

Effects of International Trade Policies on Multinational Business Expansion

Madhav Dandona

Abstract:

This paper examines how international trade policies influence the expansion strategies of multinational enterprises (MNEs) through the lens of key publications by the WTO, OECD, and IMF. As global value chains (GVCs) deepen and production becomes increasingly fragmented, trade policy instruments - tariffs, non-tariff barriers, and services restrictions - play a critical role in shaping market access, cost structures, and investment decisions. The study synthesises institutional evidence to analyse how policy environments determine entry modes, foreign direct investment (FDI) flows, affiliate output, and production relocation. It highlights how trade policy shocks, such as the 2018–2019 U.S.–China tariff escalation, trigger rapid restructuring of supply chains and shift production across countries. The paper also evaluates measurement challenges and the evolving role of digital and services trade policies. The findings underscore that predictable, transparent, and liberal trade regimes are essential for sustaining MNE competitiveness, supporting economic development, and promoting resilient global production systems.

Chapter 1: Introduction

International trade policy has become one of the most influential external forces shaping how multinational enterprises (MNEs) expand, relocate, and structure their global operations. Tariffs, non-tariff barriers (NTBs), trade agreements, standards regimes, and services-related commitments all directly affect the cost structures and strategic options available to globally operating firms. In modern global value chains (GVCs), where production is fragmented across multiple jurisdictions, even small policy changes can ripple across supply networks, influencing sourcing, investment decisions, and market entry modes.

As the World Trade Organization (2024) notes, the rise of interconnected supply chains means that trade policies not only determine cross-border flows of goods but also influence firm participation, competitiveness, and inclusiveness in the global economy. MNEs respond to these policy environments by adjusting their investment patterns, relocating production platforms, diversifying markets, and modifying their organisational structures to remain resilient and cost-efficient. Blanga-Gubbay and Rubínová (2023) emphasise that the interaction between trade openness, foreign direct investment (FDI), and economic development forms a dynamic system where policy predictability, liberalisation, and regulatory cooperation shape the long-term growth trajectories of businesses and host economies.

In this context, international trade policy becomes more than a set of legal rules; it becomes a strategic landscape that guides how MNEs plan expansion and manage risks.

Over the past three decades, MNEs have emerged as dominant actors in the global economy, accounting for more than half of world trade and driving much of global investment and technology diffusion (OECD, 2019). The integration of national economies through trade liberalisation and the proliferation of bilateral and multilateral agreements has accelerated the growth of cross-border production systems.

Foreign Direct Investment (FDI) : FDI has become a primary route for firms to establish a physical presence in foreign markets, access local consumers, exploit efficiency gains, and integrate into local

production ecosystems. Blanga-Gubbay and Rubínová (2023) argue that FDI flows are strongly tied to trade policy conditions, with MNEs favouring locations offering lower trade costs, regulatory stability, and clear commitments to liberalisation.

Global Value Chains (GVCs) : The rise of GVCs has further intensified the connection between trade policy and business expansion. Firms now distribute tasks globally according to comparative advantage, labour costs, and market access benefits. As the World Trade Organization (2024) highlights, participation in GVCs is heavily influenced by trade facilitation, tariff structures, and regulatory coherence. Even marginal increases in trade costs can incentivise firms to relocate production or redesign supply chains.

Services Trade : Services have become central to MNE expansion, especially in digital-intensive and knowledge-based sectors. The OECD (2019) reports that nearly one-third of global FDI is directed toward services, and cross-border regulations - such as licensing requirements or data restrictions - significantly condition firms' decisions to invest or deliver services abroad. Trade policy commitments in services (e.g., those negotiated under the WTO's General Agreement on Trade in Services) shape the feasibility and profitability of establishing foreign affiliates.

Together, these dynamics illustrate how deeply trade frameworks are embedded in the rise and functioning of MNEs.

The rapid evolution of global trade policy - marked by new regional agreements, rising protectionism, export controls, environmental standards, and digital trade rules - has dramatically altered the strategic environment for multinational firms. Shifts in policy can reshape cost structures, disrupt supply chains, and influence market accessibility. Recent global events, including tariff escalations, geopolitical tensions, and post-pandemic restructuring, have pushed MNEs to reassess their global footprints.

Despite extensive research, uncertainty persists about **how** specific trade policy changes affect MNE expansion decisions, particularly across dimensions such as:

- market entry mode (exporting vs FDI)
- location choice for production or affiliate operations
- sourcing strategies within GVCs
- investment in services sectors
- long-term global expansion planning

Existing studies highlight important trends, but a comprehensive synthesis using institutional insights from the WTO, OECD, and IMF remains limited. This paper addresses this gap by examining how modern trade policy frameworks shape multinational expansion patterns, drawing on authoritative institutional reports and empirical evidence.

To guide this investigation, the study is structured around the following core research questions:

1. How do international trade policies - tariffs, NTBs, and services regulations - affect multinational firms' expansion strategies?
2. In what ways do WTO commitments, OECD trade–investment insights, and IMF policy indicators shape MNE decisions related to FDI and market entry?
3. How do policy-induced changes in global value chains influence location choices and production restructuring for multinationals?
4. To what extent do trade policy shocks prompt MNEs to reorganise or diversify their international operations?

These questions allow for a systematic understanding of the mechanisms through which policy environments influence multinational strategy.

