

**MULTINATIONALS AS AGENTS OF CHANGE:  
SETTING A NEW CANADIAN POLICY  
ON FOREIGN DIRECT INVESTMENT**

*Discussion Paper Number 1  
November 1994*

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*Discussion Paper Number 1  
November 1994*

*by Lorraine Eden, Carleton University.*

*Aussi disponible en français*

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## EXECUTIVE SUMMARY

The trade and investment environment of North America has been transformed dramatically over the past 20 years by pressures coming from two directions. In terms of market structures, the main shaping force has been widespread trade liberalization in the form of such regional trading arrangements as the 1989 Canada-U.S. Free Trade Agreement and the 1994 North American Free Trade Agreement. International investment liberalization has also gained momentum causing the further globalization of world markets. In the same period, fundamental new technologies and flexible automation have caused a massive shift from mass production to lean production methods.

These forces have changed the ways in which firms produce and compete with one another. They are already forcing major structural adjustments by business as competition among firms for market share shifts from being national to being regional. In most sectors, global competition is now the norm.

How are the biggest firms in Canada responding to these changes, and what responses should they evoke from the makers of foreign direct investment (FDI) policy? This paper seeks to answer these questions.

In the context of increasing regional integration and the move to lean production, multinational enterprises (MNEs) are increasingly international actors faced by change, and, at the same time, they are agents of change themselves. As a result, it is time for government to adopt a new approach to FDI policy -- one that treats MNEs as investment bridges to the global economy and as diffusers of technology within the Canadian economy.

A brief historical summary traces Canada's treatment of foreign direct investment from 1960 to the present and the development of a "hub-and-spoke" economic relationship between Canada and the United States. The survey points to the deep integration of the Canadian and U.S. economies and suggests that this integration will become even more extensive and multifaceted as a result of regional trading agreements.

After surveying the trade and direct investment links and intra-firm trade between the two countries, the effects of regional integration and technological change on MNEs in Canada are outlined, paying particular attention to their influence on decisions about the function and location of plants. With the advent of regional trading agreements and enhanced economic integration, underlying economic factors will have more impact on MNEs' locational and organizational decisions. Because MNEs are concerned about their shares of global markets, they change the configuration of their activities so as to increase their international competitiveness. Generally speaking, MNEs will locate plants and operations with the new wider North American market in mind. More horizontal and vertical rationalization will take place, leading to more intra-firm exchanges. This means that Canada will have to articulate a clear role for itself in a North American regional strategy to attract investment from abroad. Canadian subsidiaries will have to work hard to define a role for themselves within the overall operations of the MNE.

The paper concludes by suggesting a new foreign direct investment policy for Canada; one that would not differentiate between inward and outward investment, but that would seek to maximize the gains to Canada from MNE activities in both directions. The principal policy direction proposed is for Canada to develop a new national policy centred on the strategic integration of Canada into the global economy. The goal of this new strategy would be to achieve long-run national competitiveness by emphasizing the removal of tariff and non-tariff barriers to trade and investment, by making a commitment to the knowledge-based economy with its focus on innovation, competition and sustainability and by focussing on a national education policy for the 21st century.

This strategic integration policy could be supplemented with other efforts including:

- getting the basics right by dealing with the deficit, macro-economic policy, regulatory burden and the duplication of government services;
- moving from confrontation to cooperation with MNEs in Canada;
- securing access to the U.S. market;
- reducing state aids to business and adopting a free trade zone strategy; and
- upgrading to best practice technology by attracting best practice multinationals to Canada.

In the new environment of globalized markets, governments and MNEs are partners in the race to engineer competitive advantage. Given the rising importance of MNEs and the growing importance of intra-firm trade, increasingly Canadian foreign and trade policies will have to focus on MNEs and their investments.

## INTRODUCTION

January 1, 1989, and January 1, 1994, are milestones in Canada–United States economic relations. Five years ago, we began phasing in the Canada–US Free Trade Agreement (CAFTA), freeing up trade and investment flows across the 49th parallel. This year, the North American Free Trade Agreement (NAFTA) begins levelling the playing field for firms in the three North American countries. CAFTA and NAFTA, as important as they are, should be seen as nested within a period of enormous technological change, widespread liberalization of economies and globalization of markets.

