

Kubny, Julia; Mölders, Florian; Nunnenkamp, Peter

**Working Paper**

## Regional integration and FDI in emerging markets

Kiel Working Paper, No. 1418

**Provided in Cooperation with:**

Kiel Institute for the World Economy – Leibniz Center for Research on Global Economic Challenges

*Suggested Citation:* Kubny, Julia; Mölders, Florian; Nunnenkamp, Peter (2008) : Regional integration and FDI in emerging markets, Kiel Working Paper, No. 1418, Kiel Institute for the World Economy (IfW), Kiel

This Version is available at:

<https://hdl.handle.net/10419/4281>

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## **Working Papers**

**Kiel Institute  
for the World Economy**



### **Regional Integration and FDI in Emerging Markets**

by Julia Kubny, Florian Mölders, and  
Peter Nunnenkamp

**No. 1418** | April 2008

Kiel Institute for the World Economy, Duesternbrooker Weg 120, 24105 Kiel, Germany

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**Regional Integration and FDI in Emerging Markets\***

Julia Kubny, Florian Mölders, Peter Nunnenkamp

Regional integration is often considered a means to improve member countries' attractiveness to foreign direct investment (FDI). But regional integration agreements (RIAs) as well as FDI are too diverse to allow for generalized verdicts. Our case studies on Mercosur in Latin America, ASEAN and SAARC in Asia, and SADC in sub-Saharan Africa caution against high expectations in several respects. First, country-specific factors were often more important as a stimulus to FDI than regional integration *per se*. Second, member countries are unlikely to equally share RIA-induced FDI inflows, even though the larger and richer members are not necessarily the winners taking all. Third, the regional heavyweights Brazil, China, India, and the Rep. of South Africa have played a minor role so far in fostering effective regional integration through outward FDI.

**Keywords** — foreign direct investment, regional integration, Mercosur, ASEAN, SAARC, SADC

**JEL codes** — F15; F23

**Julia Kubny**

**Florian Mölders**

German Development Institute

Tulpenfeld 6

53113 Bonn, Germany

Telephone: +49-228-94927-246

E-Mail: [Julia.Kubny@die-gdi.de](mailto:Julia.Kubny@die-gdi.de)

E-Mail: [f.moelders@uni-bonn.de](mailto:f.moelders@uni-bonn.de)

**Peter Nunnenkamp**

Kiel Institute for the World Economy

Duesternbrooker Weg 120

24105 Kiel, Germany

Telephone: +49-431-8814-209

Email: [peter.nunnenkamp@ifw-kiel.de](mailto:peter.nunnenkamp@ifw-kiel.de)

\* **Acknowledgements** — An earlier version of this paper was presented at the DIE Conference “Regional Economic Integration Beyond Europe” in Bonn in December 2007. The authors would like to thank participants for comments and suggestions. The authors also express their gratitude to the team of the Investment Issues Analysis Branch at UNCTAD for their fruitful cooperation. This paper draws extensively on UNCTAD data made available to Julia Kubny during her research at UNCTAD - DITE, Geneva.

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## 1. Introduction

There is no shortage of studies on the determinants of foreign direct investment (FDI). Likewise, a huge body of literature exists on the economic effects of regional integration agreements (RIAs) on both member countries and non-members. Both issues are not only of academic interest, but figure high on the political agenda almost everywhere in the world. Policymakers fiercely compete for FDI inflows which are widely believed to promote economic growth in the host countries. RIAs have mushroomed, partly because multilateral integration has been stalled, e.g., in the WTO context.

As matter of fact, RIAs are considered a means to improve member countries' chances to attract FDI. RIAs affect several factors on the list of possible FDI determinants, including effective market size, economic growth and trade costs.<sup>1</sup> According to Brenton et al. (1999: 95), "recent evidence suggests that regional economic integration provides an important stimulus not only to trade, but also to FDI." But it also appears that high expectations have often not been met. UNCTAD (1998: 118) notes "the failure of numerous regional integration frameworks in the 1960s and 1970s to exert any discernable influence on transnational corporations."

Most probably, both FDI and RIAs are too diverse to allow for generalized verdicts regarding the effects of RIAs on FDI flows to member countries. FDI may respond differently depending on its source (within or outside the integration scheme) as well as its motive (e.g., market-seeking or efficiency-seeking). A host of specific characteristics may determine whether, to which extent and where exactly an integration scheme has the desired effects on FDI; e.g., membership (North-South or South-South integration), the type of integration (institutionalized or market-driven), its degree on paper (ranging from free-trade area to common market) as well as in actual practice (implementation deficits), and the treatment of outsiders (fortress or open regionalism).

Against this backdrop, we take a fairly modest approach in the following. After shortly expanding on the just mentioned ambiguities in Section 2, we turn to four major examples of South-South integration schemes in Section 3. We focus on the Mercado Común del Sur (Mercosur) in Latin America, the Association of Southeast Asian Nations (ASEAN) and the South Asian Association for Regional Cooperation (SAARC) in Asia, and the Southern African Development Community (SADC) in Africa. These integration schemes have in

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<sup>1</sup> As noted by UNCTAD (2000: 21): "Economic integration increases market size and enhances economic growth. As market size and economic growth are in turn important determinants of FDI inflows, regional integration is often expected to stimulate FDI."

common that they are of major relevance in the particular region as well as for economic partner countries in the North. At the same time, these four cases reveal a high degree of diversity and sometimes offer different answers to our questions of major interest: Has FDI increased due to regional integration? Have all members benefited from higher FDI? Has outward FDI by major players in the region contributed to effective integration?

## **2. Analytical and Empirical Ambiguities**

It is for several reasons that the effects of regional integration on FDI are hard to predict. First of all, RIAs differ in various respects. Some of them are mainly market-driven, involving a minor degree of institutionalization. Regional integration in Asia is often considered to be of this type (Langhammer 2007). At the same time, institutionalized integration varies not only in terms of degree or depth, i.e, whether members are part of a free trade area, customs union or common market, but also in the extent to which formal agreements are actually implemented (see also UNCTAD 1998: 118-119). Deeper institutionalized integration has not necessarily stronger FDI effects, especially if institutionalization is largely on paper only. The discussion of Mercosur and ASEAN below provides insights in this regard.

The heterogeneity of FDI is equally important. Most obviously, regional integration may have varying effects on FDI coming from other member countries or non-members, with net effects hard to quantify. Regional integration may also have opposing effects on different types of FDI. The differentiation between market-seeking and efficiency-seeking remains useful in this context, even though the typology of FDI has become increasingly complex. The former type of FDI is motivated essentially by serving the local market of the host country or region, involving a horizontal replication of similar production lines in different locations. The latter vertical type of FDI is motivated by international cost differentials and involves slicing up the value chain through relocating specific stages of the production process to where they are most cost effective to undertake.<sup>2</sup> The horizontal type of FDI tends to dominate when relative factor endowments and, thus, relative prices are similar in the home and the host country, whereas the incentive to undertake vertical FDI increases when relative factor endowments vary (Carr et al. 2001).

We do not attempt to provide a comprehensive categorization of either RIAs or FDI. Rather, the subsequent discussion is meant to exemplify the analytical ambiguity concerning the effects of RIAs on FDI, by referring to selected transmission channels which may have

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<sup>2</sup> This reasoning implies that trade and horizontal FDI are substitutes, while trade and vertical FDI are complements; see also Blomström and Kokko (1997) as well as Levy Yeyati et al. (2003).

opposing effects.<sup>3</sup> The most obvious aspect of regional integration consists of removing or, at least, lowering internal trade barriers within the integration scheme. Trade costs tend to encourage horizontal FDI, while discouraging vertical FDI (Carr et al. 2001). Consequently, this measure alone may have several FDI effects working in different directions.

Concerning intra-regional FDI, the removal of internal trade barriers reduces FDI of the horizontal (or market-seeking) type by weakening the incentive of companies based within the integration scheme to use FDI as a tariff-jumping device.<sup>4</sup> Exports, which were no reasonable option as long as trade barriers were high, may now substitute for FDI in order to serve the markets of partner countries and realize economies of scale by producing at home. On the other hand, intra-regional FDI of the vertical type may be stimulated by the removal of internal trade barriers. This applies especially to RIAs whose member countries are at different stages of economic development. Cost differentials within the RIA may then strengthen the incentive of companies to engage in intra-regional vertical specialization by undertaking efficiency-seeking FDI.<sup>5</sup>

In contrast to intra-regional FDI of the horizontal type, horizontal FDI from sources outside the region may be stimulated by the removal of trade barriers within the RIA. This is because effective market size increases. An external investor may now locate production facilities in one member country of the RIA and serve the local markets of several or all member countries from there. FDI of this sort, so-called export platforms within a RIA, would result in overall higher extra-regional FDI if RIA members had not attracted FDI from this investor before. However, the establishment of export platforms may also result in overall lower extra-regional FDI if the investor had established production facilities in several member countries before and now “rationalizes” her regional production network (Altomonte 2007; Te Velde and Bezemer 2006).

Consequently, as mentioned by Levy Yeyati et al. (2003: 10), “within the RIA, there may be winners and losers.” Previously existing FDI stocks may be relocated in favor of some members, and at the expense of others.<sup>6</sup> UNCTAD (1998: 120) notes that it is not necessarily the larger member countries that benefit. Rather, with *local* market size becoming less relevant, cost-effective locations in small member countries may have better chances to attract

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<sup>3</sup> For a more comprehensive discussion of possible FDI effects of regional integration, see Blomström and Kokko (1997) as well as Blomström et al. (2000).

<sup>4</sup> See Levy Yeyati et al. (2003) and Altomonte (2007) for further discussion of “tariff-jumping” FDI.

<sup>5</sup> See also Helpman (1984). Levy Yeyati et al. (2003) find empirical support for a positive relationship between differences in factor endowments and FDI.