This study adopts a qualitative and analytical research design, relying primarily on authoritative institutional publications from the WTO, OECD, and IMF, supported by selected working papers and global datasets on trade and investment. The methodological approach begins with institutional document analysis, drawing on WTO reports and working papers for insights into trade rules, global value chain participation, and firm-level effects of policy commitments (World Trade Organization, 2024); on OECD analytical papers for empirical evidence concerning multinational production, services trade restrictions, and the relationship between trade and investment (OECD, 2019); and on IMF working papers for methodological perspectives on FDI measurement, global trade policy activity, and cross-country patterns. Building on this foundation, the study conducts a comparative thematic synthesis to extract and integrate core themes such as FDI determinants, GVC restructuring, and policy-driven shifts in multinational expansion. These institutional insights are then interpreted through established scholarly frameworks, including comparative advantage theory, the eclectic (OLI) paradigm, and transaction cost economics, ensuring conceptual grounding within international business theory. Finally, the research constructs a conceptual mapping of how different trade policy instruments shape multinational firm strategies, enabling the organisation of empirical findings into a coherent analytical structure. This blended methodology ensures that the study's conclusions are anchored in rigorous, policy-grounded evidence rather than isolated theoretical claims.

Chapter 2: Conceptual Foundations of Trade Policy & Multinational Activity

2.1 Trade Policy Instruments: Tariffs, Non-Tariff Barriers, and Services Restrictions

International trade policy encompasses a broad set of instruments that directly shape the competitive environment in which multinational enterprises (MNEs) operate. The most traditional of these are tariffs, which impose taxes on imported goods and alter relative prices across markets. Even small changes in tariff rates can shift cost structures and distort sourcing decisions, especially for firms integrated into multi-stage global value chains (GVCs). Tariffs accumulate across stages of production, amplifying the final cost to MNEs that rely on cross-border inputs (OECD, 2020).

Beyond tariffs, governments increasingly deploy non-tariff barriers (NTBs) - including quotas, technical regulations, customs procedures, sanitary and phytosanitary (SPS) measures, and domestic content rules. NTBs often impose compliance burdens and administrative delays that raise the effective cost of trade without being explicitly price-based. The OECD (2020) emphasises that NTBs can add substantial cumulative trade costs along GVCs, affecting decisions on where firms place production facilities and how they structure supply networks.

For MNEs operating in services, services trade restrictions are equally consequential. These may include licensing requirements, foreign equity caps, data localisation rules, restrictions on cross-border data flows, and limitations on commercial presence (Mode 3). Roy (2019) shows that service restrictions significantly influence FDI and affiliate operations by limiting the ability of foreign firms to enter, compete, or scale in domestic markets. Because services underpin many manufacturing operations - logistics, finance, digital solutions - services policies often exert indirect effects on the entire production system. Together, these trade policy instruments create a regulatory environment that either facilitates or hinders multinational expansion.

2.2 Modes of International Business Expansion:

Exporting, Licensing, FDI, and Affiliate Production MNEs choose among several modes of international expansion depending on cost structures, market conditions, and policy constraints. The simplest mode is

exporting, where firms serve foreign markets from domestic production bases. Exporting is attractive when trade costs are low and when firms can avoid large sunk costs of establishing a local presence.

Licensing and franchising represent another form of entry, allowing foreign firms to transfer intangible assets - technology, branding, or intellectual property - to local firms in exchange for royalties. This mode reduces risk and investment requirements but also limits control over operations. Licensing becomes more appealing when FDI restrictions are high or where the regulatory environment discourages foreign ownership.

The most substantial mode is Foreign Direct Investment (FDI), which involves establishing or acquiring a foreign affiliate. FDI enables firms to internalise operations, maintain tighter control, and better adapt to local market conditions. As Roy (2019) highlights, service-sector MNEs often rely on FDI because regulatory restrictions limit cross-border service delivery.

Finally, firms may adopt affiliate-based production, building or using foreign production platforms to serve multiple regional markets. This mode is especially prevalent in GVC-intensive industries such as electronics and automotive manufacturing. OECD (2020) notes that affiliate production allows firms to circumvent tariffs, reduce transportation costs, and respond to trade barriers by shifting stages of production across borders. These different modes of expansion give MNEs flexibility in responding to trade policy environments and global market volatility.

2.3 How Trade Costs Influence Entry Mode Choice

Trade costs - arising from tariffs, NTBs, logistics barriers, policy uncertainty, and services restrictions - play a decisive role in determining the entry mode chosen by multinational firms. When trade costs are low, exporting is typically the preferred mode because it avoids the fixed and sunk costs associated with establishing a foreign subsidiary. However, as trade costs rise, exporting becomes less viable. Firms then evaluate whether producing abroad through FDI or forming local partnerships provides a more efficient pathway to market access.

OECD (2020) highlights that cumulative trade costs in GVCs can be particularly distortive: when inputs cross multiple borders, tariffs and regulatory barriers compound, making exporting increasingly expensive. In such situations, firms shift toward horizontal FDI (replicating production in the foreign market) or vertical FDI (fragmenting production internationally to exploit cost differences). Similarly, services firms facing strict regulatory environments often resort to establishing affiliates abroad because service delivery through cross-border channels becomes non-viable (Roy, 2019).

The IMF (2025) Trade Policy Activity (TPA) Index further contributes to understanding how dynamic changes in trade policy shape business decisions. In periods of rising trade policy restrictiveness - such as protectionist shocks - MNEs accelerate investment relocations, diversify supply chains, or switch from exporting to FDI-based expansion. Conversely, liberalisation episodes stimulate exporting and encourage firms to integrate deeper into GVCs.

Overall, MNEs continuously balance the cost of cross-border trade against the cost of local establishment. When trade costs increase, the incentive shifts toward internalisation through ownership, whereas lower costs favour arms-length trade such as exporting or licensing. Understanding this trade-off is essential for explaining MNE behaviour in an evolving global policy environment.

Chapter 3: Trade Policy, FDI, and Economic Development

3.1 How FDI Responds to Trade Openness

Foreign Direct Investment (FDI) is closely tied to the degree of trade openness within host economies.

Trade liberalisation - such as tariff reductions, harmonised standards, and commitments to transparent regulatory frameworks - tends to attract multinational enterprises (MNEs) by lowering operational uncertainty and reducing the cost of cross-border production. Blanga-Gubbay and Rubínová (2023) emphasise that trade openness strengthens both horizontal and vertical FDI by enabling firms to integrate international production networks and exploit cost advantages across borders.