The Cold War is over. With the collapse of the Soviet Union in 1989, a whole new set of issues centred on transition economies preoccupy many economists and policy makers. As the bi-polar world that structured global politics for 50 years disintegrates, interstate relationships have become less dominated by geopolitical concerns and more influenced by economic considerations. One symbol of the new role of economics is the changing role and growing importance of the OECD. Historically a club of 24 rich nations, the Organization for Economic Co-operation and Development (OECD) opened its doors to Mexico this past year, and now is contemplating East Europeans, Asian Newly Industrializing Countries (NICs) and Russia as possible members. Another result is that trade and investment barriers related to national security (e.g., the *US Trading with the Enemy Act*, Coordinating Committee (COCOM) regulations), which historically have deterred people from doing business in many countries, have fallen, opening up new investment opportunities in countries such as Russia, Vietnam and Cuba.<sup>1</sup>

Most countries, both developed and developing, have significantly liberalized their economic policies since 1980. Lower tariff and non-tariff barriers within regions have come from regional trading arrangements such as CAFTA, NAFTA, Mercosur, EC 1992, the European Union and the Asia Pacific Economic Cooperation (APEC) Initiative. Developing countries have reduced their trade barriers and adopted macro-economic adjustment policies sponsored by the International Monetary Fund (IMF). The Uruguay Round has finally concluded, bringing with it the most significant changes in world trade liberalization, according to the well-known international trade law expert, John Jackson.<sup>2</sup>

In terms of investment, bilateral investment treaties, signalling an open-door policy to inward foreign direct investment (FDI), are expanding rapidly, with over 500 treaties among developed countries in existence in 1990 (UNCTC 1993, p. 28). Investment regimes in developing countries have also been liberalized in terms of their FDI controls, key sector restrictions, FDI approval procedures, incentives and investment guarantees (UNCTC 1993, pp. 32-33).

At the same time, there has been a fundamental, long-run shift in the underlying technology of production. Information technology, based on the microprocessor, has revolutionized product markets and manufacturing processes. In the 1970s, Japanese firms, particularly in the automotive, steel and electronics industries, first exported to North America and then moved onshore in the mid-1980s, bringing with them new methods of production known as lean production or postFordism



(Womack et al. 1990). These technology processes are slowly diffusing throughout North America and creating a new hybrid form of knowledge-based or information-mediated production. Just as the first 50 years of the 1800s were known as the Industrial Revolution, so it looks as if this period will be known as the Information Revolution.

These international shocks are already forcing major structural adjustments by businesses as competition among firms for market share shifts from being national to being regional and, in industries such as the automotive sector and consumer electronics, global competition is now the norm. Where are Canadian firms in all of this? Are they passive reactors to change, shelter seekers hiding from change, or strategic managers of change? Not surprisingly, Canada has all three. However, we contend that the third group, the strategic managers — firms that attempt to scan the international environment, anticipating technological, market and government policy changes and devising policies to take advantage of the opportunities that change offers — will do better in the economy of the late 1990s than those firms that either passively react to change or seek government protection to delay change.

We argue that *multinational enterprises are international actors faced by change, and, at the same time, they are agents of change*. The largest multinationals have been at the forefront of the process, reacting to these shocks by becoming leaner and meaner — downsizing, rationalizing, outsourcing, and forcing their captive in-house suppliers to seek new markets. This means that the firms in Canada best placed to anticipate and take advantage of change are the large multinational enterprises (MNEs) which are already heavily involved in North America, such as the Big Three auto multinationals (Ford, General Motors and Chrysler). These firms are primarily American, but Canadian MNEs are also recognizing this challenge.<sup>3</sup>

Multinationals in Canada, both foreign and domestically controlled firms, have been heavily involved in the economic integration that has taken place between Canada and the United States since the early 1900s.

The purpose of this report is to look at the question: who does what after NAFTA? It summarizes the changing locational and organizational structures of multinationals in North America as they pertain to Canada (as drawn from a new study, *Multinationals in North America* (Eden 1994b), and recommends a new policy direction toward multinationals in Canada, one that takes account of the policy and technology changes going on in the rest of the world.

The report begins with a brief sketch of the overall Canada–US economic relationship as it relates to multinational enterprises. It then reviews the history of Canadian policy toward foreign investment, focusing in particular on the investment rules in CAFTA and NAFTA. Third, it looks at the impact that regional integration and technological change can have, and are having, on the largest multinationals in Canada, drawing heavily on the key findings in Eden (1994b). Last, we suggest a new policy direction for Canada, one that shifts away from the traditional Canadian focus on restricting inward foreign direct investment to a new focus on multinational enterprises as investment bridges to the global economy and agents of change within the Canadian economy.