<sup>6</sup> Baltagi et al. (2007) focus on third-country effects and the re-allocation of FDI across host countries, e.g., when new members enter a regional integration scheme.

export platforms.<sup>7</sup> But countries that have been less attractive already before may fall further behind to the extent that regional integration fosters spatial clustering, including the concentration of FDI in a few well developed locations. Clustering and concentration of FDI within the RIA tend to be reinforced by foreign end-producers, e.g., car assemblers, inducing so-called follow-sourcing, i.e., traditional suppliers of parts and components following with FDI to where the end-producer locates.

The effects on FDI inflows from non-member countries are complicated further when taking into account that RIAs may follow different approaches with respect to protection against outsiders. If outsiders fear that the integration scheme will raise the external protection level (former concerns about “fortress Europe” may spring to mind), extra-regional FDI of the horizontal type may receive another push, whereas the incentive of outsiders to undertake vertical FDI weakens. The concept of “open regionalism” which combines preferential treatment within the integration scheme with reduced trade barriers against outsiders may have the opposite effects.

It also matters whether RIAs go beyond trade liberalization.<sup>8</sup> With regard to FDI effects, it is of obvious relevance whether the agreement includes provisions that reduce transaction costs specifically affecting cross-border capital flows. RIAs which open up more sectors to FDI inflows, harmonize legal FDI norms and/or provide for credible dispute settlement mechanisms should have a positive effect on intra-regional FDI, independently of its nature (Levy Yeyati et al. 2003). But the effects are not necessarily restricted to intra-regional FDI. Te Velde and Bezemer (2006) argue that the investment provisions of some RIAs apply to outsiders, too, so that extra-regional FDI may also increase.

Finally, the links between regional integration and FDI may be complicated by various dynamic effects. Most importantly perhaps, regional integration may have a lasting positive effect on FDI inflows to the extent that integration promotes economic growth (Blomström and Kokko 1997). The consequences of other dynamic effects are more difficult to predict. For instance, a higher degree of competition in more integrated markets – which may actually be the result of more FDI – may discourage further FDI if domestic firms are now more efficient and, thus, able to outcompete foreign newcomers.

All this implies that it is almost impossible to isolate the effects of regional integration on FDI, including the effects working rather indirectly. Some countries entered into regional integration schemes to “lock in” non-binding (unilateral) reform measures undertaken

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<sup>7</sup> The case of Ireland may be noted in this context.

<sup>8</sup> De Sousa and Lochard (2004) analyze the effects of a currency union on trade with respect to the EMU experience. According to their results, the common currency significantly increased trade through a rise in FDI.

before.<sup>9</sup> In such cases, it may be particularly difficult to credit either the unilateral reforms or regional integration for subsequent increases in FDI inflows. More generally, FDI effects tend to result from the interplay of regional integration and country-specific factors. According to Blomström and Kokko (1997), the impact of a RIA on FDI in a particular member country is most likely to be pronouncedly positive if (i) the degree of integration is high **and** (ii) the particular country enjoys strong locational advantages.

In the light of the analytical complexity concerning the effects of regional integration on FDI, it is not really surprising that policymakers are looking for obvious empirical models to make their case for RIAs among emerging economies. The EU represents the model most often referred to, and the consensus view appears to be that it was successful not least in terms of attracting FDI (Dunning 1997; Baltagi et al. 2007). Yet the EU's success has to be qualified in several respects, and its model character is open to question. The coincidence of EU deepening and rising FDI inflows does not necessarily imply that the former has caused the latter. According to Dunning (1997), almost intractable conceptual and data problems stand in the way of isolating the effects of regional integration on FDI flows. As mentioned before, the impact is rather indirect, e.g., working through economic growth and the regulatory framework. The counterfactual, i.e., growth and regulations without integration, is typically unknown. Hence, Dunning (1997: 209) concludes that it is “of questionable value” to consider the Internal Market Program (or any other integration step, for that matter) “as an independent variable.”

In summary, it is not only due to analytical complexity but also to ambivalent empirical evidence with respect to the most advanced (and researched) integration scheme, the EU, that it is almost impossible to come up with clear-cut and generalized predictions concerning the effects on FDI of major integration schemes among emerging economies. Therefore, we turn to selected case studies in the following.

### **3. Four Major Cases**

#### **a. Overview**

In the following, we present stylized facts and discuss the related literature for four regional integration schemes among emerging markets in the South: Mercosur in Latin America, ASEAN and SAARC in Asia, and SADC in Africa. Given the sheer number of existing regional integration schemes ([http://www.wto.org/english/tratop\\_e/region\\_e/region\\_e.htm](http://www.wto.org/english/tratop_e/region_e/region_e.htm)), this selection is not meant to provide a representative picture on the effects of regional

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<sup>9</sup> Mexico represents a prominent example in this respect.

integration on FDI patterns in the South. Rather, our focus is on regional integration schemes that are of major relevance in the particular region as well as for economic partner countries in the North. Economic and political heavyweights are members in three of the schemes under consideration (Brazil in Mercosur; India in SAARC; Rep. of South Africa in SADC); China represents a dominant player with respect to ASEAN, and is actually linked to it in the ASEAN+3 process. Therefore, these four case studies allow us to address several FDI-related questions:

- Has regional integration worked as a stimulus to inward FDI?
- Does the distribution of FDI within regional integration schemes suggest that any FDI-related benefits tend to be equally shared among the members, or rather to be concentrated in the large and/or richer member countries?
- What about the role of the dominant players in fostering effective regional integration through outward FDI in smaller and/or poorer neighboring countries?

Before addressing these issues in more detail for each of the four schemes, some first clues may be gained from longer-term developments in inward FDI stocks (Table 1). First of all, all four schemes have attracted rising FDI stocks since 1980, though to a considerably different degree. Not surprisingly, the rise was most pronounced for SAARC where, similar to China, FDI stocks had still been below US\$ 2 billion<sup>10</sup> at the beginning of the period under consideration. The other three regional integration schemes all hosted FDI stocks of roughly US\$ 20 billion in 1980. Yet, there are striking differences between them in terms of subsequent growth in FDI stocks, ranging from an increase by a factor of five in the case of SADC to a factor of almost 20 in the case of ASEAN.

### **Insert Table 1 somewhere here**

The steep increase for ASEAN puts into question the concern of many policymakers that FDI in China has diverted foreign investors away from more traditional ASEAN locations (see also Section 3.c below). ASEAN succeeded to maintain its share of about 14 % in FDI stocks located in all developing countries. By contrast, FDI shares dropped significantly for SADC and Mercosur, when comparing 2005 with 1980, even though FDI diversion should not have been a major issue for them.<sup>11</sup>

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<sup>10</sup> Unless marked otherwise, all FDI data originate from the UNCTAD FDI/TNC database which is partly available online (UNCTAD 2007a).

<sup>11</sup> This is not to ignore that Mercosur was concerned about FDI diversion, notably with regard to FDI from EU countries when Central and Eastern Europe became increasingly integrated with the EU. However, these concerns were found to be largely unjustified (e.g., Nunnenkamp 1998; 2000).

Table 1 also provides some tentative clues on the concentration of FDI stocks within integration schemes. The focus is on Brazil, India and the Rep. of South Africa as dominant members of regional integration schemes and, at the same time, globally important players. All three countries have in common that they accounted for at least two thirds of total FDI stocks in all member countries in 2005. While FDI concentration appears to be a longer term phenomenon in Mercosur and SADC, it gathered momentum in SAARC with India's share soaring from 27 % in 1980 to 73 % in 2005. Yet it remains open to question whether regional integration benefits the major players in the first place. The case of India may rather point to the relevance of *national* reforms and attitudes to FDI (see Section 3.d for details). More generally, smaller members may well be attractive to FDI even though concentration measures are often (mis-)conceived to indicate otherwise.<sup>12</sup>

#### **b. Mercosur: Formal Integration Alone Won't Do!**

The link between regional integration and FDI has been widely debated in Latin America. Mexico's integration into NAFTA in 1993 and the associated boom of FDI flows to Mexico have received particular attention (e.g. Kose et al. 2004; Tekin-Koru and Waldkirch 2008). Waldkirch (2003) concludes: "Had NAFTA not been formed, FDI from these countries (i.e., the United States and Canada) would have been as much as 45 % lower since 1994."

Compared to NAFTA effects on Mexico's attractiveness to FDI, a rather ambiguous picture prevails with respect to Mercosur, in terms of both overall attractiveness to FDI and the distribution of FDI among member countries. According to UNCTAD (1998: 126), "it is not obvious how far FDI gains have been the direct outcome of Mercosur." Blomström and Kokko (1997) point to significant changes in trade and investment rules in the region that should have resulted in relatively strong FDI effects for Mercosur as a whole. In the light of unilateral liberalization as well as multilateral commitments, however, "it is uncertain how much of the reforms should be credited to the formal integration agreement" (ibid: 33).<sup>13</sup> Furthermore, these authors find that the smaller members, in particular Paraguay, have been lagging behind in attracting new FDI.

Blomström and Kokko (1997) expect that the establishment of the customs union in 1995 provided an additional stimulus to FDI in Mercosur. Levy Yeyati et al. (2003) point to

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<sup>12</sup> See Nunnenkamp (2004) for a discussion of measures of concentration.

<sup>13</sup> See also Devlin and Ffrench-Davis (1999), according to whom regional integration in Latin America represented the third tier of the process of liberalization, following unilateral and multilateral liberalization. Likewise, the Inter-American Development Bank (2002: 230) argues that "it is difficult to disentangle the role of Mercosur from the other changes that took place at the same time, such as the adoption of structural reform programs and a more favorable macroeconomic climate."

the market size effect for attracting FDI. And indeed, Figure 1 reveals that FDI inflows boomed in the second half of the 1990s, reaching a peak of US\$ 53 billion in 1999. Nevertheless, Mercosur has not been particularly successful in attracting FDI. The increase in FDI inflows up to 1997 closely resembles the general trend observed for the rest of Latin America. The above-average growth in FDI inflows until the turn of the century was due to a few exceptionally large acquisitions, rather than a permanent change towards Mercosur in the composition of FDI flows to the whole of Latin America.<sup>14</sup> Most recently, Mercosur has clearly been outperformed by other Latin American host countries, for which the crisis in Argentina is only partly to blame.<sup>15</sup>

**Insert Figure 1 somewhere here**

Developments at the level of individual Mercosur member countries underscore that regional integration has been just one, and possibly even a minor factor driving FDI inflows. Argentina provides the most obvious case in point. High FDI inflows in the 1990s had the effect that Argentina's share in FDI stocks of Mercosur doubled to almost 40 %; in per-capita terms, FDI stocks in 2000 were about three times higher in Argentina than in Brazil (Table 2). But the whole period of observation was characterized by erratic FDI developments in Argentina. As concerns Brazil, a survey conducted by UNCTAD (2000) reveals that the regional effect was marginal for TNCs' decisions on investing there.