In horizontal FDI, firms replicate production to serve local markets more efficiently. Lower tariffs reduce barriers that previously incentivised “tariff-jumping” investment, enabling MNEs to choose destinations based on broader strategic considerations like market size, institutional quality, and political stability. For vertical FDI, trade openness enhances the ability of firms to manage fragmented supply chains, relying on the seamless movement of intermediate goods between affiliate locations. OECD (2019) further notes that liberalised trade regimes foster an enabling environment for technology diffusion, knowledge spillovers, and competitive upgrading, which encourages further investment inflows.

However, trade policy uncertainty - such as the threat of tariff hikes or shifting regulatory conditions - can deter investment by raising perceived risks. The IMF (2025) highlights that periods of heightened trade-policy activity, measured through its Trade Policy Activity (TPA) Index, correlate with reduced cross-border investment flows and delayed expansion decisions. Overall, openness promotes FDI by lowering transaction costs and reinforcing predictable market conditions.

3.2 Development Outcomes of Multinational Investment

FDI contributes significantly to economic development through capital accumulation, employment generation, technology spillovers, and integration into global value chains. Blanga-Gubbay and Rubínová (2023) show that foreign affiliates frequently operate at higher productivity levels than local firms, contributing to host-country competitiveness through knowledge transfer and improved managerial practices. These productivity spillovers occur through direct interactions (supplier development) and indirect diffusion (labour mobility and imitation).

OECD (2019) reports that economies deeply embedded in global production networks benefit from increased value-added generation, export diversification, and enhanced firm capabilities. Participation in GVCs allows domestic firms to access international markets indirectly by becoming suppliers to MNEs, which often impose higher standards in quality, logistics, and compliance. As a result, domestic industries experience long-term structural upgrading.

Additionally, FDI contributes to public revenue through taxation and stimulates local competition, encouraging domestic firms to innovate. Yet the developmental impact is not automatic. The IMF (2025) notes that when trade policies create distortions or when investment is highly footloose, benefits may be uneven across sectors or regions. Effective governance, strong institutions, and complementary policies - such as education, infrastructure, and financial reform - are essential to translate FDI into sustainable development outcomes.

3.3 Role of Policy Predictability, WTO Commitments, and Regulatory Regimes

Policy predictability is a core determinant of multinational investment behaviour. MNEs prefer environments where trade policy is transparent, stable, and backed by credible commitments. WTO membership and adherence to multilateral rules reduce uncertainty by binding tariff ceilings, limiting arbitrary interventions, and establishing dispute settlement frameworks. The World Trade Organization’s 2024 report highlights that predictable trade regimes significantly enhance investor confidence because firms can plan long-term operations without fear of sudden policy reversals.

WTO commitments in services - such as those under the General Agreement on Trade in Services (GATS)

- are particularly important for MNEs operating in finance, telecommunications, logistics, and digital trade. Roy (2019) demonstrates that deeper services commitments strongly correlate with higher FDI inflows and larger affiliate presence, as foreign firms rely on regulatory stability to establish cross-border services operations (Mode 3).

OECD (2019) reinforces that regulatory coherence across trade and investment frameworks amplifies the benefits of openness. For example, when trade facilitation measures are combined with investment liberalisation, the overall cost of establishing and running foreign affiliates decreases substantially. Conversely, fragmented or inconsistent regulations - particularly in data governance, licensing, or market-entry requirements - act as NTBs that discourage expansion.

The IMF (2025) provides further evidence that unpredictable shifts in trade policy intensity, such as abrupt tariff adjustments or export restrictions, disrupt multinational planning. Firms respond by delaying projects, reallocating investment to more stable jurisdictions, or restructuring supply chains to minimise exposure.

Thus, credible trade policy commitments and regulatory stability are fundamental to attracting and sustaining multinational investment.

Chapter 4: Global Value Chains, Export Platforms, and Location Decisions

4.1 Understanding Global Value Chains (GVCs) and MNE Network Structures

Global Value Chains (GVCs) represent the fragmentation of production across multiple countries, where each stage of value creation - design, component manufacturing, assembly, logistics, services - is distributed according to cost efficiency and strategic advantage. MNEs orchestrate these networks by coordinating suppliers, affiliates, and contract manufacturers across borders. According to the WTO (2014), the rise of GVCs has fundamentally redefined trade: nearly 70 percent of global trade today consists of intermediate goods and services moving within multinational networks or between closely integrated suppliers.

In this structure, trade policy becomes a decisive force. Even minor tariff changes can affect costs across multiple stages of production. Non-tariff barriers such as standards, rules of origin, or customs procedures can fragment supply chains and disrupt cross-border coordination. OECD (2020) notes that the cumulative nature of these barriers is especially damaging in GVC-intensive sectors such as electronics, automotive, and pharmaceuticals, where inputs cross borders several times before final assembly.

MNEs therefore design their global networks to minimise exposure to policy-induced trade costs. This often involves shifting critical stages of production to more predictable jurisdictions, restructuring supplier networks, or increasing redundancy across geographic locations.

4.2 Export-Platform Production: Why MNEs Build Regional Hubs

Export-platform FDI occurs when firms establish production facilities in one country primarily to export to neighbouring or regional markets rather than to serve only the host market. WTO (2014) highlights that these platforms enable MNEs to exploit economies of scale, preferential trade agreements, and regional tariff structures.

Key advantages for firms include:

- Access to regional free trade zones, which lowers tariff costs for serving multiple markets from one location.
- Consolidation of production, reducing duplication and overheads.

- Strategic flexibility, allowing firms to reroute exports quickly if trade policies shift in one of the destination countries.
- Labour or input cost arbitrage, particularly when export-platform countries offer favourable factor conditions.

Examples include Mexico (serving North America), Poland (serving the EU), and Vietnam (serving both Asia and Western markets).