The next section focuses on the trade and investment linkages forged by multinationals between the U.S. and Canadian economies. We show that deep integration of the two economies — what the political scientists refer to as complex interdependence — already exists and argue that this integration will become more extensive and multifaceted as a result of CAFTA and NAFTA.

## THE HUB AND SPOKE RELATIONSHIP

North America's economic relationships are best characterized as a hub and spoke pattern with one hub, the United States, linked to two spokes, Canada and Mexico (Eden and Molot 1992a, b).<sup>4</sup> For example, the US share of North America's Gross Domestic Product is approximately 88 percent, with Canada generating an additional nine percent, and Mexico the remaining three percent (Knubley et al. 1994, p.151). The United States is the largest partner for both Canada and Mexico in terms of inward and outward foreign direct investment and in terms of exports and imports. US multinationals are heavily represented in the largest firms in each economy. Thus the United States is both the engine that sets the pace of the North American economy, and the steering wheel that determines the direction, by virtue of the decisions made by US multinationals.

What follows are three different pictures of the hub and spoke relationship that ties Canada to the United States — a macro picture of trade and investment flows; a micro picture of the largest multinationals in Canada, both domestic and US-controlled; and a look inside MNEs in Canada at the size of intrafirm trade in goods and services.

### **The Macro Picture: Trade and Investment**

The first picture is the most familiar one: trade and foreign direct investment (FDI). The statistics give a macro-economic focus to the relationship: trade in terms of the flows of goods and services across the US–Canada border, and investment in terms of both flows and stocks. The statistics are based on data in Knubley et al. (1994, 151-54).

In 1991, three quarters of Canadian exports were sold to, and 64 percent of its imports came from, the United States. For the United States, 20 percent of its exports and 19 percent of its imports were traded with Canada. Another 8 percent of its exports, and 6 percent of its imports, were traded with Mexico. As Table 1 shows, US trading partners are, therefore, much more diversified geographically than are Canada's partners. As barriers to trade within North America have fallen in the wake of the 1978 GATT Tokyo Round, the CAFTA and the recent NAFTA, we expect intracontinental trade flows to increase, and the Canada–US trading relationship to deepen.

In 1991, over 64 percent of the inward FDI stock in Canada was held by Americans and 29 percent by Europeans (see Table 2). In terms of Canadian direct investment abroad (CDIA), 58 percent was invested in the United States and 25 percent in Europe. Half of US outward FDI went to Europe, and 63 percent of the US inward FDI stock was controlled by European investors. Canada accounted for 15 percent of US outward, and 7 percent of inward, investment. Both inward and outward FDI in Canada have diversified away from the United States and into Europe over the last 10 years. The same is true for the United States: the European shares of US inward and outward investment have risen relative to the Canadian shares (Knubley et al. 1994; Niosi 1994). The reasons for the relative decline in Canada–US cross-investments are not clear. Niosi (1994) suggests that both push (e.g., the closure of tariff factories in the wake of CAFTA) and pull (e.g., the attraction of EC

1992 for North American firms and of North America for European and Asian firms) factors may be important.

**Table 1**  
**North American Trade Patterns, 1991**  
**(Exports and Imports as Percent of Total)**

	CANADA		UNITED STATES	
to:	Exports	Imports	Exports	Imports
Canada	—	—	20	19
United States	75	64	—	—
Mexico	0.4	2	8	6
Japan	5	8	11	19
Europe	8	11	29	21
Other	11.6	15	32	35
Total Trade (US\$ billion)	127.2	118.2	421.7	487.1

Source: data are from Knubley et al. (1994, pp. 150-54).

**Table 2**  
**North American Foreign Direct Investment Patterns, 1991**  
**(Inward and Outward FDI Stock as Percent of Total)**

	CANADA		UNITED STATES	
With:	Outward FDI	Inward FDI	Outward FDI	Inward FDI
Canada			15	7
United States	58	64		
Mexico	0.2	0	3	0.1
Japan	2	4	5	21
Europe	25	29	50	63
Other	14.8	3	27	8.9
Total FDI (US\$ billion)	82.4	114.8	450.2	407.6

Source: data taken from Knubley et al. (1994, pp. 150-56).

