advanced production processes. This longer-term response can be designated technically advanced foreign investment.

A free trade area dilutes or eliminates the interdependence induced by tariff protection. If the domestic price in one country is closer to the world price then creating a free trade area will erode the interdependence between foreign owners and domestic inputs in the other country. A free trade area thus threatens prior foreign investment in branch plants established to circumvent the tariff. In the absence of a re-orientation in corporate stategy through rationalization or world product mandating, a free trade area implies disinvestment in foreign-owned branch plants.

The net impact of a free trade area on foreign direct investment depends upon the relative magnitude of the increase in technically advanced foreign direct investment compared to the decline in branch plant foreign investment. The relative magnitude is obscured by the different time horizons associated with each response. Creating a free trade area through the elimination of mutual tariff barriers immediately alters the environment for corporate decision-making to the extent that the consequences would become fully evident over a horizon of approximately five years. Technical advances in production processes are much more gradual so that their impact on the internationalization of production occurs over a horizon of between two and three decades. Hence, if a bilateral free trade area does not induce significant changes in corporate strategy for branch plants, the level of foreign direct investment will initially decline over a medium-term horizon of approximately five years and then subsequently increase over a longer-term horizon of two to three decades.