OECD analysis (2020) shows that export-platform strategies are especially attractive in industries with long supply chains and high sensitivity to trade costs. When trade barriers rise, these hubs become even more important, allowing firms to bypass restrictive markets and maintain competitiveness.

4.3 How Tariffs and NTBs Accumulate Along GVCs

Unlike single-stage trade systems, GVCs are highly exposed to the *compounding* effect of trade barriers. Each border crossing adds additional cost layers - tariffs, rules of origin paperwork, inspections, technical standards, compliance checks, or logistics delays.

OECD (2020) emphasises three critical mechanisms through which these costs accumulate:

1. Multi-border input movement: Inputs may cross borders multiple times, multiplying tariff exposure.
2. Regulatory divergence: Differing standards across jurisdictions increase compliance burdens.
3. Customs inefficiencies: Delays and procedural complexity add implicit trade costs equivalent to tariffs.

For MNEs, this means trade policy is not a simple binary variable; it is a *systemic friction*. Firms therefore respond through:

- Production consolidation
- Relocating upstream or downstream stages
- Backward integration in low-risk countries
- Increased automation to offset higher border costs

GVC firms have some of the highest sensitivity to trade policy changes, which is why policy shocks often trigger global-scale restructuring.

4.4 Policy-Induced Restructuring of GVCs and Location Choices

Trade policy changes - whether protectionist, liberalising, or regulatory - force MNEs to reassess where they locate production and how they structure their networks. WTO (2024) highlights that abrupt tariff shocks, export bans, or sanctions can cause firms to reconfigure entire supply chains, often within months.

Key responses by MNEs include:

1. **Relocating Production Across Countries** : In response to rising trade barriers, firms shift operations to alternative countries offering lower tariffs, favourable trade agreements, or more predictable regulatory regimes. The US–China tariff escalation of 2018–19 triggered widespread relocation to Vietnam, India, Mexico, and Eastern Europe, as documented by recent studies.
2. **Rebalancing or “Friend-shoring” Supply Chains** : MNEs increasingly prefer jurisdictions with geopolitical stability, treaty alignment, or reliable trade commitments. IMF (2025) indicates that the higher the uncertainty in the policy environment, the greater the incentives for diversification.
4. **Increasing Intra-regionalisation** : As global trade becomes more uncertain, firms concentrate production within integrated regions such as ASEAN, the EU, or the USMCA. Export-platform hubs gain significance in these shifts.
5. **Reconfiguring Input Sourcing** : Tariff hikes on upstream inputs force firms to source components locally or from alternative suppliers abroad. OECD (2020) highlights that such adjustments reshape supplier networks and influence the long-term competitiveness of regional production bases.

6. **Upgrading Affiliates in Strategic Markets** : When exporting becomes too costly, firms expand the role of foreign affiliates - turning them into manufacturing hubs, R&D centres, or regional headquarters.

Overall, trade policies are no longer passive background conditions; they are active drivers of global production geography. Through tariff schedules, NTBs, services commitments, and regulatory enforcement, governments shape the architecture of international production systems and influence where MNEs invest, operate, and innovate.

Chapter 5: Services Trade Restrictions and Multinational Expansion in Services

5.1 Why Services Matter in MNE Operations

Services have become the backbone of modern multinational enterprises (MNEs), not just as standalone sectors (finance, IT, logistics, telecommunications) but as critical enablers of global value chains. Services provide the coordination, data management, financial intermediation, transport, and digital infrastructure that allow manufacturing and distribution systems to function efficiently. According to the OECD, services now account for over 60 percent of global FDI flows and form the foundational layer supporting production networks across countries (OECD, 2020).

Furthermore, the rise of digitalisation and intangible assets has increased the importance of service-based capabilities in multinational expansion. Whether through cloud services, digital payments, intellectual property, software platforms, or remote operations management, MNEs depend heavily on cross-border service flows. Roy (2019) underscores that restrictions in services trade directly constrain multinational operations, as firms require seamless access to finance, data, and digital infrastructure in foreign markets.

5.2 Services Trade Restrictiveness: Types of Barriers and Their Impact

Service trade restrictions vary widely across countries, often involving complex regulatory frameworks rather than traditional tariff measures. These restrictions include:

- Foreign equity caps limiting foreign ownership in critical sectors
- Licensing and certification requirements that impose administrative barriers
- Local presence mandates requiring firms to operate through domestic entities
- Data localisation laws restricting cross-border data flows
- Regulated pricing in sectors such as telecommunications or finance
- Restrictions on movement of professionals (Mode 4 under GATS)

Roy (2019) highlights that these restrictions significantly inhibit the ability of MNEs to deliver services across borders (Mode 1), send personnel (Mode 4), or establish a commercial presence (Mode 3). Because services are deeply embedded in manufacturing supply chains - transport, logistics, ICT, finance - services barriers also indirectly raise the cost of goods trade.

OECD (2020) further identifies that high Services Trade Restrictiveness Index (STRI) values correlate with:

- Reduced foreign affiliate output
- Lower FDI inflows
- Higher operational costs for multinational firms
- Higher GVC fragmentation costs

Service restrictions therefore have a multiplier effect compared to goods-related barriers.

5.3 Impact of Services Liberalisation on FDI and Affiliate Output

Services liberalisation - through domestic reforms, WTO commitments, or bilateral agreements - plays a

key role in shaping FDI patterns. When services markets are open and predictable, MNEs are more likely to:

- Establish subsidiaries
- Expand affiliate operations
- Integrate into domestic supply chains
- Introduce advanced managerial and technological capabilities

Roy (2019) demonstrates that countries that bind their commitments under the WTO's General Agreement on Trade in Services (GATS) experience higher levels of Mode 3 (commercial presence) investment. For instance, liberalising financial and telecommunications services lowers transaction costs and improves the infrastructure that foreign firms rely on.

