Economic Integration and Bilateral FDI stocks: the impacts of NAFTA and the EU

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This paper investigates the factors affecting Foreign Direct Investment (FDI) stocks in high income countries. It feeds in to the debate on the impact of EU Integration on the UK economy. The Single Market Programme (SMP) appears to have raised intra-EU FDI stocks by around 40 per cent as compared to what it would otherwise have been. The formation of the North American Free Trade Area (NAFTA) has not had a similar impact.

We investigate bilateral FDI stocks from the 14 largest high-income OECD countries to all OECD countries over 1995-2015, covering the period of intense Globalisation and European Integration that began after the WTO was set up and the Single Market Programme (SMP) in Europe completed. We look at the impacts of measures of market size, proximity and distance, membership of the Single Market and impacts from the Euro.

FDI has increased much more rapidly within Europe than elsewhere, and between 2003 and 2012 French and German outward FDI stocks almost doubled as percent of their GDP, with an increased orientation to other Europeans. The inward FDI stock in the UK rose from 28 to 48 percent of GDP over the same time, with the European share rising from 47 to 58 percent, and the US share falling from 38 to 29 percent.

Our most important finding is that the SMP has significantly increased stocks of FDI within the Market, given the other factors driving FDI. Single Market membership raises FDI from other members by over 40 per cent, with supply chains spreading across the market area. The research suggests that the UK's departure from the Single Market may reduce the stock of FDI in the UK from EU countries such as Germany, France and the Netherlands by 30 per cent.

Our research suggests that the UK has not attracted additional FDI from outside the EU, apart from that which can be explained by the use of a common language with economies such as the US, Canada and Australia. There appears to be no unique set of factors or institutions attracting FDI to the UK.

Gradual improvements in communications technology and the growth of the internet may lead to the 'Death of Distance'. Our findings indicate that distance is becoming a less important factor over time for FDI decisions, but, given the speed of decline it will remain important for the next 150 years or more. Over our sample period if distance increased by one per cent, the bilateral stock of FDI would have fallen by about 0.43 per cent in the long run.

The effect of host country size is fifty percent larger than that of either home country size or distance between home and host. Our results therefore suggest that FDI is market seeking. Leaving the Single Market will reduce the size of the market available to foreign producers located in the UK, which will reduce FDI stocks. We estimate overall stocks of FDI in the UK could fall by 20 percent.

We have tested for equivalent effects in NAFTA and they are not significant. The nature of integration within the NAFTA region is different from that within the EU, and such trade agreements are not aimed at increasing economic integration between the countries involved. Substituting a free trade agreement for the SMP will not reverse the negative effects on FDI.

Our findings indicate that there is no additional effect from the creation of a common currency. When both countries are in the Euro zone, FDI is around the level other factors would predict.