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Foreign Direct Investment

The impact of NAFTA

The calculations presented earlier have estimated the static effects of changes in tariffs and non-tariff barriers, including regulatory barriers. In reality, the so-called dynamic effects may be just as important – indeed a common practice among analysts estimating the effects of changes in trade regimes is to double the static effects to get the overall effects. The dynamic effects derive from the incentives to plan for future trade expansion through investing in plant and equipment in the sectors where foreign barriers are reduced, transferring technology and management skills from abroad, undertaking research into production techniques and market opportunities, training and human resource development in general. Most of these activities involve investment expenditures of one sort or another. Like trade itself, investment designed to enable future trade expansion may be created or diverted by changes in trade regimes, including multinational liberalisation as under the UR or the establishment of a free trade area in NAFTA. It is not surprising that the concerns of the Caribbean are as much to do with the diversion of direct foreign investment to NAFTA members as they are with the direct loss of exports.

As far as the Caribbean is concerned, the major concern is diversion of FDI towards Mexico, the principal competitor in those goods which the Caribbean exports. I have argued that the sector where trade diversion is likely to be greatest is apparel, particularly apparel exports from Jamaica. Jamaica is a witness to the mobility of international apparel companies, both American and from the Far East. If conditions of access to the North American market are clearly more favourable, after taking into account investment costs, labour costs, environmental and other legal and social legislation, and transport costs, these companies would have no hesitation in moving their operations, either in part or lock, stock and barrel to Mexico.

A report of the United States International Trade Commission analysed the extent to which NAFTA could affect investment in the assembly-type apparel industry in the CBI countries. The factors most often cited as favouring investment in Mexico over the Caribbean were:

- cost savings from tariff-free entry;
- opportunities for vertical integration and/or scale economies;
- elimination of quotas.

Against investment in Mexico were the projected appreciable changes in rules of origin which are not in all cases more liberal under NAFTA than under the CBI (CARICOM 1994)[15]. In the most sensitive products, free trade within NAFTA is reserved for apparel that is yarn-forward, that is not only must the fabric be made within NAFTA but the yarn must be woven within NAFTA. A lesser requirement is that a product be fabric-forward, that is the fabric must be made within NAFTA (similar to the requirement for Caribbean 807A exports to the US). Thus, for the most sensitive articles, the NAFTA rule is actually more demanding than the CBI rule. One of the reasons for the expansion of 807A exports from the Caribbean to the US was difficulty in meeting the GSP rules of origin. Now that NAFTA has imposed even stricter rules, at least for a subset of apparel products, it is perfectly possible that the rules may discourage companies from Mexico and encourage them to stay in the Caribbean, or if they are not there already, to invest there.

Still, the cost savings from tariff-free entry of 807A-type goods may be quite significant – Mexican producers will be saved the tariff on the value-added by the Caribbean assembler, on average some 25 per cent of the fob value – since the peak rates of the US and Canadian tariff schedules include disproportionate numbers of items of apparel. 42 per cent of US imports of textiles and apparel faced pre-UR tariffs of over 25 per cent with significant numbers of tariffs in excess of 40 per cent. Even after the UR tariff reductions, there will be plenty of US tariffs on apparel in excess of 30 per cent.

As regards apparel exports subject to MFN tariffs and, in many cases, MFA quotas, the advantages of investing in Mexico are clear cut. The US and Canadian tariffs on imports from Mexico will be removed within five years and the MFA quotas phased out over the same period, roughly five years in advance of their final elimination under the UR Final Act. Mexico has also had an 807A-type derogation of tariffs on apparel assembled from US-formed and -cut fabrics. Now with quota-free exports to the US, it may be worthwhile resourcing some of the imported fabrics in third countries where the cheaper materials may justify the tariffs that have to be paid on them.

There may also be gains from scale economies for firms operating in Mexico that become available as the costs of importing inputs, perhaps in the form of fabrics, falls as the Mexican tariff is phased out. The market for these firms does of course include the local Mexican market.

On those goods where the CBI in principle does give tariff-free access to the US and Canadian markets but that benefit is not taken up, either because of the rules of origin, the bureaucratic costs or for other reasons, exporting to the US or Canada from Mexico will, within five years, be tariff-free. In this case, the advantage of producing in Mexico will be less clear cut because of the possibility that CBI utilisation rates could be rapidly increased.

