

Akhmetzaki Y.Zh.
**Foreign direct investment and
free trade agreement**

The article examined works on free trade agreement effect on foreign direct investment flows (FDI). Further focusing on Eurasian economic union (EAEU) members' FDI flows and business climate characteristics including easiness of doing business and strength of legal rights. Studies indicate that FDI will be reallocated to host countries, which experienced trade policy liberalization. Free trade zones are expected to attract the export-oriented investors since they are exempt from import duties. In order to achieve higher FDI inflows to the region, it is essential to coordinate the enforcement of investment provisions on fair treatment and dispute resolution of the EAEU Treaty with member states and enhance such provisions to non-member states.

Key words: foreign direct investment (FDI), Eurasian economic union (EAEU), free trade agreement (FTA).

Ахметзаки Е.Ж.
**Тікелей шетелдік
инвестициялар мен еркін
сауда туралы келісім**

Мақалада еркін сауда жөніндегі келісімнің тікелей шетелдік инвестицияларына (ТШИ) әсері жөніндегі жұмыстар қарастырылған. Сонымен бірге, Еуразиялық экономикалық одақ (ЕЭО) мүшелерінің ТШИ ағыны және бизнес-климат ерекшеліктері, заңды құқықтардың индексі мен бизнес жүргізудің жеңілдігі қарастырылған. Зерттеулер сауда саясатын ырықтандыру тәжірибесін өткізген мемлекеттер көбірек ТШИ қабылдайтынын анықтады. Экспортқа бағдарланған инвесторлардың еркін сауда аймақтарына келуі ықтимал, өйткені олар импорттық баж салықтарынан босатылады. Өңірге көп ТШИ тарту үшін, ЕЭО шартының мүше мемлекеттеріне қатысты инвестициялық тараптарының әділ қарау және дауларды шешу ережелерінің орындалуын қадағалау және мұндай ережелерді мүше емес мемлекеттерге қолдану маңызды болып табылады.

Түйін сөздер: тікелей шетелдік инвестициялар, Еуразиялық экономикалық одақ, еркін сауда туралы келісім.

Ахметзаки Е.Ж.
**Прямые иностранные
инвестиции и соглашение
о свободной торговле**

В статье проанализированы эмпирические исследования о влиянии соглашений о свободной торговле на потоки прямых иностранных инвестиций (ПИИ). Вместе с тем рассмотрены ПИИ стран Евразийского экономического союза (ЕАЭС) и их инвестиционные характеристики, включая легкость ведения бизнеса и индекс юридических прав. Исследования показывают, что ПИИ будут перераспределены в принимающие страны, которые осуществили либерализацию торговой политики. Экспортно-ориентированные инвесторы будут заинтересованы в зонах свободной торговли из-за освобождения от импортных пошлин. Для достижения более высоких притоков ПИИ в регион необходимо координировать исполнение инвестиционных положений договора ЕАЭС, касающихся справедливого обращения и разрешения споров с членами ЕАЭС и расширить применение данных положений на государства, не являющиеся членами ЕАЭС.

Ключевые слова: прямые иностранные инвестиции, Евразийский экономический союз, соглашение о свободной торговле.

FOREIGN DIRECT INVESTMENT AND FREE TRADE AGREEMENT

Empirical studies: foreign direct investment and free trade agreement effect

UNCTAD highlights that developing countries' foreign direct investment (FDI) inflow's share doubled to 43.4 percent since 1999, while developed countries FDI inflow share declined by 23 percent, amounting 54.6 percent in 2015 [1]. The role of FDI in economy can hardly be overestimated. A large strand of literature refers to the potential benefits from FDI and confirms the positive effect of FDI on economic growth of a recipient country through technology spillovers.

Alfaro et al. examine the causality between FDI and economic growth, and find that the improvement of financial market performance of the region is the essential prerequisite for positive effects of FDI on growth. They used lagged FDI and real exchange rate as instrumental variables for FDI and a legal measure for creditor rights for financial markets development in order to cope with endogeneity issue. They found that 20 of 49 countries gained considerably from FDI, where financial markets are used as the channel for positive impact. The authors highlight that for the long-run positive development and extended gains from FDI, country policies should include not only incentives intended for luring investments, but also those aimed at improving local financial markets [2].

