

# When free trade agreement meets competition: The impact of the EU-Korea FTA on Japanese firms' investment behavior

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## Abstract

This study analyzes the impact of bilateral free trade agreements (FTAs) on the decision-making of multinational enterprises from a third country. Specifically, we analyze how Japanese overseas affiliates located in the European Union (EU) changed their investment behavior in response to the EU-Korea bilateral FTA concluded in 2011. By applying unique Japanese data at the affiliate level, we estimate how the EU-Korea FTA affects the performance of Japanese firms operating in the EU. To mitigate the endogeneity problem due to self-selection into the region, we employ a difference-in-differences method and compare the performance variation of Japanese affiliates located in the EU with that of affiliates outside the EU, after controlling for firm and regional characteristics. We find that the EU-Korea FTA reduces the amount of foreign direct investment (FDI) made by Japanese affiliates within the EU. Furthermore, we explore industry heterogeneity and find that industries in which Japanese and Korean firms compete the most have Japanese affiliates more prone to be negatively affected by such external shocks. The study reveals that the indirect impact of an FTA on third-party FDI can be substantial.

*Keywords:* FTA; Firm-level data; Difference-in-differences; Industry competition

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