Investment will clearly be affected by a myriad of other factors than ease of access under NAFTA – for example wage costs, locational advantages, transportation and other infrastructure facilities and fiscal and other governmental incentives. Under Section 936 of the US tax code, US investment in the Caribbean may be eligible for advantageous tax treatment. There are also certain fiscal aspects of NAFTA which give FDI in the Caribbean a certain limited advantage (see World Bank, 1994a, 101).

The UR does impose disciplines on Trade Related Investment Measures (TRIMs), which mean that NAFTA has not been able to introduce grossly distortive regulations favouring FDI from other members. Indeed, it even appears that Mexico has gone out of its way to be multilateral in its recent-promulgated foreign investment rules. The UR also requires that countries offer national treatment to overseas investors, though there is a five-year transition period for developing countries. Mexico has traditionally been highly unwelcoming to foreign investors, limiting the areas in which they could operate. Ownership was restricted in a number of sectors such as land, forestry, financial institutions, the media, oil extraction, petrochemicals and gas. However, in 1989 the first of a series of liberalisations took place.

Now the 1993 Mexican foreign investment law has effectively extended NAFTA's liberal investment regime to all other countries. Some sectors remain excluded, in particular oil, gas and petrochemicals, but the local content rules and export requirements have been dropped far in advance of any requirement under the UR. Although this multilateral liberalisation goes beyond what the UR or NAFTA require for the present, the UR and NAFTA do give some confidence that the new liberalisation will not quickly be undone. There are other, more tenuous but not necessarily less real, factors affecting investment decisions and which could lead to investment diversion to Mexico – or elsewhere in NAFTA – from the Caribbean. Simply being part of a large trading bloc must improve Mexico's attractiveness to foreign investors.

On the other hand the momentum for trade liberalisation may make investors think twice about relocating from the Caribbean to Mexico, or choosing Mexico in the first place on the basis of what might be ephemeral advantages. The potential gains from trade diversion for Mexico are dependent on the continuance of significant tariffs on US and Canadian imports from other sources, given that the UR will be broadly successful in eliminating the non-tariff barriers of the developed countries. If the liberalisation momentum continues, the favourable tariff differentials will be eroded in due course. Already there is talk of a new round of multilateral trade negotiations. After that has taken place, MFN tariffs should be largely confined to remaining sensitive products – which may still include apparel.

FDI in the Caribbean

As long as tariffs are significant obstacles to trade, in attracting third country investment, the Caribbean countries retain one significant trump card – exports can generally obtain tariff-free entry on the US, the Canadian and the EU markets.

Foreign direct investment has made a major contribution to filling the overall payments gap in a number of ACP Caribbean countries. Table 16 gives net inflows of FDI between 1987 and 1993[16]. For most countries these have fluctuated from year to year, in some cases indicating significant disinvestment. However, there has been a considerable increase over the period, with just an indication that net inflows into the region may have peaked in 1992. The experience of the region reflects that of the developing world as a whole. FDI has held up remarkably well despite the recessions in the developed countries and the emergence of Eastern and Central Europe, and the efforts of those countries to attract investment.

The main driving force behind FDI is globalisation. There has been a breakdown in the relevance of traditional national markets as transnational companies seek to establish production facilities where costs are low, the regulatory and fiscal frameworks are benign and the political framework is predictable, in order to service regional or even world markets. It is part and parcel of this new order that parts for a single product may be fabricated in many different countries, and indeed that the product itself may undergo a number of manufacturing processes in different countries. Of course, the transnational corporations (TNCs) must take into account the costs of trade barriers on intra-company trade. They must also take into account the benefits of a large domestic market for the product in the country of its final processing.

On both these scores the Commonwealth Caribbean countries fare badly. Domestic markets are small. And there are still significant tariff and non-tariff barriers on trade, even within CARICOM, and even more so between the CARICOM countries and the non-CARICOM islands and Central America.