Any sustained effects of Mercosur integration were clearly dominated by country-specific boom and bust phenomena.<sup>16</sup> The exceptionally large privatization-related FDI inflows in 1999 are just one example. Likewise, "regular" FDI (i.e., subtracting FDI due to privatizations and debt conversions) accounted for just 12 % of total FDI inflows in 1991-1993 – i.e., immediately after the creation of Mercosur (Inter-American Development Bank and IRELA 1996: 48). Recently, any integration-related gains in attractiveness were wiped out completely by the financial crisis and Argentina's volte-face concerning the role of FDI in privatizations.

**Insert Table 2 somewhere here**

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<sup>14</sup> Most notably, without Spanish Repsol having acquired the Argentine oil company YPF for more than US\$ 13 billion, FDI flows to Mercosur would have surpassed FDI flows to the rest of Latin America in 1999 by just a small margin (UNCTAD 2000: 60).

<sup>15</sup> FDI flows to Brazil in 2004-2005 amounted to little more than half of FDI inflows in 1999-2000 (World Bank 2007).

<sup>16</sup> Concerning developments up to the mid-1990s, Blomström and Kokko (1997: 38) conclude that (country-specific) macroeconomic stabilization was more important for FDI inflows than regional integration.

At the same time, Table 2 qualifies widely held concerns that Mercosur integration has reinforced the concentration of foreign investors on Brazil. This is not to ignore that the scheme's dominant member hosted more than three quarters of total FDI stocks in 2005 – similar to its share prior to the creation of Mercosur. Also, the two small member countries clearly failed to attract a larger share of FDI stocks in Mercosur. But their small shares tend to disguise that Paraguay and Uruguay differ strikingly in terms of attractiveness once FDI stocks are related to the host countries' population. By this relative measure, Uruguay has been fairly close to Brazil throughout the period of observation, whereas Paraguay fell considerably behind. This difference speaks against any generalized verdicts on the consequences of regional integration on the attractiveness to FDI of small and less advanced partner countries.

Rather than diverting FDI away from the small Mercosur partners, Brazil might be expected to provide a major source of intra-regional FDI. Since the economic liberalization in the early 1990s, outward FDI (OFDI) of Brazil has considerably increased to a stock of US\$ 79.3 billion in 2005. According to the Economist Intelligence Unit (EIU 2007), the OFDI stock further augmented to US\$ 107.5 billion or roughly 10% of GDP in 2006, a development that may have been helped by the appreciation of the Real which assisted external purchases by Brazilian firms. However, a large proportion of Brazil's FDI goes to tax havens, largely for fiscal reasons. UNCTAD (2007b: 24) suspects that the bulk of capital flows to tax havens is reinvested in Brazil.

Apart from fiscal motives, Brazil's OFDI is mainly resource-seeking (Petrobrás, CVRD) or market-seeking (Marcopolo, EMBRAER, Itausa). The share of Mercosur partner countries as destinations for Brazil's OFDI greatly depends on whether or not OFDI in tax havens is part of the denominator. Excluding tax havens, the share of Mercosur ranges from 14 to 42% of Brazil's OFDI stocks in the period 2001-2005 (compared to 6-10% with tax havens included in the denominator). Since Brazil's stocks in Mercosur remained more or less constant in absolute terms, the (relative) share of Mercosur declined sharply in the given period (Figure 2). Ignoring tax havens, Uruguay and Argentina rank 6<sup>th</sup> and 7<sup>th</sup> on the list of major destinations in 2005, while Paraguay is far behind and not among the top-20 (reflecting the aforementioned inferior attractiveness to FDI in general).

**Insert Figure 2 somewhere here**

Nevertheless, Brazil's OFDI is fairly important for Paraguay: After the United States, Brazil was the second largest source country for FDI inflows between 1980 and 2005 with a share of almost 20%. Another 17% of FDI inflows came from Argentina and Uruguay. Uruguay attracted sizeable amounts of FDI from Brazil, though being smaller than Paraguay in terms of population. UNCTAD (2007b) suspects that Uruguay's competitive tax regime raised the country's attractiveness – with traditional tax havens becoming subject to stricter scrutiny by the international community - but also attests a stable operational framework for business.

It generally appears that the actual progress of Mercosur integration lacks considerably behind de jure integration. Internal tariffs are officially abolished and common external tariffs have been agreed upon, but various exemptions account for a large part of actual tariff revenues and are supplemented by a range of non-tariff barriers. The expected effects of Mercosur integration on the FDI attractiveness of its members are unlikely to materialize before narrowing the wide gap between the rhetoric about integration and actual practice.

Devlin and French-Davis (1999: 277) stress that the effects of regional integration critically depend on whether agreements are implemented fully and enforced effectively. Mercosur has not been particularly successful in this regard. Preusse (2001: 930) argues that the integration process has virtually come to a standstill in the second half of the 1990s: “Neither a consistent macroeconomic concept exists within the region nor is there a reliable framework for the establishment of a more intense (market oriented) intra-regional specialization.” Member countries repeatedly erected trade barriers against each other on an ad-hoc basis.<sup>17</sup> Rather than deepening integration, it appears that the customs union “is getting more imperfect over time” (*The Economist* December 9<sup>th</sup>, 2004).

There are, however, a number of recent regional initiatives which raise new hope for a deeper de facto integration within Mercosur. According to UNCTAD (2007c), important initiatives, e.g. in the energy, infrastructure and automotive sectors, have eased cross-border transactions and led to more integrated production schemes between the member countries.

### **c. Asean and China: Can Do without Formal Integration?**

In contrast to Mercosur, ASEAN attracted an almost constant share of FDI stocks located in all developing countries (Table 1). The fact that ASEAN did not lose market shares may be surprising. The Chinese challenge of diverting FDI away from more traditional locations applied to ASEAN in the first place, if relevant at all. But Figure 3 suggests that ASEAN's

attractiveness was hardly affected by FDI flows to China. ASEAN witnessed a fairly continuous increase in FDI inflows over more than a decade until the Asian crisis struck in 1997. The FDI boom in China at most caused a minor dent in this trend line in 1992.

**Insert Figure 3 somewhere here**

The widening gap between FDI flows to China and ASEAN in the aftermath of the Asian crisis (Figure 3) is largely due to just one ASEAN member, i.e., Indonesia where the fallout of the Asian crisis was most severe and prolonged. Excluding Indonesia, the decline in average annual FDI flows to ASEAN-8 in 1998-2002 was less than US\$ 4 billion (or 14 %), compared to more than US\$ 10 billion (or 33 %) for ASEAN-9.

Many Asian neighbors actually performed better than China in attracting FDI in the 1990s once the relative size of Asian economies is taken into account (Wu and Keong 2002).<sup>18</sup> Moreover, the distribution of FDI stocks within ASEAN (Table 3) clearly reveals that the small FDI shares of ASEAN countries such as Cambodia and Lao PDR must not be read as implying that less advanced and small members of regional integration schemes have no reasonable chance to compete for FDI with their larger and/ or more advanced neighbors. Relating FDI stocks to country size in terms of population, Cambodia (with a population of just 14 million) proved more attractive in 2005 than the (much larger and more advanced) Philippines; likewise, small and poor Lao PDR outperformed Indonesia by this measure recently.

**Insert Table 3 somewhere here**

The relevance of country-specific factors is also evident when looking at longer-term trends concerning the three heavyweights within ASEAN, each of which accounted for 25-28% of ASEAN's total FDI stocks in 1980 (Table 3). While Indonesia and Malaysia lost a large part of their FDI shares, Singapore alone accounted for half of ASEAN's FDI stocks in 2005. Surprisingly perhaps, changes in FDI shares were most pronounced in the 1980s, i.e., before institutionalized integration started with the ASEAN Preferential Trade Agreement

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<sup>17</sup> For example, Paraguay and Uruguay complain "that access to Brazil's market is theoretical" (*The Economist* January 19<sup>th</sup>, 2006).

<sup>18</sup> UNCTAD's Inward FDI Performance Index, relating a country's share in global FDI to its shares in global GDP, employment and exports, ranked China only in the middle of a large sample of host countries in 1998-2000. Moreover, reported FDI flows to China are inflated by round-tripping, i.e., local investment funds channeled through Hong Kong and offshore tax havens back to mainland China and registered there as FDI (see also below).

(APTA) in 1992. Note that the concentration of FDI in Singapore has not increased since then.

Singapore represents the most important ASEAN member not only in terms of inward FDI but also as a source of FDI.<sup>19</sup> Singapore's outward FDI is concentrated in Asia, particularly so with respect to FDI in manufacturing (where Asia accounted for more than 90% of Singapore's outward FDI stocks in 2003). Strikingly, however, this concentration is hardly due to ASEAN integration. Partner countries within ASEAN hosted just about one fifth of Singapore's total FDI stocks. Concerning FDI in manufacturing, the focus has actually shifted away from ASEAN since the early 1990s, largely because of the declining importance of Malaysia as a host of Singaporean FDI. Note that the minor importance of intra-ASEAN FDI relations is not restricted to FDI from Singapore. According to UNCTAD (2003: 46), intra-regional FDI flows contributed less than 15% to total FDI flows to ASEAN in 1999-2001.

