.000			
5	**Human Capital**	lnlbrfrc	0.519	0.822	-0.293	-0.621	1.000		
6		Lnteredu	-0.099	-0.170	0.33	0.293	-0.389	1.000	
7	**Trade Agreement**	lntta	0.307	0.400	0.22	-0.192	0.246	0.344	1.000

Table 3: Results with Fixed Effects Panel Method

Variables	Proxy Used	1	2	3	4	5	6
Market Size	**Lngdp**	1.4746*** (0.5987)	3.8780*** (0.4808)	3.1960*** (0.4140)	5.9006*** (1.4311)	6.6895*** (1.4504)	6.7329*** (1.4350)
Development Level	**lngdppc**		-2.8003*** (0.5570)	2.2937*** (0.4743)	-4.9764*** (1.4366)	-5.6907*** (1.4494)	-5.6205*** (1.4342)
Openness	**Lntrade**			1.1987*** (0.1408)	1.2037*** (0.1397)	1.2013*** (0.1379)	1.2003*** (0.1364)
Human Capital	**lnlbrfrc**				-2.1191*** (1.0722)	-2.3320** (1.0621)	-2.2186** (1.0520)
	lnterredu					-1.7491*** (0.7353)	-0.9504 (0.8133)
Trade Agreement	**Lntta**						0.6074** (0.2768)
No. of Observations		189	189	189	189	189	189

*** Significant at 1%, ** Significant at 5%, * Significant at 10%

4.2 Results & Analysis:

The results obtained using panel fixed effect estimation technique for all the estimation models are given in table three. The size of coefficient of the market size (Lngdp) is 1.47 which means that 1 unit increase in GDP will causes almost one and half times increase in FDI at one percent level of significance. With the addition of development level (Lngdppc), in model two the impact of market size remains significant and development level (Lngdppc) exhibits a negative coefficient of -2.80 but it is only significant at ten percent.

Including the third variable openness (Lntrade) in model three shows its positive significance whereas market size and development level retains their earlier significance. Similarly, including the fourth variable human capital (lnlbrfrce) in model four proves to be negatively significant like development level. This when read together with the positive significance of market size and openness proves that multinationals seek large open markets but are apprehensive of high wages. Development level not only acts as a degree of progress but also of relative wage rate and purchasing power of the people. Increased availability of labour shall positively influence multinationals operations but they should be skilled also. This negative insignificance may be due to their relative inexperience and untrained nature. Moreover, using another proxy used for human capital as average territory education also proves to be highly negatively significant. Hence, this provides further evidence that skill level matters but at a low wage.

By including the main variable trade agreements (Lntta), it has a significant effect. This highlights that multinationals realise that trade agreements increases the size of the host market. The target market is now not only that of the host but also of all the member countries especially in a regional trade agreement.

5. Conclusion:

This paper has examined the factors that affect the presence of transnational corporations in developing Asia. The main focus is on the trade agreements but they alone are not enough to attract the overseas investors. The other factors like size of the host market, development level, openness to the trade and human capital are also analysed. They provide a good framework to promote FDI. The analysis shows that all these factors significantly affect MNCs to do investment in these countries.

According to the results market size and development level are important factors. More FDI is done in the countries having larger markets and an enhanced purchasing power of the consumers. FDI stock is also attracted by those countries, which are more open to trade and have a liberalised investment and business environment. Lower the trade barriers more shall be FDI inflows to that region. Along with these factors the presence of educated labour is also an important element in determining FDI. MNC while deciding to make investment in other region not only look for the location, trade barriers but also the availability of the cheap, trained and skilled labour.

Finally the results show the significant relation between trade agreements and FDI stock. Trade agreements with in the specific region are the reason for the higher FDI between these regions. The republics, which are member of trade agreements, have open trade and investment polices with other member countries and hence positively influences their investment decision.

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