

Preferential Trade Liberalization and Content-Requirement of Rules of Origin under Imperfect Competition

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Abstract

This paper investigates the effects of a free trade agreement (FTA) with preferential rules of origin (ROOs) by an international oligopoly model where the production costs of firms are heterogeneous. In order to be qualified for tariff-free exports in the FTA, ROOs require the firms to use a certain fraction of parts and intermediates produced within the FTA. Outside firms can make foreign direct investments (FDI) by incurring a fixed cost. It is found that the external tariffs of FTA are positively related to the restrictiveness of preferential ROOs, and the formation of FTA with the content-type ROOs may cause FDI diversion in which a market-oriented FDI by an efficient firm is replaced by an export-platform FDI by a less efficient firm.

JEL Classification Numbers: F12, F13, F15

Keywords: rules of origin; free trade agreements; foreign direct investment; content requirement

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