**The Micro Picture: The Top Firms in Canada**

Our second picture is a micro one, focusing on the largest firms in Canada versus the United States. Table 3 provides information on the 20 largest firms in Canada, as measured by sales. This information was compiled by Industry Canada as part of a study of the top 1,000 firms in North America (Knubley et al. 1994). Of these largest firms, 158 were located in Canada, and of them 39, or about one quarter, were foreign controlled. The top 20 in Canada cluster in five sectors: resources, food, transportation, communications, and banking and insurance (see Table 3), and four of the top 20 are US-controlled. The top 20 in the United States in 1991, as ranked by sales, fall into seven sectors: resources, food, transportation, electrical/electronics, communications, retail trade and finance (Knubley et al. 1994, p.165). While the patterns are similar, Canada has relatively more of its top firms in the banking sector than does the United States, reflecting the historical differences in their treatment of branch banking.

**Table 3**  
**The Big 20 Firms in Canada, 1991**

Company Name	Industry	Owner-ship*	Sales (\$mill)	Rank by Sales	Rank by Assets
<i>The Resource Sector Firms</i>					
Imperial Oil Ltd.	Mining	US	7,994	11	11
Brascan Ltd.	Mining	C	7,979	12	16
Alcan Aluminium Ltd.	Primary metals	C	7,748	13	12
Noranda Inc.	Lumber and wood	C	7,118	16	10
Ontario Hydro	Utilities	C	6,179	19	6
<i>The Food Sector Firms</i>					
George Weston Ltd.	Wholesale trade	C	9,316	5	17
Loblaw Companies Ltd.	Retail trade	C	7,381	14	20
Seagram Company Ltd.	Food and products	C	6,242	18	13
<i>The Transportation Sector Firms</i>					
General Motors of Canada Ltd.	Motor vehicles and equipment	US	16,847	2	15
Ford Motor Company of Canada Ltd.	Motor vehicles and equipment	US	10,531	4	18
Canadian Pacific Ltd.	Transportation	C	8,711	8	9
Chrysler Canada Ltd.	Motor vehicles and equipment	US	7,157	15	19
<i>The Communications Sector Firms</i>					
BCE Inc. (Bell)	Communications	C	17,200	1	5
Northern Telecom Ltd.	Communications equipment	C	8,182	10	14

Company Name	Industry	Ownership*	Sales (\$mill)	Rank by Sales	Rank by Assets
<i>The Financial Sector Firms</i>					
Royal Bank of Canada	Depository institution	C	12,414	3	1
Canadian Imperial Bank of Commerce	Depository institution	C	9,176	6	2
Bank of Montreal	Depository institution	C	8,861	7	3
The Bank of Nova Scotia	Depository institution	C	8,287	9	4
Sun Life Assurance Company of Canada	Insurance	C	6,856	17	7
Manufacturers Life Insurance Company	Insurance	C	5,845	20	8

\* Ownership: C for Canadian controlled, US for United States-controlled.

Source: data from Knubley et al. (1994, Table 7).

The top 20 US corporations, on average, are twice the size of, but are less outward oriented than, the top Canadian firms; Mexican firms are smaller and less outward oriented, according to the Industry Canada study. Knubley et al. (1994) find that Canadian big firms have a revealed comparative advantage in resources and resource-intensive manufacturing and financial services, US firms in technology-intensive manufacturing and commercial services, and Mexican firms in resources and in the low-skill parts of resource-intensive and technology-intensive manufacturing.

In terms of the largest Canadian controlled firms in Canada, *Business Week* has recently published its 1994 list of the "Global 1000," the world's largest publicly traded companies, ranked by market value.<sup>5</sup> There are 22 Canadian-controlled firms on the list (see Table 4); none of these firms, however, makes it into the top 150 companies (the largest is Seagrams, ranked 196). The average market value of these 22 firms is US\$118 billion, with US\$76 billion in sales and US\$597 billion in assets. In comparison, there are 379 US firms on the global top 1,000 list, with an average market value of US\$3.2 trillion, sales of US\$2.9 trillion and assets of US\$7.4 trillion. Thus the Canadian firms are much smaller, and less numerous, than their US competitors. Most of the Canadian firms are, not surprisingly, in three broad sectors: banking, telecommunications/electronics and energy/metals, reflecting Canada's historical comparative advantage in these sectors.