Traditionally, institutionalized regionalism has played a minor role in East and Southeast Asia (Langhammer 2007). APTA was the "only major formal regional trade arrangement in East Asia through the 1990s" (Urata 2004). The envisaged free trade area AFTA will be implemented fully by all current ASEAN members only by 2010. Earlier empirical assessments of the effects of RIAs on FDI flows to ASEAN have produced mixed results. According to Bende-Nabende et al. (2001: 383), APTA had "a lagged influence on FDI inflows to the advantage of the more-developed member countries, and disadvantage of the less-developed countries." UNCTAD (2003: 47) notes that Parsons and Heinrich found the AFTA effect to be ambiguous in their (unpublished) study on US FDI. Heinrich and Konan (2001: 141) anticipated some years ago that "a reduction of regional trade barriers could make Southeast Asia a more attractive investment destination to service ASEAN consumers, and integrate production processes within the region."

It is open to question whether recent steps towards closer institutionalized integration will cause major changes in the approach to integration - and what the implications might be for FDI flows to ASEAN.<sup>20</sup> In addition to the well-known Chiang Mai Initiative of 1999 on monetary cooperation and other so-called ASEAN-plus initiatives, more specific FDI-related steps taken in the direction of institutionalized integration include the ASEAN Investment

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<sup>19</sup> For details, see Ellingsen et al. (2006).

<sup>20</sup> For a detailed discussion of the shift from market-driven regionalization to more institutionalized regionalism in East Asia, see Urata (2004).

Area (AIA)<sup>21</sup> and the Industrial Cooperation Scheme which promotes joint ventures in manufacturing between ASEAN-based companies (Te Velde and Bezemer 2006: 47).

The effectiveness of such measures obviously depends on implementation. Past experience invites scepticism in this regard. *The Economist* (November 24<sup>th</sup>, 2007) considers ASEAN's promise of an integrated market for goods, services, capital and labor by 2015 to be "fanciful." Reportedly, the Centre for Strategic and International Studies in Washington criticized recently that only about 30% of ASEAN's agreements are ever implemented. Moreover, the persistence of various non-tariff barriers means that ASEAN is still far from a genuine free trade area. *The Economist* also notes that the US-ASEAN Business Council still sees the integration scheme as "ten separate markets with ten sets of regulations."

More generally, it cannot be ruled out that East Asia's fairly recent interest in institutionalized integration may prove temporary. Analysts largely agree that the shift in East Asia's integration approach was largely due to external factors, rather than internal political processes as in the case of European integration (e.g., Langhammer 2007; Urata 2004). International financial crises, notably the Asian crisis of 1997/98, represented one of these factors, and the stalemate in multilateral trade negotiations another one. A third external factor that may have led to a reconsideration of institutionalized integration in East Asia is more specifically related to FDI, namely the widespread fear that China's emergence as an attractive location would result in FDI diversion at the expense of neighboring countries, including ASEAN.

China may thus be regarded as a "push factor" that brought forward ASEAN integration by provoking fears of FDI diversion (Ariff 2006). Wu and Keong (2002) agree that competition for FDI between ASEAN and China was likely to intensify after China joined the WTO. Yet, these authors contradict "the popular perception that China has been taking FDI from ASEAN." Indeed, recent econometric studies conclude that, with hindsight, ASEAN's concerns were unjustified:

- Zhou and Lall (2005: 1) summarize their fixed-effects regression results as follows: "China raised rather than diverted such investment (i.e., FDI) into neighbouring economies during 1986-2001.... This may be because countries do not compete for foreign direct investment in market and resource-seeking activities; the only competitive segment is likely to be export-processing – here China may be

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<sup>21</sup> The Framework Agreement on the AIA, signed in 1998, aims at attracting more FDI from both within and outside the region. A liberal and transparent investment environment is envisaged for ASEAN investors by 2010, and for all investors by 2020 (Heinrich and Konan 2001).

complementing other countries in electronics, where they are being integrated into a regional production network.”

- Chantasawat et al. (2005) corroborate the finding that FDI creation in the context of production networks involving China **and** other Asian countries (including five major ASEAN members) was more important than any FDI diversion. In their regression model covering the period 1985-2002, a 10% increase in FDI flows to China would raise FDI flows to the sample of East and Southeast Asian countries by 1-3%, depending on the exact specification.
- Rather than addressing the issue of FDI creation versus FDI diversion, Puah et al. (2007) employ cointegration and Granger causality analyses to show that there exists a positive (long-run) relationship between FDI in China and GDP in ASEAN-5. In other words, more FDI in China (Granger-) causes economic growth in ASEAN countries.

Its own outward FDI (OFDI) may represent an important mechanism through which China stimulates FDI in neighboring countries. But this mechanism is hard to quantify as Chinese OFDI data are notoriously deficient.<sup>22</sup> Realized outflows are available from 2003 onwards only. Chinese OFDI is inflated by “round-tripping”; about one third is likely to be channeled via Hong Kong back to China again. Furthermore, offshore financial centers such as Cayman Islands accounted for about 45% of Chinese OFDI flows in 2003-2005.

Taken together, ASEAN-10 attracted just about 10% of the remaining Chinese OFDI flows in 2003-2005. This share was comparable to that of the United States as a host of Chinese OFDI, as well as to the combined share of Kazakhstan, Nigeria and Sudan. Hence, it does not appear that ASEAN integration provided a major stimulus to Chinese OFDI.<sup>23</sup> Rather, specific factors and local attributes seem to be important. Singapore is a major target due to its hub status in financial services, trade, shipping and logistics (Chia 2004; Chia and Sussangkarn 2006). Malaysia and Thailand attracted Chinese firms in relatively labor intensive manufacturing (e.g., electronics) (Chia 2004).<sup>24</sup> Availability of resources represents the major attraction of Indonesia to Chinese investors (Pangestu 2004).

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<sup>22</sup> We do not discuss data deficiencies in any detail here, but more specific information is available from the authors on request.

<sup>23</sup> Buckley et al. (2007) analyze the driving forces of Chinese OFDI more systematically, employing data from the State Authority of Foreign Exchange. They find outflows to be significantly correlated with cultural and geographical proximity, the host country’s degree of political liberalization, its endowment with natural resources, and its market size. They did not include membership in an RTA as a separate FDI determinant.

<sup>24</sup> The FTA between China and Thailand, together with the provision of infrastructure by the Thai government, has promoted FDI especially in Northern Thailand (Frost 2004).

According to Frost (2004), China ranks among the five most important investors in Viet Nam, and also in minor ASEAN host countries such as Cambodia.<sup>25</sup> Indeed, this author observed that Chinese OFDI has triggered a change in the mindset of top politicians with regard to regionalization, e.g., in Malaysia. China is viewed no longer as a threat, but rather as offering promising market opportunities, and ASEAN countries are eager to pull in Chinese FDI (Chia and Sussangkarn 2006). At the same time, the Chinese government actively aims to increase cooperation and investment in ASEAN, especially in sectors such as the biotech industry and electronic information. In this way, China seeks access to advanced technologies that are available in ASEAN countries (Chia and Sussangkarn 2006; Ping 2007).

In summary, ASEAN integration appears to have had limited impact on Chinese OFDI so far. But the effects may become stronger in the future considering the recent nature of integration agreements, especially if implementation deficits are overcome. For instance, Wong and Chan (2003: 279) attach high expectations to the free trade agreement between China and ASEAN:<sup>26</sup> “In the near future, China could well constitute the fourth wave of FDI for Southeast Asia, following the first three waves associated with the West, Japan, and the four Asian NIEs.”

#### **d. SAARC: All about India?**

Though SAARC experienced the largest relative increase in FDI stocks compared to the other three integration schemes between 1980 and 2005, its share of FDI stocks in all developing countries remains the lowest at 2.3% (see Table 1 and Figure 4). Moreover, the increase in FDI stocks can largely be ascribed to soaring FDI flows to India which accounted for 76% of the region’s inflows in 2006.

**Insert Figure 4 somewhere here**

Policy reforms in the early 1990s and in 2001 were the major driving force of the FDI boom in India. During the first period of reforms India started to open up its economy for trade and investment flows. Bajpai and Sachs (2000) regard the reform programs (including

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<sup>25</sup> Note that Frost (2004) generally estimates Chinese FDI stocks in ASEAN countries to be much higher than official data from the Ministry of Commerce of the People’s Republic of China (MOFCOM). Frost thus supports UNCTAD (2007b) which also argues that OFDI is likely to be underestimated when measured by official data. For instance, Frost suspects significant amounts of Chinese capital to be routed to Viet Nam via offshore financial centers. Dhume and Lawrence (2002: 30) argue along similar lines.

<sup>26</sup> The Framework Agreement on Comprehensive Economic Cooperation between ASEAN and China was signed in 2002 and envisages realization of an ASEAN-China free trade area (ACFTA) by 2010 for ASEAN-6 and by 2015 for Cambodia, Myanmar, PDR Lao, and Vietnam (<http://www.aseansec.org/17310.htm>).

deregulation of the economy and decentralization) as the crucial factor leading to the boost in FDI flows.<sup>27</sup> Further liberalization was induced by a second sequence of reforms in 2001. Over the whole period, annual FDI inflows rose substantially from an average of US\$ 200 million during 1987-1990 to US\$ 5.6 billion during 2002-2005. India has so far become the only South Asian country to show up in the top-5 destinations of FDI flows to Asia (Palit and Nawani 2007). However, regulatory restrictions<sup>28</sup>, political opposition regarding privatization and labor laws<sup>29</sup> may cause FDI to remain well below its potential. Regional integration is hardly mentioned in the literature as a possible determinant of FDI in India.

The other SAARC member countries together account for a stagnant share of less than 1% of FDI flows to all low and middle-income countries. Apparently the SAARC integration process did not help increase this share so far. It rather appears that country-specific factors were relevant also for this group of countries. While economic reforms have been implemented in all SAARC member countries, their success in terms of attracting FDI varies considerably (Sahoo 2006).