OECD (2020) also finds that lower service restrictions significantly increase **foreign affiliate output**, especially in digital-intensive sectors. When regulatory barriers fall, MNEs can deliver services more efficiently, consolidate regional operations, and scale up their service provision to multiple neighbouring markets.

In contrast, restrictive environments force firms to adopt second-best strategies - such as licensing local partners or relying on joint ventures - reducing control and operational coherence.

5.4 How Services Trade Policies Shape Foreign Market Entry

Trade policies governing services determine not only whether MNEs enter a market but also *how* they enter. The choice between exporting services, franchising/licensing, and establishing fully owned subsidiaries is heavily shaped by regulatory conditions.

1. **Market Access Conditions (Ownership Rules)** : Foreign equity caps and joint-venture requirements often discourage full FDI entry, pushing firms towards lighter, less effective forms of presence.
2. **Domestic Regulation** : Rules on qualification standards, professional licensing, or local hiring influence the depth of affiliate operations.
3. **Data and Digital Regulations** : Data localisation or data transfer restrictions impede digital service providers, forcing them to establish expensive in-country infrastructure.
4. **Sector-Specific Regulations** : Sectors such as banking, insurance, telecom, and health services have stricter regulatory controls, shaping MNE decisions on scale and timing of entry.

Roy (2019) shows that in sectors with stringent restrictions, Mode 3 entry becomes costlier and more fragmented, while in open markets, MNEs prefer integrated, wholly owned subsidiaries with strong operational autonomy.

5.5 Why Services Trade Policy Is Central to the Future of MNE Expansion

The IMF (2025) emphasises that the future of multinational expansion increasingly hinges on regulatory policies rather than traditional tariff schedules. As manufacturing becomes more automated and less labour-intensive, it is services - especially digital, managerial, and technological services - that differentiate competitive MNEs.

Key trends include:

- Digitalisation and cloud-based operations
- Cross-border data flows as a new “trade frontier”
- Remote service delivery enabled by AI
- Integration of services into every stage of GVCs

Thus, services trade policies act as gatekeepers of future expansion. Liberal, predictable regulatory regimes attract high-tech, knowledge-intensive MNEs, whereas restrictive policies deter investment and

reduce innovation spillovers.

In short, services policy is no longer a subcomponent of trade policy - it *is* trade policy in the modern global economy.

Chapter 6: Trade Policy Shock Responses by Multinational Firms

6.1 How MNEs Respond to Sudden Tariff Changes

Sudden tariff changes - often triggered by geopolitical tensions, domestic protectionism, or retaliatory trade measures - create immediate cost pressures for multinational enterprises (MNEs). These shocks alter relative prices, disrupt supply chains, and force firms to reassess their global production footprints. The OECD (2020) highlights that firms operating in global value chains (GVCs) are especially exposed, as even small tariff increases accumulate through multiple border crossings.

MNEs typically respond to tariff shocks through three primary mechanisms:

1. Short-term adjustments, such as switching suppliers, stockpiling inventories, renegotiating contracts, and repricing products.
2. Medium-term restructuring, including shifting production stages abroad, revising logistics networks, and altering sourcing relationships.
3. Long-term strategic relocation, where firms permanently move factories, diversify production bases, or exit high-risk countries.

The IMF (2025) notes that tariff shocks also increase uncertainty, leading to delayed investment, cautious capital allocation, and a higher reliance on risk-averse strategies. Firms ultimately weigh tariff-related costs against the sunk costs of relocation, choosing the path that preserves competitiveness.

6.2 Production Relocation, Rerouting, and Supply Chain Redesign

When persistent trade policy shifts raise operational costs, MNEs often resort to large-scale structural responses. WTO (2024) emphasises that, in an era where production networks are geographically dispersed and capital-intensive, firms must adapt rapidly to maintain their global positioning.

1. **Relocation of Manufacturing** : MNEs move production from high-tariff jurisdictions to alternative hosts with preferential trade agreements, lower geopolitical risk, or stable regulatory environments. Examples include the post-2018 relocation of electronics, apparel, and consumer goods production from China to Vietnam, India, and Mexico - documented widely across institutional research.
2. **Rerouting Exports** : Rather than change production locations, some firms redirect goods through tariff-free or preferential countries. This can involve:
 - “Hub-and-spoke” routing through regional trade blocs
 - Using export-platform subsidiaries to bypass tariffs
 - Leveraging special economic zones
 - OECD (2020) shows that rerouting is especially common in industries with modular production systems, such as automotive and electronics.
2. **Supply Chain Redesign** : MNEs may diversify suppliers, add redundancy, or adopt “China +1”, “friend-shoring”, or “near-shoring” models.

These redesigns reduce dependence on any single country and shield firms from future trade disruptions.

6.3 The U.S. Tariff Shocks of 2018–2019 as a Natural Experiment

The 2018–2019 U.S.–China tariff escalation offers one of the clearest real-world examples of how MNEs respond to trade shocks. Graziano, Sztajerowska, and Volpe Martincus (2024) demonstrate that MNEs

quickly reallocated production to countries not subject to punitive tariffs, highlighting the agility of global production networks.

Key empirical findings include:

- Significant shifts in production toward third-country locations such as Vietnam, Malaysia, Mexico, and Eastern Europe.
- Reduced U.S. imports from China, but increased imports from non-tariffed economies, proving that GVCs readily adjust to tariff differentials.
- Investment reallocation, where MNEs expanded manufacturing capacity in alternative hubs rather than in the tariff-imposing country.
- GVC restructuring, including changes in sourcing patterns for intermediate goods.

The WTO (2024) notes that this episode illustrates how GVCs act as shock absorbers: production moves, but firms maintain market access by leveraging flexible multinational structures.

