Is FTA/EPA Effective for a Developing Country to Attract FDI? Simulation Analysis Based on an Extended Knowledge-Capital Model

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Abstract

To prepare an answer to the question of how a developing country can attract FDI, this paper explored the factors and policies that may help bring FDI into a developing country by utilizing an extended version of the knowledge-capital model. With a special focus on the effects of FTAs/EPAs between market countries and developing countries, simulations with the model revealed the following: (1) Although FTA/EPA generally ends to increase FDI to a developing country, the possibility of improving welfare through increased demand for skilled and unskilled labor becomes higher as the size of the country declines; (2) Because the additional implementation of cost-saving policies to reduce firm-type/trade-link specific fixed costs ends to depreciate the price of skilled labor by saving its input, a developing country, which is extremely scarce in skilled labor, is better off avoiding the additional option; (3) If a country hopes to enjoy larger welfare gains with EPA, efforts to increase skilled labor in the country, such as investing in education, may be beneficial.

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