In Bangladesh and Pakistan, the World Bank and the International Monetary Fund (IMF) imposed targets for macroeconomic reforms. Bangladesh implemented structural adjustment policies in the 1980s and early 1990s. In the course of these programs, Bangladesh liberalized its FDI policies by relaxing regulatory requirements and took efforts to improve the investment climate. This resulted in an increase in FDI inflows from an average of US\$ 2.13 million during 1987-1990 to an average of US\$ 458 million during 2002-2005.

Pakistan's reform process was effective only after 2001. This resulted in delayed increases in FDI inflows which rose from an average of US\$ 177 million (1987-1990) to US\$ 1.17 billion (2002-2005). The main problem concerning Pakistan's investment prospects is the counterproductive investment climate that is affected by political instability, regulatory hurdles and high labor costs. Political instability also explains low and volatile FDI flows to Nepal after 2000, resulting in the lowest FDI-to-GDP ratio in the SAARC region.

Established in 1985, SAARC remains a weak regional integration agreement due low intra-regional trade and investment patterns. To promote trade and economic integration, SAARC members signed the South Asian Preferential Trade Agreement (SAPTA) in 1993. SAPTA was seen as a temporary agreement to be replaced by the South Asian Free Trade

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<sup>27</sup> See Jayasuriya and Weerakoon (2002) for further information on the reform programs.

<sup>28</sup> According to the Economist Intelligence Unit (April 19<sup>th</sup>, 2007): To cap it all; available at [http://www.economist.com/business/displaystory.cfm?story\\_id=9040409](http://www.economist.com/business/displaystory.cfm?story_id=9040409), regulations such as restrictions for foreign ownership in the fastest growing industries discourage major investments.

<sup>29</sup> The Economist Intelligence Unit (Sept. 6<sup>th</sup>, 2007): Three Asian Giants, available at [http://www.economist.com/agenda/displaystory.cfm?story\\_id=9769084](http://www.economist.com/agenda/displaystory.cfm?story_id=9769084).

Agreement (SAFTA), which went into force in 2006. It was hoped that SAFTA will bring the intended surge in intra-regional FDI which has been missing since SAARC was set up<sup>30</sup>. However, Iyengar (2007) points to a lack of political will to encourage more intensive regional integration and thus promote a favorable investment climate in South Asia. The ongoing conflict between India and Pakistan over Kashmir complicates negotiations for further economic integration, and trade and investment barriers worsen the regional investment climate.

Being aware of the limitations of SAARC, India arranged further regional agreements with Asian countries to guarantee preferential treatment for trade and investment. Examples are: the Asia-Pacific Trade Agreement (APTA, also known as Bangkok Agreement)<sup>31</sup>; BIMSTEC (Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation)<sup>32</sup>; and the Indo-Sri Lanka Free Trade Agreement.

SAARC also plays a minor role with respect to India's OFDI, the analysis of which suffers from similar data restrictions as the analysis of Chinese OFDI. Data at the country level are only available on an approval basis, but aggregate approved outflows differ significantly from realized outflows as reported in the Balance of Payments. Having said this, OFDI from India increased significantly since the late 1990s; the overall OFDI stock reached almost US\$ 13 billion in 2006. While FDI in the manufacturing sector still dominates, FDI in services and particularly in IT services is on the rise.

Indian OFDI stocks in SAARC countries accounted for only 2% of India's total OFDI stock in 2005. Main destination countries were Russia, the United States, Mauritius and Sudan. Apart from a few resource-rich countries, Indian OFDI is generally rather oriented towards developed economies. Pradhan (2007) shows that acquisitions by Indian multinationals have a strong market-seeking motivation. Consequently, the market size of the host economies (both by population and per-capita GDP) plays an important role in attracting Indian acquisitions, just like a large and skilled pool of labor. This explains the attractiveness of developed countries for Indian OFDI and represents a significant difference to Chinese OFDI which is more oriented towards developing countries.<sup>33</sup>

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<sup>30</sup> Article 8h of SAFTA includes the "removal of barriers to intra-SAARC investments."

<sup>31</sup> APTA includes Bangladesh, China, India, Republic of Korea, Lao People's Democratic Republic, and Sri Lanka.

<sup>32</sup> Comprising Thailand, Myanmar and all SAARC members with the exception of Afghanistan, the Maldives, and Pakistan.

<sup>33</sup> The Business Line asserts on June 22, 2006, that "India went global to pitch for a bigger stake in the world knowledge-based industry market, unlike China, which sought to establish its brand image for manufacturing products and to feed its hunger for resources."

The geographical distribution of Indian OFDI within SAARC is displayed in Figure 5. Sri Lanka attracts the lion's share with over 50% of total stocks, while Nepal accounts for almost a third. Looking at the source-country break-down of inflows to different SAARC countries, Sahoo (2006) finds that only Nepal seems to be heavily dependent on Indian FDI. In most other countries (including Sri Lanka) inflows from developed countries play a more important role. Not surprisingly, Indian OFDI stocks in BIMSTEC and APTA countries developed largely parallel to the stocks in SAARC (Figure 6). Membership patterns overlap, with Sri Lanka playing a key role as a host of Indian OFDI stocks also in BIMSTEC and APTA.

**Insert Figures 5+6 somewhere here**

In contrast, OFDI to ASEAN and ASEAN+3 increased a lot more in recent years, represented by a stock of around US\$ 1.1 and 1.3 billion respectively, in comparison to a stock below US\$ 300 million in SAARC. Indian investments in the small city state of Singapore alone more than double the stock of OFDI in all SAARC countries together. Singapore's hub status and developed trade-related infrastructure entails a position in the top-8 destination countries of Indian OFDI and assures an undisputed leading position within Asia (Pradhan 2007).

Hence it is not surprising that India negotiated several bilateral FTAs<sup>34</sup> and started talks on the ASEAN-India FTA in 2002. India's aspiration to integrate economically with Southeast and East Asia has accelerated since 2003; and it has become a dialogue partner of ASEAN.<sup>35</sup> India's "look-east policy" might be a sign of resignation as India seeks stronger investment and trade relations than those achieved by SAARC and SAFTA so far. China and the ASEAN region have more to offer with respect to economic integration than India's South Asian neighbors.

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<sup>34</sup> As an example, the India-Singapore Comprehensive Economic Cooperation Agreement (CECA) was signed in 2005; it includes investment protection.

<sup>35</sup> India has been a member of the ASEAN Region Forum since 1996.

**e. SADC: The Africa Factor Again?**

Regional integration in Southern Africa has a long history, reaching from the South African Customs Union (1910) over the Common Monetary Agreement (1986) to the South African Development Community (SADC) which was established in 1992. The Trade Protocol, which was signed by the SADC member states in 2000, envisaged a free trade area for 2008 and a customs union for 2010.

FDI flows to SADC member countries are highly volatile (Figure 7) and dominated by some large investment projects.<sup>36</sup> Annual average inflows to SADC increased more than fivefold when comparing 1990-1995 with 2001-2006. Nonetheless, FDI stocks as a proportion of FDI stocks in all developing countries declined substantially over the last decades (see Table 1). SADC performed hardly better than the rest of Africa in attracting FDI; its average share of foreign investment in Africa rose slightly from 21.4% to 23.6% comparing 1990-1995 with 2001-2006.

**Insert Figure 7 somewhere here**

Especially after the end of the apartheid in the Republic of South Africa (RSA) in 1994, the liberalization of domestic markets and privatization had a significant effect on FDI inflows from non-African countries (Jenkins and Thomas 2002; Gelb and Black 2004). Moreover, the government of the RSA decided to join the WTO, TRIPS and TRIMS agreements which increased the trust in the new policy regime. RSA being the major player in Southern Africa, the reforms increased the FDI attractiveness of the region as a whole.

Although the resource-seeking type of FDI plays an important role in Southern Africa, Jenkins and Thomas (2002) show that the size of the local market is the main motivation for investors in SADC.<sup>37</sup> These authors argue that a “functioning and sustainable free trade area is more likely to offer the economies of scale required for investment to be profitable and thus should encourage more direct investment in the region” (Jenkins and Thomas 2002: 44). Consequently, one might have expected a rise in FDI inflows in connection with the signing of the Trade Protocol, if foreign investors considered the envisaged integration steps to be credible.

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<sup>36</sup> See Goldstein (2003) for further discussion on such projects.

<sup>37</sup> According to their survey of 81 enterprises, the market-seeking motivation was by far the most important determinant for multinationals (68%), followed by the availability of natural resources (32%). This is accentuated by the fact that 70% of the multinationals that are active in SADC have established subsidiaries in the RSA and serve the local and foreign market from this destination.

A number of explanations have been offered in the literature as to why anticipation effects have not been visible so far. One factor that may upset potential investors is the overlapping membership pattern between the various RIAs in sub-Saharan Africa<sup>38</sup>. Yet the majority view blames obstacles associated with an adverse business climate and high costs of doing business. Specific factors mentioned in this context include macroeconomic instability, the weak regulatory framework, slow progress of structural reforms, and lack of skills<sup>39</sup> and infrastructure (Goldstein 2003). Jenkins and Thomas (2002) point to foreign exchange availability, exchange rate volatility and quality of governance as the most common risk factors. This list can be extended by various commonly perceived problems like the high incidence of corruption, crime and HIV/AIDS.

By now almost every SADC member has set up an investment promotion agency offering investor services and policy advocacy to facilitate doing business for foreign investors (Goldstein 2003). This may represent a step towards improved regulatory quality in SADC which, according to Wolf (2002), is required for regional integration to result in higher FDI flows. But this alone may not turn the tide. Asiedu (2002: 18) identifies a regional effect in her econometric study on FDI determinants, implying “that Africa is perceived as overly risky and therefore a country in the region will receive less FDI by virtue of its geographical location.” This empirical finding suggests that – at least until recently – common perceptions of foreign investors, rather than hard economic facts, worked against higher FDI flows to sub-Saharan Africa (see also Aryeteey 2002). The African Growth and Opportunity Act (AGOA)<sup>40</sup> is meant to help overcome such obstacles and inspire investors to make use of low labor costs and preferential access to the United States. According to Gelb (2005), AGOA boosted FDI from Asian countries and especially from Taiwan, whose investments recently accounted for over 700 projects in sub-Saharan Africa.