6.4 Evidence of Shifting Value Chains Across Countries

Trade policy shocks have now produced visible and measurable changes in global production geography. OECD (2020) and the IMF (2025) collectively highlight several structural trends:

1. **Rise of Secondary Hubs** : Countries with favourable trade agreements and stable policy regimes - such as Vietnam, Poland, Thailand, and Mexico - have become new GVC hubs.
2. **Deeper Regionalisation of Supply Chains** : MNEs increasingly prefer region-based production ecosystems (e.g., ASEAN, EU, USMCA) to minimise exposure to long-distance trade friction.
3. **Growth of Export-Platform Economies** : Export-platform FDI allows firms to serve multiple markets from a single base that enjoys preferential trade access, lowering risk and cost.
4. **Realignment in High-Tech and Strategic Sectors** : Sectors like semiconductors, EV batteries, telecom equipment, and pharmaceuticals increasingly relocate production based on geopolitical alignment and national security concerns, not just cost efficiency.
5. **Risk Diversification** : The IMF's Trade Policy Activity (TPA) Index indicates that rising policy volatility pushes firms to distribute production across several countries rather than rely on a single "factory economy."

6.5 Policy Implications for Future MNE Behaviour

Trade shocks are no longer isolated events - they're becoming structural features of the global economy. As WTO (2024) emphasises, multinational firms now operate under a new normal characterised by policy unpredictability, geopolitical competition, and regulatory divergence.

Key implications include:

- Higher emphasis on supply chain resilience rather than pure efficiency
- Greater reliance on regional trade blocs and preferential agreements
- Strategic diversification of FDI across multiple jurisdictions
- Increased investment in automation to offset higher trade costs
- Greater scrutiny of geopolitical alignment before entering markets

Ultimately, MNEs treat trade policy shocks as strategic signals. These signals influence long-term investment, organisational design, and global market participation. Firms that adapt quickly secure competitive advantage; those that remain rigid face cost escalation and loss of market share.

Chapter 7: Measuring Trade Policy and MNE Activity

7.1 Datasets: AMNE, FDI Statistics, and the Trade Policy Activity (TPA) Index

Understanding how international trade policies influence multinational enterprise (MNE) expansion requires robust, harmonised datasets that capture both policy measures and firm-level activity. Three major institutional sources provide the most authoritative data:

1. **OECD's Analytical AMNE Database** : The OECD's Activities of Multinational Enterprises (AMNE) dataset combines detailed information on production, employment, value added, and trade flows of foreign affiliates across countries and sectors. It enables researchers to identify the scale, distribution, and economic impact of multinationals. As emphasised by OECD (2020), the AMNE database is especially useful for tracking how MNEs reshape global value chains (GVCs) in response to policy changes, and how foreign affiliates contribute to host-country development.
2. **FDI Statistics from the IMF and OECD** : Cross-border investment data - covering inflows, outflows, and stock measures - helps capture how trade policies affect firm decisions regarding commercial presence. IMF analyses (2025) highlight that conventional FDI statistics require careful interpretation due to special purpose entities (SPEs), pass-through capital, and tax-motivated flows. Enhanced FDI measurement frameworks therefore allow researchers to distinguish *real* investment from financial restructuring, improving the accuracy of policy evaluation.
3. **IMF Trade Policy Activity (TPA) Index** : Introduced in the IMF (2025), the TPA Index measures the **intensity, direction, and frequency** of trade policy measures across 197 economies since the Global Financial Crisis. It covers tariff adjustments, NTBs, export restrictions, trade agreements, and regulatory changes. This index is invaluable for understanding how volatility or predictability in trade policy environments influences MNE expansion decisions, risk assessments, and supply chain configurations.

Together, these datasets form the empirical backbone for analysing how policy shapes multinational activity.

7.2 Methodologies for Linking Trade Policy to Multinational Behaviour

Empirical analysis of trade policy effects on MNE activity typically involves integrating policy indicators with firm-level or country-level data. OECD (2020) outlines several methodological strategies:

1. **Gravity Models with Policy Variables** : Gravity models - traditionally used for explaining bilateral trade flows - are adapted to include variables representing tariffs, NTBs, or services restrictions. This helps isolate the impact of trade costs on export-platform FDI, affiliate sales, and sourcing decisions.
2. **Difference-in-Differences Analysis** : Sudden trade policy shocks (e.g., tariff hikes) can be treated as natural experiments. Researchers compare firm behaviour before and after shocks, or between affected and unaffected countries. IMF (2025) notes that such quasi-experimental methods reveal how uncertainty and policy movements influence investment timing.
4. **Production Network Models** : These models capture how input-output linkages propagate policy changes through GVCs. OECD studies show that policy changes in one node of a supply chain can magnify downstream or upstream effects, influencing MNE location strategies.
5. **Structural Models of Firm Heterogeneity** : These models account for differences in firm productivity, size, and ownership structure. Since MNEs are typically larger and more productive, they respond differently to trade barriers compared to domestic firms.
6. **Affiliate-Level Regressions Using AMNE Data** : By examining output, employment, and trade performance of foreign affiliates, researchers can directly connect policy conditions to MNE expansion

patterns.

These methodologies allow policymakers and researchers to determine not just *whether* trade policy matters, but *how* and *through which mechanisms* it affects firm activity.

7.3 Challenges in Interpreting Global Production Data

Despite improvements in global statistical systems, measuring multinational activity remains complex. Several challenges persist:

1. **Fragmented Data Across Jurisdictions** : MNE operations span multiple tax regimes, reporting rules, and statistical systems. OECD (2020) notes that inconsistencies in how countries record affiliate data complicate cross-country comparisons.
2. **Special Purpose Entities (SPEs) and Pass-Through Investment** : A significant portion of global FDI flows is routed through tax havens and financial centres, distorting the link between *actual* production activity and investment statistics. IMF (2025) stresses the need to separate genuine productive investment from nominal financial flows.
3. **Overlapping Production Boundaries in GVCs** : Inputs often cross borders multiple times, making it difficult to attribute value creation to specific jurisdictions. Traditional trade statistics fail to capture the distributed nature of GVCs.
4. **Limited Coverage of Services Trade Restrictions**: Service barriers - licensing, data rules, equity caps - are more qualitative and harder to quantify. Roy (2019) highlights that incomplete or inconsistent regulatory data creates measurement gaps in understanding services-driven MNE expansion.
5. **Policy Lag Effects** : Trade policy changes may take years to influence investment decisions. Interpreting short-term data without accounting for these lags risks misleading conclusions. These challenges highlight the need for careful methodological design when interpreting multinational behaviour.