Similarly, Xu estimated the growth rate of total factor productivity (TFP) of US multinational enterprises (MNEs) in the manufacturing sector of 40 countries. Empirical results indicate that there is a "catch-up effect" between technologically developed and less developed host countries, as the technology gap variable is found to be significant and with a negative sign. The value added of the affiliates' ratio to recipient country's GDP is positive and statistically significant, thus providing evidence of local firms' productivity growth. He suggests that improved productivity may be caused by higher competition with MNEs in the domestic host market [3].

Xu incorporated in the model MNEs' expenditures on licensing and royalties (TR) as a measure of technology transfer intensity in the recipient country, which appeared to be higher in developed countries – 4.3 percent and lower in less developed – 2.4 percent

during 1966-1994. TR has a significant and positive effect on annual growth of recipient country's total factor productivity. Additionally, the technology diffusion of US MNEs, approximated by affiliates' expenditures on TR as a share of host GDP, exhibits a positive and significant effect on TFP. Moreover, if there were no technology transfer from US manufacturing MNEs, the growth of host economies' TFP would be less by 0.35 percentage points. For developed economies the MNEs technology transfer and trade, the latter measured as the bilateral imports share of the weighted sum of R&D capital stocks between trading countries, account for a 1.34 percentage points increase of annual TFP growth, out of which MNEs' impact appeared to be about 40 percent. In contrast, the technology diffusion was found to be insignificant for less developed countries, due to the fact that threshold level of human capital for technology diffusion is required to be in the range of 1.4-2.4 years of secondary school attainment by males [3].

In his review of empirical studies on determinants of FDI Blonigen highlights that partial equilibrium analysis based on firm-level (or industry-level) models lack long-run determinants, and typically, two-country models fail to address the issue of interdependency of investment choices in neighboring host countries. The general equilibrium framework, which encompasses the aggregate country-level indicators, factor endowment differences of parent and host countries and spatial interdependence, is expected to reflect the complexity of FDI phenomenon better than the partial equilibrium model [4].

An earlier study by Rolfe et al. of the Caribbean region explored the FDI determinants. The survey results indicated that market orientation, country location, investment and product types, investing period and investment amount were highly favorable incentives for 103 American companies in 17 countries. Most companies did not specify labor force size to influence on investing incentives, while the alleviation of import duties was more preferred by export-oriented investors than MNEs interested in horizontal FDI. They suggest that free trade zones are most likely to attract such export-oriented investors since they are exempt from import duties, which implies a benefit for a firm in any case including the periods of no earned profits, while for tax holidays to be an incentive the company is required to have some profits. Above all other factors, no control or restrictions on dividend remittances was identified to be the most important, uncovering the fact that for MNEs the elimination of foreign exchange risk was the largest determinant for FDI [5].

Free trade agreements (FTA) are aimed at enhanced trade relations among member countries by lessening trade and non-trade barriers. In addition to trade creation and trade diversion outcomes, FTA can exhibit either positive or negative effect on FDI flows: higher FDI to the region or FDI reallocation to other countries. Trefler examined the Canada-US Free trade agreement by using secular growth fixed effects, industry-specific terms and business conditions in a difference-in-difference specification for industry and plant levels. For the Canadian market, the tariff cut resulted in a short-term job loss of 12 percent in import competing sectors and 5 percent job loss in manufacturing. Additionally, he found that import competing and export-oriented sectors experienced an increase in labor productivity of 15 and 14 percent respectively, which he attributed to low-productivity firms exiting the market and a possible reorganization of plants. The productivity increase of 7.4 percent in the manufacturing sector leads to 0.93 percent of annual economic growth. Trefler highlights the total positive effect of the FTA, as trade creation coefficient is higher than that of trade diversion. In addition, the import prices' decline in import competing sectors was about 7 percent. He attributes a slight increase in annual earnings of 5 percent to either a productivity increase or an increase in labor quality associated with changes in achieving tenure in that period [6].

Since the Australia – US Free trade agreement (AUSFTA) was introduced (2005) the allowed acquisitions' threshold of a foreign investor in Australia was subsequently raised from USD 50 million to USD 219 million. Kirchner's out-of-sample forecast analysis on AUSFTA showed the actual amounts of FDI compared with forecast values started to rise in 2006, subsequently reaching in 2011 the value of roughly USD 75 billion. He found that for Australia the portfolio investments variables and FDI appeared to be substitutes. In addition, trade openness and FDI were substitutes. The latter case is evidence of "tariff-jumping" FDI. Moreover, Kirchner pointed out that the foreign real interest rate and the exchange rate negatively influence FDI flows [7].