The RSA absorbs most FDI to SADC, accounting for two thirds of the region’s FDI stocks in 2005. Angola ranked second with a share of 13% in 2005<sup>41</sup>. Opinions differ with regard to the future role of RSA. Will it function as a magnet for FDI to the region, as hoped by Jenkins and Thomas (2002), or divert FDI from other SADC countries? Considering

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<sup>38</sup> According to Thomas (2004: 12), “conflicting memberships of regional economic agreements create uncertainty and increase the resources required for cooperation.”

<sup>39</sup> Goldstein (2003) also points to brain drain in Southern Africa leading to the emigration of the higher-skilled labor force to the United States, United Kingdom and other Commonwealth states, which distracts FDI to other developing regions.

<sup>40</sup> AGOA was signed in 2000 by the United States and 39 sub-Saharan countries including all SADC members except Zimbabwe. It aims at improving economic ties and enhancing African exports to the United States by expanding market access for certain products, e.g. textiles.

<sup>41</sup> Angola pulls in mainly resource-seeking FDI due to its abundance in natural resources such as oil and gas (Goldstein 2003).

RSA's conducive business climate, developed infrastructure and the large market in terms of GDP<sup>42</sup>, investors may well continue to concentrate market-seeking FDI there and use this country as an export platform to serve regional markets. This could retard the process of catching up of other SADC members, in particular since there is few evidence of regional production networks. Hence, RSA's neighbors are not very likely to benefit from FDI through vertical integration.<sup>43</sup>

Considering intra-regional FDI, all members of SADC have invested in other SADC countries to some degree (Goldstein 2003). The bulk of these investments originates from the RSA but also Mauritius and, to a lesser extent, Zimbabwe have considerable FDI stocks in other SADC countries. Goldstein (2003) argues that those companies that are already familiar with the African business climate are set to further invest in the region and thus add to intra-regional FDI flows.

RSA's stock of outward FDI amounted to US\$ 36.8 billion in 2005; 91% of this stock is located in developed countries and only 8% on the African continent. Due to insufficient data we cannot precisely assess SADC's share in RSA's OFDI; but Te Velde and Page (2004) estimate that 90% of RSA's OFDI to Africa stays within SADC.<sup>44</sup> With SADC's share in overall OFDI hardly exceeding 7%, it is clearly of minor importance for investors based in the RSA. Yet, RSA is a very important source of FDI for SADC (Table 4). RSA is the top foreign investor in seven SADC countries<sup>45</sup> and accounts for more than half of foreign investment in five of them. This FDI is mainly in the form of greenfield investment in natural resources, followed by basic industries, utilities, and services (Nordas 2001).

According to Gelb (2005), RSA's FDI in Africa has been driven by the liberalization of regulations and lowering of entry barriers in the host countries. The RSA concluded a number of bilateral investment treaties and double taxation treaties within the region in the late 1990s. Te Velde and Page (2004) reckon that the regional and bilateral agreements stimulated the RSA's investment in SADC which was driven by cost reduction concerns, especially regarding wage costs. Thomas (2004) expresses hopes that OFDI from RSA will improve the balance of payments of poorer SADC members. She also suspects, however, that this effect may partly be offset if regional capital increasingly flows to the RSA in the course of further integration.

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<sup>42</sup> RSA represented almost 70% of SADC's GDP in 2006, followed by Angola with a share of 12% (World Bank 2007).

<sup>43</sup> As noted in Section 3.c above, vertical production schemes are a factor preventing large scale FDI diversion from ASEAN to China.

<sup>44</sup> According to Te Velde and Page (2004), investment in neighboring African countries has recently increased.

<sup>45</sup> These are Lesotho, Malawi, Dem. Rep. of Congo, Swaziland, Botswana, Mozambique, and Zambia.

**Insert Table 4 somewhere here**

#### **4. Summary and Conclusions**

It is probably not by pure coincidence that RIAs have mushroomed while policymakers around the world fiercely compete for FDI inflows. RIAs are often considered a means to improve member countries' attractiveness to FDI. This is even though the links between regional integration and FDI are highly complex analytically, and previous empirical evidence is less straightforward than policymakers make us believe.

Both RIAs and FDI are too diverse to allow for any generalized verdicts concerning the effects of regional integration on FDI flows to member countries. Our four case studies on Mercosur, ASEAN, SAARC and SADC clearly reveal that it depends on various factors, some of which are at best loosely related to regional integration, whether high expectations will be met. RIAs differ with respect to the degree of institutionalization, and it cannot even be taken for granted that RIAs with more developed institutions are more successful in attracting FDI than RIAs that are rather market-driven. A loosely defined cooperation scheme may have stronger effects than an officially declared common market if the latter suffers from serious implementation deficits. The degree of openness of RIAs towards outsiders is likely to affect the type of FDI from extra-regional sources, with uncertain effects on overall inflows.

Furthermore, it is almost impossible to isolate the FDI effects of regional integration. On the one hand, effects may be underestimated by looking at FDI developments only *after* the conclusion of RIAs – e.g., if credible policy announcements lead to anticipation effects. On the other hand, regional integration often goes hand in hand with unilateral liberalization, which may be the ultimate reason of a country's improved attractiveness to FDI. And finally, the data situation leaves much to be desired, notably with regard to outward FDI activities in neighboring countries by major regional players such as Brazil, China, India and the Rep. of South Africa.

Against this backdrop, it is not really surprising that the four case studies provide just tentative answers to the three major questions addressed in this paper. First, it appears that country-specific factors were often more important as a stimulus to FDI than regional integration viewed in isolation. National boom and bust phenomena played a particularly important role in Mercosur. FDI trends for the heavyweights in ASEAN diverged markedly. India experienced substantial FDI inflows after domestic economic reforms. Similarly,

increasing FDI to SADC members in the late 1990s is commonly ascribed to liberalization and privatization policies.

Second, the distribution of FDI within regional integration schemes tends to support the skeptical view that RIA members are unlikely to equally share FDI-related benefits. At the same time, however, the larger and richer members are not necessarily the winners taking all. In per-capita terms, Uruguay's attractiveness to FDI hardly trailed Brazil's. Several small ASEAN members outperformed larger partner countries once FDI is related to country size. In South Asia, the FDI boom in India has little to do with RIA-induced concentration.

Third, the deficient data situation cautions against strong conclusions concerning the role of the four regional heavyweights in promoting effective regional integration through outward FDI in neighboring countries. Indications are, however, that one should not expect too much (Table 4). The intra-regional share of outward FDI by Brazil, China, India and the Republic of South Africa does not appear to be on an upward trend, even though the starting point typically was fairly low. This is not to ignore that the RSA, for instance, represented an important source of FDI from the perspective of some SADC partners; the same applies to Brazilian FDI in Paraguay or Indian investments in Nepal.

In the end, outward FDI from these regional heavyweights is likely to resemble FDI from more traditional sources in that it is driven by various motives. Current examples include: Brazil's tax-induced FDI directed to or through offshore financial centers; China's resource-seeking FDI in sub-Saharan Africa; and India's asset- and market-seeking FDI in highly developed host countries such as the United States. Market-seeking and efficiency-seeking FDI in neighboring countries, induced by regional integration, may gain in relative importance as the European example suggests. However, this requires sound implementation of RIAs in the first place. Moreover, regional integration is most likely to remain just one reason to undertake outward FDI.