7.4 Limitations and Reliability Considerations

Although datasets from the OECD, WTO, and IMF are authoritative, researchers must remain cautious:

- **Timeliness**: Many datasets - especially FDI and AMNE - are released with significant delays, limiting their usefulness for real-time analysis.
- **Aggregation Bias**: Aggregate statistics may mask firm-level heterogeneity, especially in sectors dominated by a few large multinationals.
- **Policy Measurement Error**: Tariff data are precise, but NTBs and services regulations often lack standardised quantification, leading to estimation uncertainty.
- **Model Specification Risk**: Selecting the wrong functional form or failing to include key variables can distort results.
- **Comparability Issues**: Differences in national reporting standards (e.g., between OECD and non-OECD economies) reduce cross-country comparability.

Despite these limitations, the combined use of WTO, OECD, and IMF data remains the gold standard for understanding how trade policy structures multinational expansion decisions.

Chapter 8: Policy Implications for Multinational Expansion

8.1 How Governments Shape MNE Investment Through Trade Rules

Governments hold significant influence over multinational enterprises (MNEs) through the design, implementation, and stability of trade policies. These policies determine the cost of cross-border

operations, the predictability of market access, and the overall attractiveness of investment locations. According to the WTO (2024), tariff structures, non-tariff measures, and services commitments collectively shape the “rules of engagement” for international business.

Liberal trade regimes - characterised by low tariffs, streamlined customs procedures, and transparent regulations - encourage MNEs to integrate deeper into domestic markets. OECD (2019) emphasises that such openness attracts higher levels of foreign direct investment (FDI), stimulates competition, and enhances the participation of domestic firms in global value chains (GVCs). Conversely, restrictive regimes deter investment, reduce foreign affiliate activity, and may incentivise multinational firms to divert investments to more predictable jurisdictions.

Governments therefore serve as central architects in the global business environment. Their policy choices determine whether MNEs perceive a market as a high-risk frontier economy or a stable strategic hub for regional and global operations.

8.2 Balancing Protectionism With Competitiveness

As geopolitical tensions rise and domestic political pressures intensify, many economies are turning toward protectionist policies, including tariff hikes, domestic content rules, export controls, and screening mechanisms for foreign investment. While such measures aim to protect local industries, they often carry unintended consequences.

OECD (2020) highlights the “double-edged” nature of protectionism: although it may temporarily shield domestic firms, it can also undermine long-term competitiveness by raising input costs, weakening supply chain efficiency, and discouraging foreign investment. Protectionist policies tend to:

- reduce the competitiveness of downstream industries
- slow productivity growth
- reduce technology transfer from MNEs
- exacerbate GVC fragmentation costs

The IMF (2025) adds that protectionist shocks increase economic uncertainty, making firms more reluctant to invest and prompting them to diversify away from unpredictable markets. Countries therefore face the policy challenge of protecting domestic interests without undermining the long-term competitiveness needed to attract and retain multinational activity.

8.3 Impacts on Developing Economies

Developing countries face unique opportunities and risks in the context of trade policy. When well-designed, openness to trade and FDI can accelerate structural transformation, upgrade industrial capabilities, and integrate domestic firms into global production networks. WTO (2024) emphasises that participation in GVCs has helped many developing economies achieve rapid export growth and industrial diversification.

However, trade restrictions - whether imposed domestically or in key partner countries - can disproportionately harm developing economies by:

- reducing access to intermediate goods
- limiting opportunities for export-platform FDI
- deterring high-value investment
- reducing the availability of advanced services (finance, telecom, digital infrastructure)
- increasing vulnerability to external shocks

OECD (2019) shows that developing countries benefit most when trade policy frameworks prioritise regulatory coherence, capacity building, and WTO-aligned commitments. For example, improvements in

customs efficiency, services liberalisation, and investment facilitation create favourable conditions for MNE entry and expansion.

On the other hand, sudden protectionist measures in major economies can redirect MNE investment to developing markets - as seen during the 2018–19 US–China tariff crisis - offering both opportunities and challenges. These economies may gain short-term investment inflows but must strengthen governance and infrastructure to retain firms over the long run.

8.4 Future Directions: Digital Trade, Sustainability, and Inclusive Growth

Global trade policy is evolving rapidly in response to technological change, environmental pressures, and shifting expectations around inclusivity and resilience. These emerging policy directions will significantly shape multinational expansion strategies.

1. Digital Trade and Data Governance

With the rapid growth of digital services, cloud infrastructure, AI-enabled operations, and cross-border data flows, digital trade rules now occupy the centre of trade negotiations. OECD (2019) highlights that clear and open data policies attract digital-intensive MNEs, while restrictive data localisation laws discourage investment.

Future trade policy must address:

- cross-border data flows
- cybersecurity standards
- digital taxes
- e-commerce rules
- regulations for AI and platform-based businesses

2. Sustainability and Green Trade Policy

Climate-related trade policies - such as carbon border adjustment mechanisms, green supply chain standards, and environmental certifications - will increasingly determine where MNEs invest. WTO (2024) notes that green compliance costs may alter comparative advantage across regions, pushing MNEs to invest in environmentally aligned jurisdictions.

3. Inclusive and SME-Friendly Growth

Trade and investment policies are beginning to prioritise inclusive participation, enabling small and medium enterprises (SMEs) to integrate into GVCs. Policy frameworks promoting digital adoption, financing, and export incentives help domestic firms work alongside MNEs, increasing the developmental impact of foreign investment.