Baltagi et. al use the spatial heteroskedasticity autocorrelation consistent (SHAC) method of variance-covariance matrix for resolving the spatial error measurement in estimating bilateral FDI in European countries. The model includes such independent variables as the sum of GDP of host and home countries, a dummy variable for the European Agreement, the difference of log GDP of countries i and j , the difference between the ratios of the human capital endowment of countries i and j , interaction term for distance between the capitals

of each country pair, also an interaction term for the effect of human capital endowment on FDI. The total unbalanced panel data includes 24 parent and 28 host countries for 1989–2001. They note that the regional trade agreements (RTA) exerted a negative effect on FDI in Western Europe, and was followed by reallocation of FDI to Eastern European countries. Generally, the results indicate that FDI will be reallocated to host countries, which underwent trade policy liberalization [8].

FDI in Eurasian economic union countries

The Eurasian economic union (EAEU) was established on the territory of Belarus, Kazakhstan, Russia, Kyrgyzstan and Armenia since The Treaty on Eurasian Economic Union became effective in January 2015. The major aim of EAEU is to achieve free movement of labor, capital, goods and services among member countries. The Treaty on Eurasian Economic Union provides the legal framework for the liberalization of trade in services, incorporation, investment, regulation of financial markets, provisions on intellectual property, patent rights and production secrets. The investment section of the treaty ensures the provision of unbiased treatment for investing member states, protection of member state firms' property from expropriation and guarantees just settlement of disputes. Although the EAEU Treaty contains the investment provisions section, it does not specifically state the creation of a free investment zone and lacks some provisions on investments from countries outside the EAEU region.

The Eurasian Development Bank's Integration Research Center reported that the estimated results of enhanced trade relations, production cooperation and leveling of technology development among Kazakhstan, Russia and Belarus would lead to a long-term annual GDP growth of 2.5 percent for each integration member. In 2030, the excess of GDP of Russia will amount USD 75 billion (in 2010 prices), USD 13 billion for Kazakhstan and USD 14 billion for Belarus. For 2011-2030 period, the total accumulated effect of integration enhancement is estimated to be more than USD 900 billion, out of which accumulated effect for Russia will be USD 632 billion (in 2010 prices.), for Kazakhstan - USD 106.6 billion and for Belarus - USD 170 billion [9].

Kheifetz argues that a free investment zone should be established on the territory of Eurasian economic union, which will stimulate investment flows to the region, and enable quicker integration of separate financial markets into common financial market, subsequently leading to free capital movement among EAEU countries. He provides an example of the Association of Southeast Asian Nations (ASEAN), under which the ASEAN Comprehensive Investment Agreement (ACIA) was adopted in order to create a special investment zone. The major goals of ACIA were to: provide liberal conditions for investments, protect ASEAN investors and their funds, maintain transparency and consistency by adopting common rules and create favorable investment climate for ASEAN investors [10].

Table 1 – Ease of doing business for EAEU countries, World Bank data

Indexes for 2015	Kyrgyz Republic	Belarus	Kazakhstan	Russian Federation	Armenia
Ease of doing business index (1=most business-friendly regulations)	67	44	41	51	35
Strength of legal rights index (0=weak to 12=strong)	8	2	4	6	5
Procedures to register property (number)	3	2	3	3	3
Time required to register property (days)	3.5	3	4.5	15	7
Time required to enforce a contract (days)	410	275	370	307	570
Time to resolve insolvency (years)	1.5	3	1.5	2	1.9

Despite the fact that the Russian Federation and Kyrgyzstan have stronger indexes of legal rights - 6

and 8 respectively, their business regulations are less friendly. Belarus and Kazakhstan have the most

business friendly regulations, and it requires less time to register property in these countries than in other EAEU members - about 3-4 days (Table 1). Kazakhstan needs to improve reinforcing legal rights and accelerate the contract enforcement time, since in comparison with other EAEU countries, legal rights in Kazakhstan appear to be rather weak and contract enforcement is time-consuming – 370 days. Although Belarus has favorable conditions for business, the strength of legal rights is the weakest among other EAEU countries. Additionally, time to resolve insolvency is twice larger in Belarus – 3 years, than in Kazakhstan and Kyrgyzstan, where the resolution of insolvency takes 1.5 years. In Armenia and Kyrgyzstan, it takes 570 and 410 days respectively to enforce a contract,

which must give investors concern [11]. In 2014 among the EAEU countries, Russia and Kazakhstan received the largest net FDI inflows - USD 20 958 mln. and USD 9 562 mln., whereas Kyrgyzstan and Armenia had the least incoming FDI of about USD 211 mln. and USD 383 mln (Figure 1). FDI inflows to Belarus increased from USD 191 mln. in 1998 to USD 1 798 mln. in 2014. The total net FDI to EAEU region in 2014 was USD 32 911.3 mln., which has declined by 42 percent since the Customs Union was adopted in 2010. Kazakhstan and Belarus are largest investors of the EAEU countries in Russian Federation, which during 2007-2015, amounted to approximately USD 1 592 mln. and USD 702 mln. respectively [12].