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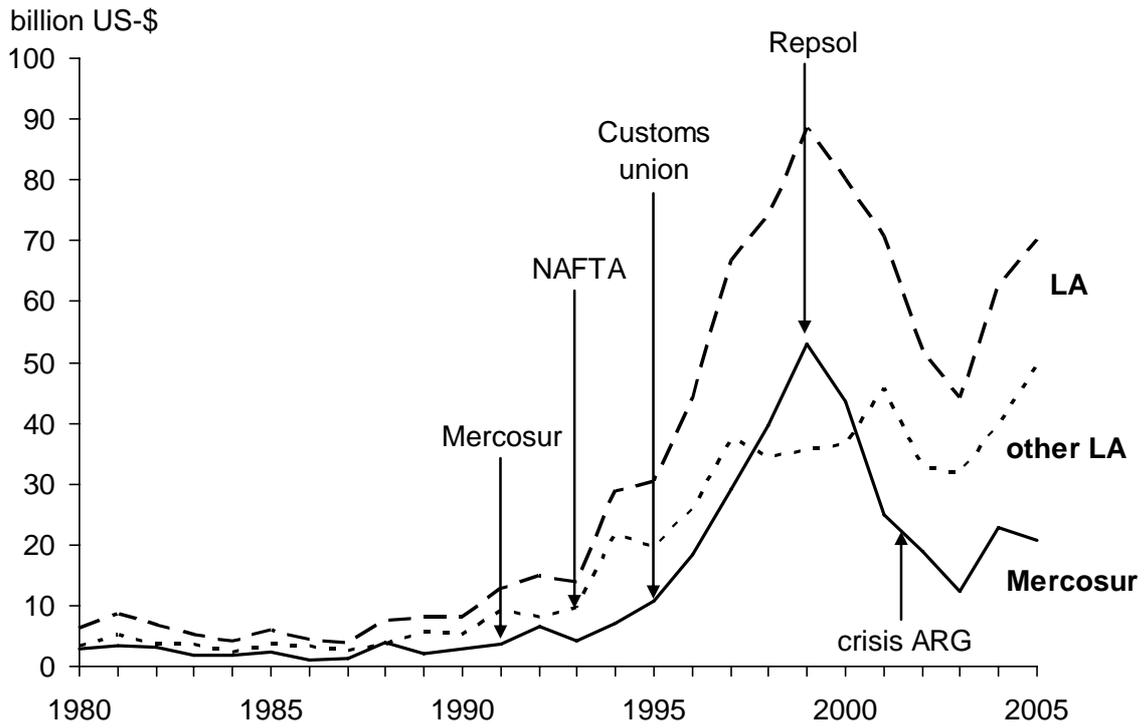
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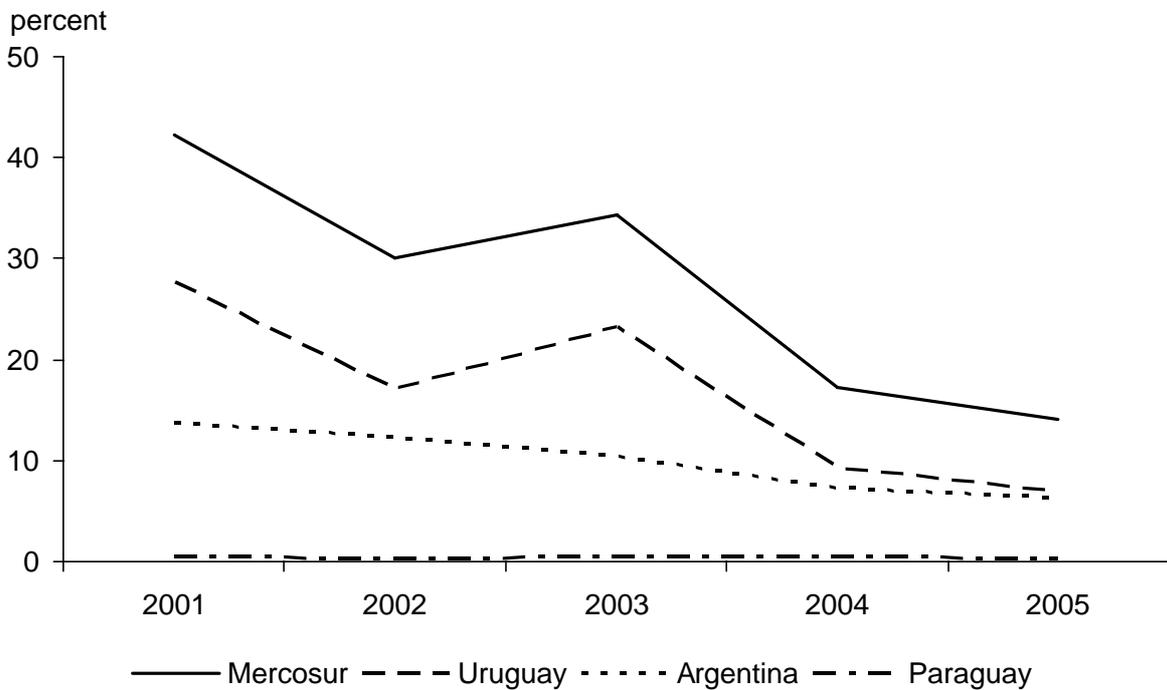
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Figure 1 — FDI Inflows: Mercosur in the Latin American Context, 1980-2005



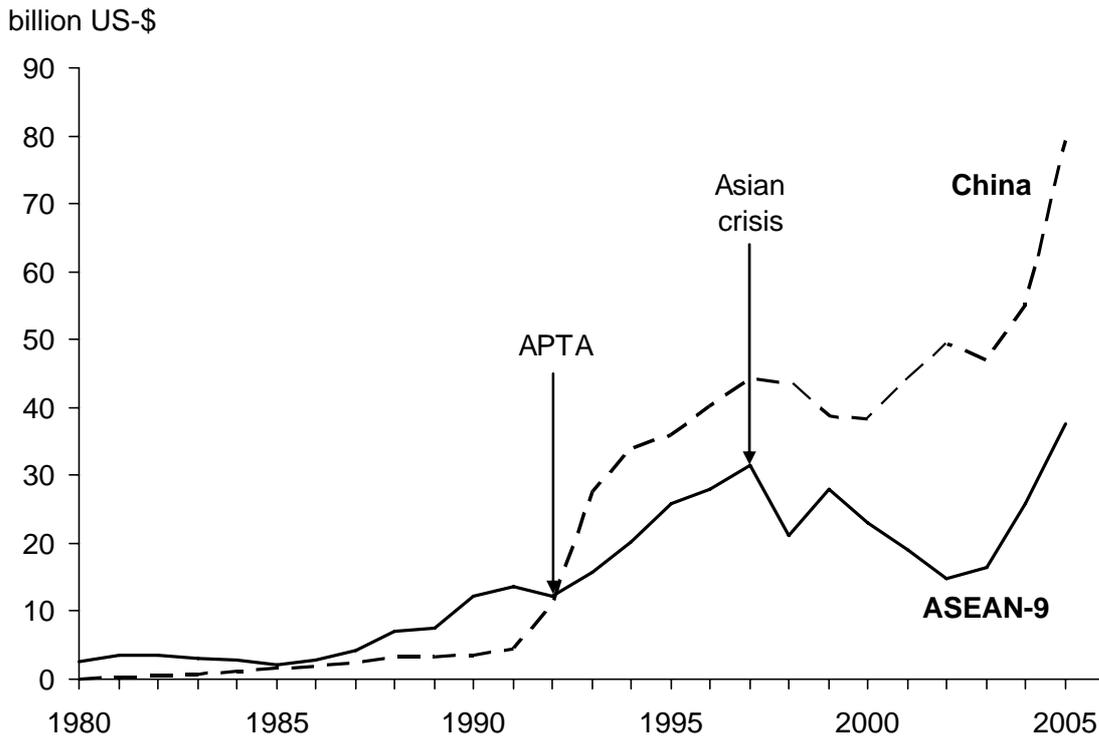
Source: World Bank WDI 2007

Figure 2 — Share of Mercosur in Brazilian Outward FDI (excluding flows to tax haven countries), 2001 - 2005



