

Foreign investment in the new millennium: A view from the Canadian side of the border

THE WELCOME MAT

Public sentiment and government policies toward foreign direct investment (FDI) have varied over time and the behaviour of multinational enterprises has correspondingly responded to the differing government policies. In Canada, the late 1960s saw a fairly hostile view of FDI, which culminated in the establishment of the Foreign Investment Review Agency in 1974. By contrast today, Industry Canada has a welcome mat out for FDI, except in the case of a few industries such as telecommunications, broadcasting, airlines, etc., where foreign ownership is limited. Trade policies are also one of the key variables affecting FDI. Canada's investment climate has changed with the adoption of the 1965 Canada-U.S. Auto Pact, the 1989 Free Trade Agreement (FTA) with the United States and its extension, in 1994, to Mexico in the North American Free Trade Agreement, as well as with the multilateral trade liberalization rounds under GATT auspices.

TRENDS IN FDI AND THE IMPLICATIONS FOR CANADA*

The Auto Pact allowed the major auto manufacturers, based in the United States, to substantially increase the length of their production runs and thereby obtain scale economies. Vehicles would no longer be produced in Canada solely for the domestic market. Rather, there would be substantial intra-firm, intra-industry trade between the United States and Canada. The agreement was, and still is, highly successful, especially for the province of Ontario, where new investment was stimulated by a surge in Canadian demand for vehicles.

In the early 1990s, during a critical phase in the implementation of the FTA,

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investment in Canada was discouraged by the very high value of the Canadian currency brought about through tight monetary policies. The overvalued currency meant a lack of competitiveness in the export sector as well as low domestic demand. While Canada has continued to attract inward FDI, outward FDI has grown much more rapidly in recent years, with Canada becoming a net outward investor in 1996.

In 1998, the latest year for which we have data, the stock of outward FDI was 10.5 percent above that of the inward stock. It amounted to nearly 27 percent of GDP. Between 1990 and 1997, the United States was the destination for more than a third of Canada's cumulative net FDI outflows, down from two-thirds between 1982 and 1989. Increasingly, Canadian outward

FDI has been directed into services, accounting for 44 percent of the stock of outward FDI in 1998, up from 29 percent in 1985.

The 1990s have seen a very significant increase in inward FDI (to 24.2 percent of GDP in 1998), with the United States accounting for more than 70 percent of those inflows. Cross-border capital accounted for 76.5 percent of the net FDI inflows, compared with only about 32 percent during the 1980s. The composition of the inward FDI has been fairly constant except for some fall in the area of resources. Inward FDI is highest in the manufacturing sector. In the 1990s, the importance of inward FDI flows for business investment has increased from 4 percent in 1991 to 21.2 percent in 1998. Foreign-controlled firms in Canada also outperformed Canadian-controlled firms in terms of revenues. Between 1989 and 1996, the share of foreign-controlled firms (mostly U.S.) in total corporate revenue increased about 6 percentage points, whereas their asset base remained stable. The relative superior performance also extends to productivity.

Overall, Canada's productivity performance in the 1990s was very weak, relative to that of the United States. Beginning from a lower base, between 1990 and 1998, productivity growth in Canada was only 16.4 percent, compared with 29.2 percent in the United States. However, a substantial drop in the value of the Canadian dollar vis-à-vis the American one, combined with lower compensation costs in Canada, led to a significant fall in Canadian unit labour costs, compared with the United States. In a few industries, such as motor vehicle production, lower wages and higher productivity provide a significant advantage for Canada.

PRODUCTIVITY PROBLEMS

Why on average is productivity lower in Canada than the United States? We do not have very definitive answers but some hypotheses certainly can be considered:

1. With the Auto Pact, tariffs were cut more substantially, on average, than with subsequent trade liberalization.
2. Unlike the rationalization under the Auto Pact, where product run size was the key variable, under subsequent trade liberalization, the gains may be different and perhaps less dramatic. There may also be a geographic factor—that is, that rationalization between operations, which are close by, may be different from those in another continent.
3. Even though Canada's inward stock of FDI is nearly 2.5 times that of the average for the G7 countries, further FDI could increase productivity given the evidence indicating that foreign-controlled firms operating in Canada exhibit higher productivity than domestically controlled ones, although this could be partly due to the size of operations. Had Canada's currency not been so high, due to a tight monetary policy, we might have attracted more FDI during the early stages of the FTA.

Other factors less related to FDI may also be important, including:

4. The Canadian economy lagged behind the recovery in the United States during the 1990s. Consequently, Canada has not been operating at close to capacity for as long as the United States, resulting in less capital expenditure, and it is the latter that often triggers productivity increases.
5. Canadian firms have been consistently bailed out by a falling currency that has allowed them to remain competitive without making major changes to enhance productivity. Some have termed the phenomenon "the lazy dollar hypothesis."
6. The industry composition in the two countries is different. Although the

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high-technology electrical, electronic products, and industrial machinery sectors are growing rapidly in Canada, they are relatively less important than in the United States.

MOBILIZATION

In summary, Canada's position in terms of FDI has changed to a country that now has more outward FDI than inward. However, there is still much that we need to know about how FDI affects the Canadian economy, especially in the area of productivity growth. The evidence that we do have suggests that on balance it has a very positive impact. Hence, perhaps we should be thinking about further liberalization of inward FDI in those areas where restrictions

now apply. This view is strengthened by the fact that if a relatively small economy such as Canada is going to have globally reaching multinational enterprises (MNEs), these will have to be large. Without effective competition afforded by foreign firms operating in Canada, there may be too much industrial concentration. The current situation in the airline industry is a clear example. In addition, controls on foreign multinationals operating in Canada may result in retaliation directed against Canadian-based MNEs abroad. 🍁

* Data are taken from Industry Canada, *The Trade and Investor Monitor*, Fall–Winter 1999/2000.

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