**Table 4**  
**The Largest Canadian-Controlled, Publicly Traded Companies in Canada, 1994**

	Industry	Global 1000 Rank	Market Value (US\$ bill)	Sales (US\$ bill)	Assets (US\$ bill)
Seagram	Beverages & Tobacco	196	11.1	6.0	11.7
Bell Canada Enterprises (BCE)	Telecommunications	202	10.9	14.3	26.5
Northern Telecom	Electrical & Electronics	314	7.8	8.1	9.5
American Barrick Resources	Gold Mines	348	7.1	0.7	1.6
Thomson	Broadcasting & Publishing	351	7.0	5.8	8.2
Royal Bank of Canada	Banking	389	6.3	na	119.0
Imperial Oil	Energy Resources	417	6.0	6.4	9.2
Placer Dome	Gold Mines	459	5.5	0.6	1.6
Canadian Pacific	Multi-industry	464	5.4	4.7	12.4
Alcan Aluminium	Metals - Nonferrous	478	5.2	7.3	9.8
Toronto-Dominion Bank	Banking	530	4.7	na	61.3
Bank of Montreal	Banking	537	4.6	na	84.3
Canadian Imperial Bank of Commerce	Banking	540	4.6	na	101.9
Bank of Nova Scotia	Banking	567	4.4	na	77.6
Pancanadian Petroleum	Energy Resources	634	4.0	0.8	2.3
Noranda	Metals - Nonferrous	660	3.9	3.8	7.0
Nova Corp.	Utilities - Electrical & Gas	676	3.7	2.4	5.0
Newbridge Networks	Electronic Components & Instruments	689	3.7	0.2	0.3
Shell Canada	Energy Resources	725	3.5	3.4	4.3
Imasco	Multi-industry	825	3.1	5.8	36.4
Inco	Metals - Nonferrous	876	3.0	2.1	3.9
Bombardier	Aerospace & Military Technology	963	2.6	3.4	3.1
Country Composite			118.0	76.1	597.1

Source: data are from *Business Week*, July 11, 1994, p. 62.

How international are these firms? In terms of the top 1,000 North American firms, Knubley et al. (1994) treat outward orientation by foreign assets as a percentage of total assets, and foreign sales as a percentage of total sales. The authors find that Canadian firms are more outward-oriented than US or Mexican firms (1994, p. 183), but this varies widely by industry. The index of multinationality is not the share of foreign sales in total sales, but foreign assets in total assets. With the exception of agriculture and fishing (not recorded) and public utilities (one percent), the share of foreign assets ranges from 22 to 68 percent for the largest firms in Canada, suggesting that most of these firms are multinationals. The US figures, on the other hand, range between 6 and 43 percent.

Some general evidence on multinationals in Canada can be found in UNCTC (1993). The UN centre estimates that there are about 37,000 parent MNEs with 170,000 majority-owned foreign affiliates (MOFAs) around the world, for an average of about five MOFAs per MNE (UNCTC 1993, pp. 20-21). Since this number does not include minority investments, strategic alliances and the like, the number of total foreign affiliates is likely to be much higher. The comparable statistics for the United States are 3,000 parents with 14,900 MOFAs (an average of five per MNE), and for Canada, 1,308 parents with 5,874 MOFAs (an average of four). Note, however, that an unknown (but probably relatively high) number of the Canadian parents are themselves subsidiaries of foreign MNEs, given the statistics presented above on the largest of the MNEs in Canada.

### **Inside the Multinationals: Interaffiliate Trade**

How large is interaffiliate trade between Canada and the United States as a percentage of total Canada–US trade? This is an important question because such trade is conducted inside the multinational and, therefore, at internal transfer prices which can be manoeuvred by the MNE. In this way, transfer prices are more likely to be set by the head office in order to satisfy overall MNE objectives (such as maximizing overall profit, avoiding tariffs or reducing dividends paid to minority shareholders) and be different from the prices that would be established by negotiation between unrelated firms operating at arm's length (Eden, forthcoming). Thus our third picture looks inside these MNEs at their intrafirm trade patterns as a percentage of Canada–US trade.

It is difficult to estimate the size of intrafirm trade, given the paucity of data in this area. However, we were able to piece together two sets of estimates: Table 5 on merchandise trade using data from the Bureau of Economic Analysis in the US Department of Commerce, and Table 6 on services trade using Statistics Canada data.