To offset some of these problems, a number of Caribbean countries have established export processing zones (EPZs). These allow trade to take place unburdened by import barriers on material inputs or semi-processed goods or export restrictions and taxes which still exist in some countries. Their establishment was boosted by the Special Access Programme whereby apparel and metal manufactures are admitted to the US market on favourable tariff terms if they are fabricated from US-produced steel or cloth. In these cases US firms have been attracted by low wages in the Caribbean region, though East and South Asian firms have also been attracted, in their case as a way to circumvent the MFA quotas on their exports of apparel to North America.

As of the middle of 1989, there were already nine EPZs in Barbados and seven in Jamaica (USITC 1991). The USITC also reports 14 new CBERA-related investment projects in Jamaican EPZs in 1992, including in the fruits and vegetables, cut flowers and house plants and electrical devices sectors. But US tariff concession on 807A apparel has been the greatest single

Table 16: **Net inflows of foreign direct investment, 1987-93, $ million**

	1987	1988	1989	1990	1991	1992	1993
Antigua	39	31	41	59	52	20	15
The Bahamas	11	37	25	-17	0	7	-24
Barbados	7	11	8	11	7	14	n.a.
Belize	7	14	19	127	15	18	11
Dominica	10	7	8	8	11	14	10
Grenada	15	15	10	13	15	23	31
Guyana	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Jamaica	53	-12	57	138	127	87	139
St. Kitts	17	13	41	49	21	14	12
St. Lucia	15	16	27	45	58	46	50
St. Vincent	6	10	11	8	9	19	29
Trinidad	33	63	149	109	169	178	n.a.
Total exc. Guyana	**213**	**205**	**396**	**550**	**484**	**440**	**n.a.**
Domin. Rep.	**89**	**106**	**110**	**133**	**145**	**180**	**183**
Mexico	**1,184**	**2,011**	**2,785**	**2,549**	**4,742**	**4,393**	**4,901**

Source: IMF, Balance of Payments Yearbook, 1994

magnet for FDI in Jamaica, as well as in the Dominican Republic. Incidentally, by the end of 1992 there were 27 EPZs in the Dominican Republic.

The EPZs have generally helped the process of export diversification, though there has been widespread criticisms that (i) they have failed to promote skills, and (ii) there has been minimal vertical integration with the local economy. Part of the reason for the latter is the lack of financial incentive to buy local inputs or sell on local markets, problems that are being attacked by a number of fiscal derogations for local firms who trade with firms inside the EPZs.

A number of Commonwealth Caribbean countries have made other efforts to improve the climate for FDI. These efforts have often been undertaken in the context of policies to improve structural adjustment. In other cases, traditional fiscal incentives such as tax holidays have been instituted and restrictions on the repatriation of profits and capital and other disincentives, including sectoral investment restrictions or embargos and authorisation and registration procedures, have been reduced. Efforts are often required to sell FDI to local people, who resent the privileges given to foreign firms and individuals and worry about their property rights.

Another approach is through signing bilateral investment treaties with developed countries which typically guarantee at least national treatment of foreign investments plus other elements such as the full compensation in the event of nationalisation. A few countries of the region have recently signed bilateral investment treaties (BITs), including Barbados and Trinidad and Tobago with the United Kingdom, Trinidad and Tobago with France and Jamaica with France, the United Kingdom and the United States. The practice is likely to grow, not least because any further regional preferences introduced by the United States, and most certainly membership of an expanded NAFTA, are going to require that such a treaty be signed.

Table 16 suggests that Jamaica and Trinidad and Tobago have gained particularly from FDI over the past decade. However, if the figures are related to the size of the economy a different picture emerges. Relative to GDP, FDI has in general been greatest in the small island states of

Table 17: **Domestic and foreign investment in Jamaica, 1986-93,** J$m. and per cent