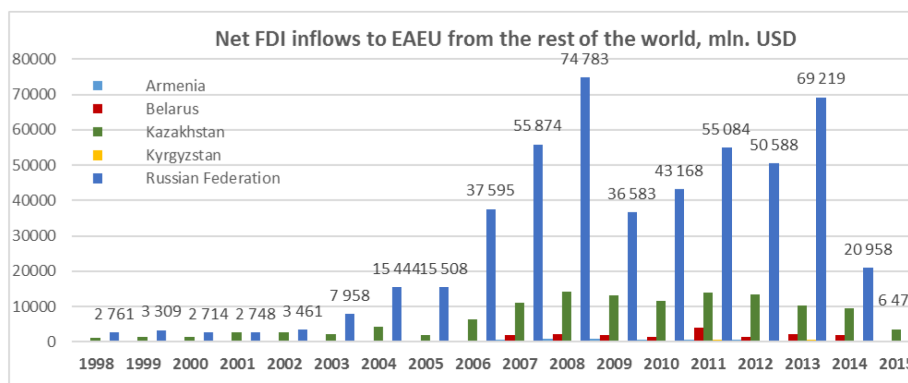


Figure 1 – Net FDI inflows to EAEU from the rest of the world, UNCTAD data

In 2014 the net FDI outflows from the EAEU region amounted USD 60 079.3 mln., out of which Russian Federation's outward FDI share was approximately 94 percent and Kazakhstan's share was 6 percent. Although

since Customs Union adoption the EAEU's total FDI outflow remains at a relatively same level, Kazakhstan's FDI outflow dropped from USD 7 885 mln. in 2010 to USD 3 624 mln. in 2014 (Figure 2).

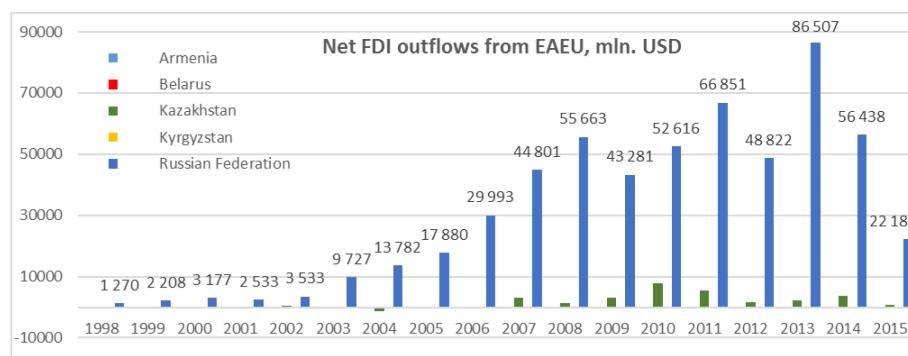


Figure 2 – Net FDI outflows from EAEU countries, UNCTAD data

Conclusion

The studies on free trade agreement's impact on FDI flows showed that there might be either positive or negative outcomes depending on various factors. Certainly, investment climate characteristics may play essential role in luring multinational enterprises to the region, apart from that there might be other crucial triggers such as whether the integration implies not only elimination of trade and non-trade barriers, but also establishing a free investment zone on the territory of integrated countries. In 2014, Russia and Kazakhstan obtained the largest net FDI inflows in the EAEU region, while Kyrgyzstan and

Armenia received the least FDI inflows. Kazakhstan needs to improve reinforcing legal rights and accelerate the contract enforcement time. In contrast, Russian Federation and Kyrgyzstan have stronger indexes of legal rights, but their business regulations are less friendly. Belarus has overall favorable conditions for business, however the strength of legal rights is the weakest among other EAEU countries. In order to achieve higher FDI inflows to the region, it is essential to coordinate the enforcement of investment provisions on fair treatment and dispute resolution of the EAEU Treaty with member states and enhance such provisions to non-member states.

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