#### *Intrafirm Trade in Goods*

We can estimate the size of intrafirm trade by amalgamating three sets of US Department of Commerce data: data on US parents with majority-owned foreign affiliates (MOFAs) in Canada, data on Canadian parent firms with foreign affiliates (FAs) in the United States and data on total US merchandise trade.<sup>6</sup> By adding the trade among related firms reported by MOFAs and by FAs and



comparing this to the total size of US trade, we can estimate the share of US-Canada trade that is intrafirm. This is reported in Table 5.

**Table 5**  
**US Intrafirm Merchandise Trade, 1990**

	All Countries	Canada	Mexico	Japan	E.C.
US Intrafirm Merchandise Exports (US\$ million)					
Non-arm's length US exports shipped abroad by:					
- US parents to MOFAs abroad	89,649	30,599	7,062	7,098	26,598
- foreign affiliates to foreign parents	37,795	1,139	64	22,480	8,698
- foreign affiliates to other foreign affiliates	7,097	1,925	0	1,283	2,874
Total non-arm's length US exports	134,541	33,663	7,126	30,861	38,170
Total US exports, customs value	374,537	78,218	27,468	46,138	93,087
Intrafirm exports as % of total US exports	35.92%	43.04%	25.94%	66.89%	41.00%
Canada relative to all countries		1.20			
US Intrafirm Merchandise Imports (US\$ million)					
Non-arm's length US goods, imported by:					
- foreign-based MOFAs to US parents	75,364	33,210	7,164	1,799	1,156
- foreign affiliates from foreign parents	136,672	6,763	588	73,180	31,613
- foreign affiliates from other foreign affiliates	4,384	712	0	728	2,148
Total non-arm's length US imports	216,420	40,685	7,752	75,707	34,917
Total US imports, customs value FOB	491,332	91,198	29,506	89,612	87,540
Total US imports, customs value CIF	512,542	93,601	30,127	92,701	n.a.
CIF as % of US imports FOB	4.32%	2.63%	2.11%	3.45%	n.a.
Canada relative to all countries		0.61			
Intrafirm imports as % of total US imports	44.05%	44.61%	26.27%	84.48%	39.89%
Canada relative to all countries		1.01			

Source: author's calculations (Eden, forthcoming) using data from the US Department of Commerce (1993a, b, c).

Table 5 shows that, in 1990, 35.9 percent of total US merchandise exports and 44.1 percent of US imports were conducted between affiliates of the same enterprise. These trade flows were

dominated by affiliate imports from their parents, whether these were US parents exporting to MOFAs or FAs importing from foreign parents.

For US merchandise trade with Canada, the estimates are that 43.0 percent of exports and 44.6 percent of imports were at non-arm's length. This means that 43 percent of Canadian merchandise imports from the United States (since US exports are Canadian imports) and 45 percent of Canadian exports to the United States (since US imports are Canadian exports) were intrafirm.<sup>7</sup>

In terms of the composition of US intrafirm trade with Canada, the distribution for exports is:

- US parent exports to MOFAs (90 percent);
- FAs to their parents (3.4 percent); and
- FAs to other affiliates (5.7 percent).

For imports it is:

- US parent imports from their MOFAs (81.6 percent)
- FA imports from their foreign parents (16.6 percent); and
- FA imports from other affiliates (1.8 percent).

The big surprise here is that US parent–MOFA trade dominates both US intrafirm exports and imports by a wide margin. While all FA imports from their parents worldwide represent 63 percent of US intrafirm imports, FA imports from Canadian parents were only 17 percent of all US intrafirm imports from Canada. This suggests that Canadian MNEs engage less heavily in intrafirm trade than do their US counterparts.<sup>8</sup>

#### *Intrafirm Trade in Business Services*

Table 6 analyzes data provided in Statistics Canada (1991), showing Canada's international transactions in business services with the United States in 1989. Canadian receipts from all countries that year totalled \$7.5 billion (the US share was 58 percent); total payments were \$11 billion (the US share was 71 percent), for a net overall deficit of \$3.5 billion. The US share of receipts was highest in tooling (88.9 percent) and research and development (85.8 percent); the US share of payments was highest in tooling charges (100 percent), research and development payments (92.1 percent) and management fees (91.2 percent).