	1986	1987	1988	1989	1990	1991	1992	1993
Domestic Investment								
total, J$m.	**226.2**	**540.4**	**891.0**	**124.8**	**138.7**	**592.7**	**683.0**	**281.0**
				per centage				
agriculture	48.4	32.5	2.1	9.8	23.2	3.0	81.5	14.5
tourism	6.9	52.7	1.9	24.0	62.5	92.1	1.0	38.4
inform. proc'g.	5.8	2.3	–	2.2	0.6	0.8	–	1.0
manuf.	10.3	7.8	85.6	0.2	0.7	–	–	–
min'ls, chems.	21.7	0.5	0.2	–	–	2.8	10.8	7.9
textiles	5.8	3.7	0.3	42.9	9.7	0.1	1.1	1.2
other(a)	1.1	0.4	10.0	20.8	3.4	1.1	5.6	36.9
total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Foreign Direct Investment								
J$m.	**64.0**	**166.0**	**141.0**	**28.0**	**127.0**	**129.0**	**410.0**	**393.0**
				per centage				
agriculture	46.6	4.1	4.2	35.8	5.2	22.1	6.6	–
tourism	6.2	53.7	45.0	12.1	0.2	6.7	8.5	1.6
inform. proc'g.	2.8	–	0.1	–	3.1	1.2	3.9	27.7
manuf.	17.1	5.2	15.8	0.4	–	14.2	2.3	–
min'ls, chems.	–	–	–	–	–	14.8	5.4	1.0
textiles	23.8	31.1	22.2	11.6	82.9	13.9	9.6	34.7
other(a)	3.5	5.9	12.6	40.2	8.5	27.2	63.7	34.9
total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

a: includes investment in general services, film, small businesses and consultancies
Source: GOJ

the OECS. This investment has largely been in the tourist industry where it is clearly motivated by rather different factors from that in manufacturing. The same small country disadvantages are less constraining, though there have been widespread complaints about the difficulties (import licences etc.) and/or import duties on capital equipment which generally cannot be supplied locally.

Evidence of a NAFTA effect

It is not too early to expect FDI statistics to reflect some investment creation or diversion. The investment effect associated with the Single European Market anticipated the event by several years. However, it is too early to decipher the trends in FDI, let alone their causes. Obviously there have been a number of important factors influencing FDI flows, not least the recession in the DME countries and the differentially-timed recovery process.

Clearly, FDI in Mexico grew much faster over the 1987 to 1992 period than it did in the Caribbean, nearly quadrupling in the former case but only doubling in the latter. It more or less tripled in the Dominican Republic. 1993 was the first year in which investors could have had any certainty about NAFTA's terms. Nevertheless, there could have been a significant inflow into

Mexico even earlier on the expectation that NAFTA would be agreed. There was certainly a surge in 1991 but it is also obvious from the table just how fickle FDI flows are. The establishment of a sound macro-economic policy stance may explain the investment surge more than NAFTA expectations. Moreover the inflows were almost replicated by Brazil where there was no possible NAFTA effect.

Thus, any clear trend or recent expansion of FDI in Mexico that might be associated with NAFTA is confounded by other factors, recession and political uncertainty in particular. In 1993 the US became even more dominant as the source of investment – but whether this had anything to do with NAFTA is impossible to say[17]. American or Canadian companies may divert investment because costs of production or transportation are lower in Mexico. Companies from a third country have the added incentive of avoiding tariff barriers, not only Mexican but United States and Canadian as well.

Thus, while all factors do not point in the same direction, NAFTA membership, together with Mexico's new welcoming policy, must, on balance, lead to the expectation of some diversion of FDI. This will not be confined to the textiles and apparel sector where the tariff (and in the short-run quota) advantage is clearest.

In Jamaica, foreign investment has largely been concentrated in clothing and the tourist trade. As Table 17 indicates both domestic and foreign investment has been very lumpy. Single large projects can have a major impact on annual figures. The trends, however, are positive, with both the foreign and the domestic components expanding substantially since the mid-1980s. What the table does not reveal is any clear trend towards diversification of the productive structure. There are no identifiable upward trends in the shares of information processing, manufacturing, chemicals and minerals.

A more optimistic slant is given by USITC (1994), which, quoting JAMPRO, states that in 1993 over 100 projects benefited from FDI, worth $19.3 million. However, only three of these were CBERA-related (with an investment value of $1.4 million in agribusiness, mining, chemicals and castings), though a number of others were identified as likely to yield exports to the US (coffee liqueurs, bottled spring water, fruit puree, marble, bricks, bus assembly and refurbished auto parts). Clearly, FDI and diversification are proceeding hand-in-hand. The only question is whether the process is moving fast enough.