External Trade Liberalization and Economic Growth in an FTA: Cases of Exogenous and Endogenous FDI Policy

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Abstract

This paper shows that the properties of an external tariff rate set by a home government in a free trade area (FTA) may change drastically, depending on whether economic growth in the FTA means a growth of the market or a decline in the inside firms' marginal costs. Furthermore, the properties of the optimal external tariff will be reversed depending on whether FDI policy is determined exogenously or endogenously. We use a three-country model which is a FTA variant of the "third country model" of the strategic trade policy. We assume that firms outside the FTA may supply, either by export or by FDI, homogeneous goods to the home market and that the home government can choose a fixed cost, as an FDI policy, that outside firms must incur in order to have production plants in the home country. First, when FDI cost is *exogenous*, if that cost is sufficiently low, the optimal external tariff rate is the critical rate at which the outside firms switch their supply mode from export to FDI. This tariff rate is *lowered* when the demand in the home market grows, while it is *raised* when the inside firms' marginal costs decline. Furthermore, this optimal tariff rate will be *lowered* when the number of outside firms is smaller

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while the effect of the number of inside firms is ambiguous. Second, when FDI policy is *endogenously* determined, the optimal external tariff rate is the tariff rate at which the home welfare is maximized when outside firms choose export. In contrast to the case of exogenous FDI policy, this tariff rate is *raised* when the demand in the home market grows, while it is *lowered* when inside firms' marginal costs decline. The optimal external tariff rate and FDI cost chosen will be *higher* when the numbers of inside and outside firms are smaller.

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