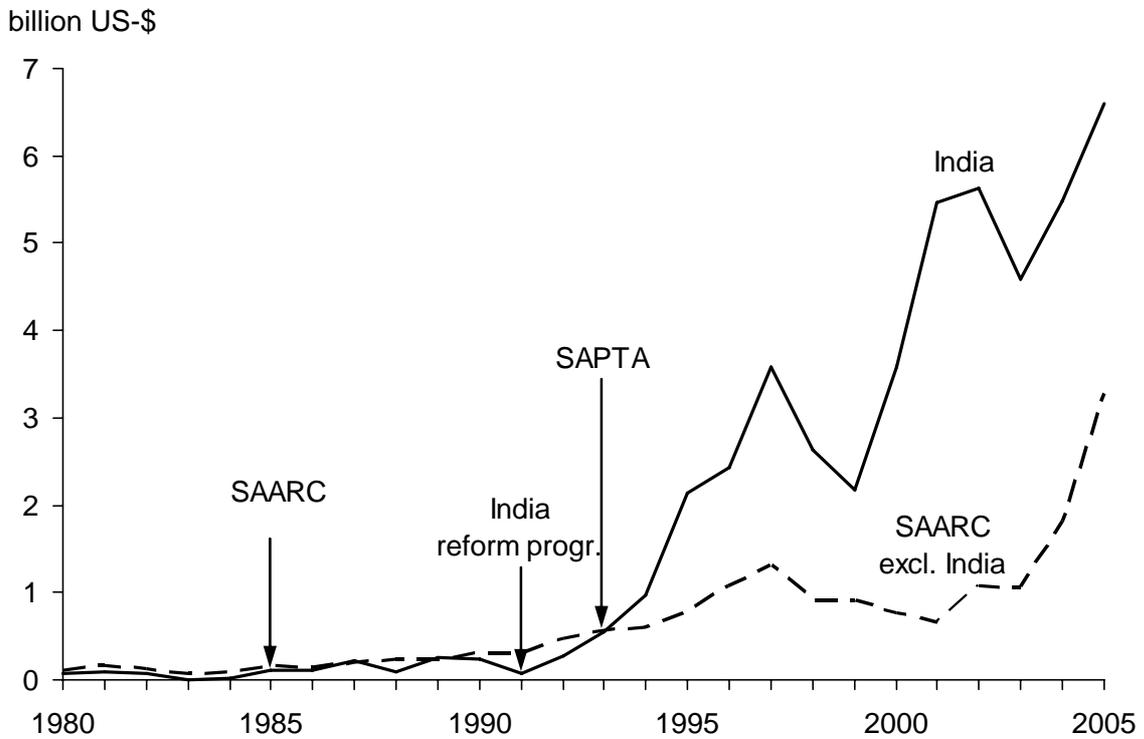
Source: UNCTAD FDI/TNC Database

Figure 3 — FDI Inflows: ASEAN (excluding Brunei) and China, 1980-2005



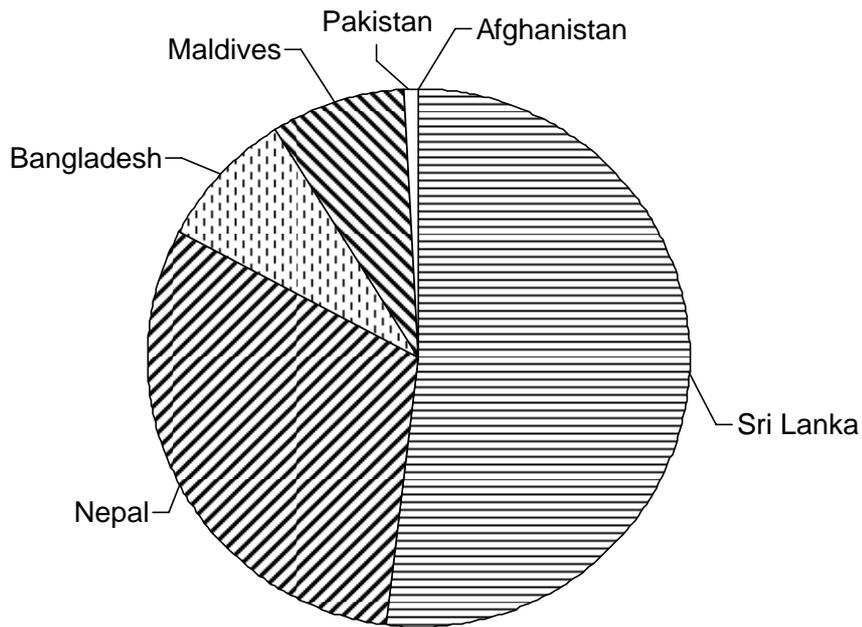
Source: World Bank WDI 2007

Figure 4 — FDI Inflows: SAARC, 1980 - 2005



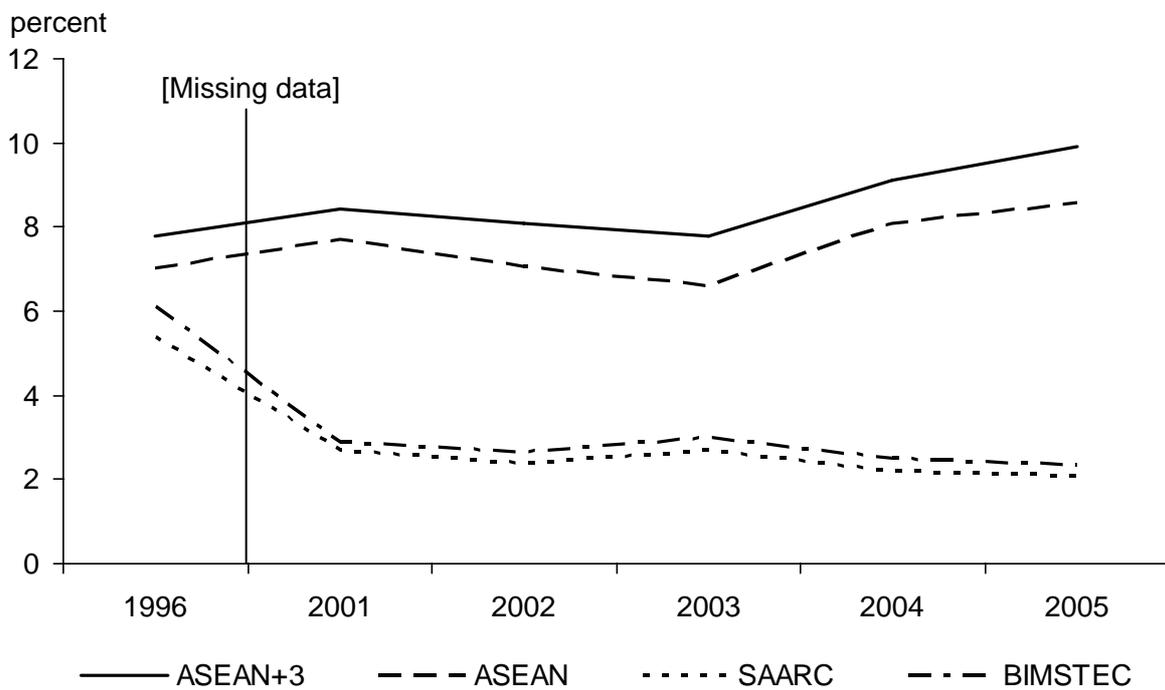
Source: World Bank WDI 2007

Figure 5 — India's Outward FDI Stock in SAARC: Distribution by Country, 2005



Source: UNCTAD FDI/TNC Database

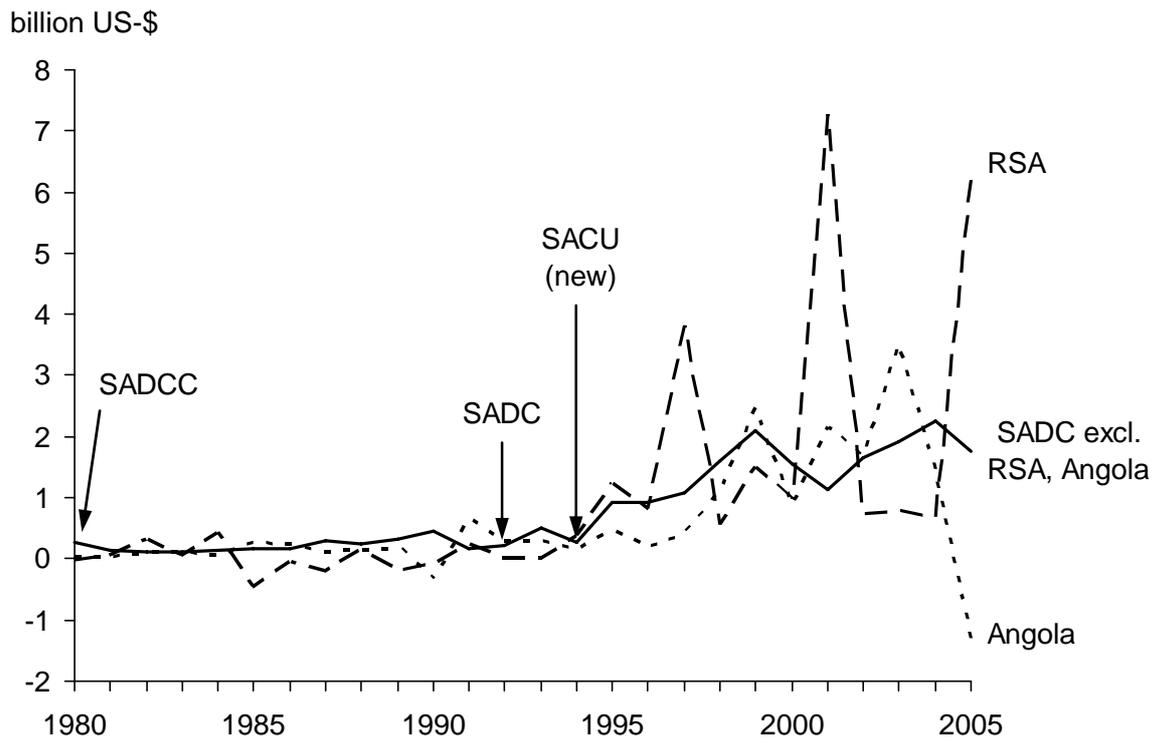
Figure 6 — Regional Shares in India's Outward FDI Stocks, 1996 - 2005



Note: flows to offshore financial centres have been excluded from totals.

Source: UNCTAD FDI/TNC Database

Figure 7 — FDI Inflows: SADC, 1980 - 2005



Source: World Bank WDI 2007

Table 1 — Inward FDI Stocks, 1980 and 2005: Four Major Integration Schemes

	Stocks 2005/1980	Share in FDI stocks in all developing countries (percent)		Share of major player in FDI stocks in all member countries (percent)	
		1980	2005	1980	2005
Mercosur	11.1	17.8	9.8	74.6 (Bra)	77.3 (Bra)
SADC	4.9	16.1	4.0	77.5 (RSA)	66.0 (RSA)
SAARC	36.7	1.3	2.3	26.8 (Ind)	73.1 (Ind)
ASEAN	19.8	14.3	14.1	---	---
Memo: China	296	0.8	12.0	---	---

Source: UNCTAD

Table 2 — FDI Inward Stocks in Mercosur Member Countries, 1980-2005

	1980	1990	2000	2005
	Mercosur = 100			
Argentina	22.8	18.6	38.8	21.2
Brazil	74.6	79.1	59.2	77.3
Paraguay	0.8	0.9	0.8	0.4
Uruguay	1.8	1.4	1.2	1.1
	US\$ per capita			
Argentina	190.2	269.4	1832.2	1425.8
Brazil	143.7	249.1	591.5	1076.8
Paraguay	61.9	98.1	247.6	196.4
Uruguay	145.0	216.2	629.2	826.4

Source: UNCTAD

Table 3 - FDI Inward Stocks in ASEAN Member Countries, 1980-2005

	1980	1990	2000	2005
	ASEAN = 100			
Brunei Darussalam	0.1	0.1	1.5	2.5
Cambodia	0.2	0.1	0.6	0.7
Indonesia	24.7	14.0	9.4	5.6
Lao People's Dem. Rep.	0.0	0.0	0.2	0.2
Malaysia	27.3	16.3	20.0	12.7
Myanmar	0.0	0.4	1.5	1.3
Philippines	6.8	5.2	4.9	3.7
Singapore	28.3	48.2	42.8	49.9
Thailand	5.2	13.0	11.4	15.1
Viet Nam	7.5	2.6	7.8	8.3
	US\$ per capita			
Brunei Darussalam	96.3	128.9	11599.7	24854.8
Cambodia	5.6	3.9	123.6	177.1
Indonesia	31.0	48.4	117.1	93.4
Lao People's Dem. Rep.	0.7	3.1	106.4	118.1
Malaysia	375.5	570.0	2266.4	1862.2
Myanmar	0.0	7.0	84.2	101.4
Philippines	26.6	53.4	168.1	165.9
Singapore	2216.0	10100.9	28036.1	43195.3
Thailand	20.9	151.8	493.1	897.5
Viet Nam	26.7	24.9	260.4	366.2

Source: UNCTAD

Table 4 — Anchor Countries (AC) and Regional Integration

	AC's OFDI to region / AC's total OFDI	Tendency	Influence of regional integration observable?	AC's OFDI to region / Total IFDI to region	Tendency
China/ ASEAN	13% <sup>1</sup>	→	ambiguous	0.3%	↗
India/ SAARC	2.1%	→	no	1.6%	→
RSA/ SADC	~7% <sup>2</sup>	?	ambiguous	25% <sup>(2003)</sup>	?
Brazil/ Mercosur	13.7%	↘	no	7.9%	→

Stock data from 2005 unless indicated otherwise, excluding major flows to offshore financial centers.  
<sup>1</sup> The Chinese OFDI stock in ASEAN+3 accounts for 23% of China's total OFDI.  
<sup>2</sup> This is based on own calculations for OFDI to Africa (8%) and to eight SADC countries for which data are available (5%), and the assertion in Te Velde and Page (2004) that 90% of RSA's OFDI in Africa goes to SADC.

Source: UNCTAD FDI/TNC Database; Te Velde and Page (2004)