4. Resilient Supply Chains

The IMF (2025) underscores that resilience - not just cost efficiency - will guide future multinational decisions. Governments that support supply chain diversification, logistics infrastructure, and trade predictability will be more attractive investment destinations.

Collectively, these trends suggest that future trade policy will be broader, more complex, and more intertwined with regulatory domains traditionally outside trade - digital, environmental, and social policy.

Chapter 9: Conclusion

The relationship between international trade policy and multinational enterprise (MNE) expansion has become increasingly complex as the global economy grows more interconnected, digitalised, and politically volatile. This paper examined how trade policies - ranging from tariffs and non-tariff barriers (NTBs) to services-sector regulations and emerging digital frameworks - influence where and how

multinational firms invest, produce, and compete. Drawing on authoritative insights from the WTO, OECD, and IMF, the study synthesised conceptual foundations, empirical evidence, and contemporary policy developments to provide a comprehensive understanding of the mechanisms linking trade policy to multinational behaviour.

Trade policy remains a decisive factor in shaping global business strategy. As shown throughout the analysis, policy instruments directly alter the cost of cross-border transactions, determine the predictability of market access, and condition the feasibility of different modes of foreign market entry. MNEs increasingly structure their global value chains (GVCs) in response to policy environments, relocating production, shifting suppliers, or diversifying investment portfolios to minimise exposure to regulatory risk. Evidence from global trade disruptions - including the U.S. tariff shocks of 2018–2019 - demonstrates that firms rapidly reconfigure production networks when confronted with changing policy landscapes.

The rise of services trade and digitalisation has further deepened the interaction between policy and multinational expansion. As services become integral to manufacturing, logistics, technology, and finance, restrictions in services trade exert substantial influence on MNEs' operational models. Liberal, transparent, and predictable regulatory regimes consistently attract higher levels of investment and support deeper GVC integration, while restrictive settings impede both entry and scaling. This underscores the increasing importance of non-tariff and regulatory measures relative to traditional tariff policy.

At the same time, the developmental implications of trade policy are profound. For developing and emerging economies, strategic openness combined with institutional stability can attract FDI, drive productivity gains, and embed domestic firms into global production systems. However, policy uncertainty or protectionist shifts - whether domestic or external - can disrupt these gains, widen capability gaps, and hinder long-term structural transformation. Hence, effective governance, regulatory coherence, and alignment with multilateral commitments remain essential for translating trade openness into sustainable development outcomes.

Looking ahead, trade policy will continue to evolve in response to technological change, geopolitical shifts, and growing expectations surrounding sustainability and inclusiveness. Digital trade rules, data governance, green standards, and supply chain resilience frameworks will shape the next era of multinational expansion. Governments that prioritise predictable policy environments, invest in regulatory clarity, and support adaptive domestic capabilities will be better positioned to attract high-value investment and participate meaningfully in global production networks.

In conclusion, the evidence presented in this paper affirms that trade policy is not merely a backdrop to international business - it is a central determinant of how multinational firms expand, compete, and innovate. As global economic relationships grow more interdependent and multidimensional, the strategic interaction between trade policy and MNE behaviour will become even more critical for shaping the future of international production, investment, and development.

Chapter 10: Reference

1. Andrenelli, A., et al. (2018). *Multinational production and trade in services*. Organisation for Economic Co-operation and Development. https://read.oecd-ilibrary.org/trade/multinational-production-and-trade-in-services_16ec6b55-en
2. Blanga-Gubbay, M., & Rubínová, S. (2023). *Foreign direct investment, trade and economic development: An overview* (WTO Staff Working Paper ERSD-2023-11). World Trade Organization. https://www.wto.org/english/res_e/reser_e/ersd202311_e.pdf

3. Cadestin, C., et al. (2018). *Multinational enterprises and global value chains: The OECD analytical AMNE database*. Organisation for Economic Co-operation and Development. https://www.oecd.org/en/publications/multinational-enterprises-and-global-value-chains-the-oecd-analytical-amne-database_d9de288d-en.html
4. Casella, B., Borga, M., & Wacker, K. (2023). *Measuring multinational production with foreign direct investment statistics: Recent trends, challenges, and developments* (IMF Working Paper 2023/113). International Monetary Fund. <https://www.imf.org/-/media/Files/Publications/WP/2023/English/wpia2023113-print-pdf.ashx>
5. Graziano, A. G., Sztajerowska, M., & Volpe Martincus, C. (2024). *Trading places: How trade policy is reshaping multinational firms' location* (CESifo Working Paper No. 11514). CESifo. <https://www.nottingham.ac.uk/gep/documents/papers/2024/24-06.pdf>
6. International Monetary Fund. (2025). *Measuring global trade policy activity* (IMF Working Paper 2025/220). <https://www.imf.org/-/media/Files/Publications/WP/2025/English/wpia2025220-source-pdf.ashx>
7. Organisation for Economic Co-operation and Development. (2019). *Trade and investment*. https://www.oecd.org/content/dam/oecd/en/publications/reports/2019/02/trade-and-investment_c1593613/74205232-en.pdf
8. Organisation for Economic Co-operation and Development. (2020). *Trade policy implications of global value chains*. https://www.oecd.org/content/dam/oecd/en/publications/reports/2019/11/trade-policy-implications-of-global-value-chains_f182d1f5/4989ef9e-en.pdf
9. Roy, M. (2019). *Services trade policy, WTO commitments, and their role in trade and FDI* (WTO Staff Working Paper ERSD-2019-01). World Trade Organization. https://www.wto.org/english/res_e/reser_e/ersd201901_e.pdf
10. World Trade Organization. (2014). *Global production with export platforms* (WTO Working Paper ERSD-2014-17). https://www.wto.org/english/res_e/reser_e/ersd201417_e.htm
11. World Trade Organization. (2024). *World trade report 2024: Trade and inclusiveness*. https://www.wto.org/english/res_e/booksp_e/wtr24_e/wtr24_e.pdf