**Table 6**  
**Canada-US Trade in Business Services, 1989**

<b>Business Services Category (Only Major Categories included)</b>	<b>Receipts from the United States</b>			<b>Payments to the United States</b>		
	Total Receipts from US (\$ mill)	US Share of Total Canadian Receipts	Intrafirm Share of Receipts from US	Total Payments to US (\$ mill)	US Share of Total Canadian Payments	Intrafirm Share of Payments to US
Consulting and other professional	172	21.1	38.4	290	63.6	53.4
Transportation related	258	31.0	0.0	296	32.7	1.7
Management and administrative	327	63.0	99.9	1,111	91.2	96.9
Research and development	633	85.8	93.8	860	92.1	97.3
Royalties, patents and trademarks	47	39.2	46.8	1,130	84.0	88.8
Insurance and brokers	527	70.6	22.4	762	62.0	22.7
Other financial	192	44.0	1.6	348	41.7	2.0
Tooling and other automotive	744	88.9	100.0	859	100.0	99.7
<b>Total Business Services</b>	<b>4,343</b>	<b>57.8</b>	<b>48.8</b>	<b>7,797</b>	<b>70.9</b>	<b>67.3</b>

Source: author's calculations based on Statistics Canada (1991, tables 2 and 8).

The US figures also show us what percentage of business services trade was intrafirm or non-arm's length trade, that is, conducted between affiliates of the same multinational enterprise. The average for all business services trade was 48.8 percent for Canadian receipts from the United States and 67.3 percent for payments to US firms. The intrafirm shares vary widely from a low of almost zero for transportation-related services (that is, all trade with the United States is arm's length trade) to 100 percent for receipts of tooling and other automotive charges and for management fees (that is, all receipts in these two categories are intrafirm trade). Research and development payments and receipts are heavily intrafirm (93.8 percent and 97.3 percent); royalties and patent payments to the US are primarily intrafirm (88.8 percent) although receipts are not (46.8 percent).

*Putting the Numbers Together: Canada–US Intrafirm Trade*

In 1990, 43 percent of Canadian merchandise imports from the United States and 45 percent of Canadian goods exports to the United States were traded among related firms. In 1989, 49 percent of all Canadian receipts for business services exports to the United States were intrafirm, and 67 percent of all payments for business services imports from the United States were intrafirm. Thus intrafirm trade represents about 45 percent of Canada–US merchandise trade, 50 percent of Canadian business service exports to the United States and two thirds of Canadian business services imports from the United States. Clearly, multinationals are important to Canada–US trade patterns.

**Summary: The Hub and Spoke Relationship**

Canada's economic relationship with the United States is its premier relationship by a large margin. Canada, on the other hand, is less important to the United States. This fact of life is captured by our hub and spoke metaphor: the United States is the hub around which and through which Canada, and Mexico, engage in most international economic transactions. It is also clear from the statistics that US multinationals dominate the trade and investment components of the hub and spoke relationship.

Before examining the impact MNEs are likely to have on this relationship in the wake of the two free trade agreements, CAFTA and NAFTA, we will review the history of Canadian treatment of multinationals, particularly the investment rules under the two agreements, which will be helpful in the understanding of the impact of regional integration on MNEs in Canada.

## **LOOKING BACKWARD: A BRIEF HISTORY OF CANADIAN FDI POLICY**

### **A Focus on Restricting FDI: 1960-1985**

Canadian policy on foreign direct investment has been a one-sided policy: the focus has been almost exclusively on inward FDI with little attention paid to outward FDI (or, as it is now generally called, direct investment abroad or DIA), with attention paid both to the general level of FDI and to its sectoral distribution.<sup>9</sup>

Regulating inward foreign direct investment has been an important policy goal of the Canadian government for many years.<sup>10</sup> Canadian public concern about high levels of US ownership of the Canadian natural resource and manufacturing sectors started in the early 1960s. In the early 1970s, foreign controlled firms represented 58 percent of Canadian manufacturing, 75 percent of petroleum and natural gas sectors.

Over the 1965-1972 period, three major reports on FDI (the Wahn, Watkins and Gray reports) were published by the federal government, and the last recommended a screening agency. In 1974, the Foreign Investment Review Agency (FIRA) was established by the Liberal Government of Pierre Trudeau. FIRA was designed to ensure that inward FDI conveyed significant benefit for Canada. Takeovers (mergers and acquisitions) of established businesses and new business start-ups by foreign firms were both reviewed. Since 1974, the general trends in FIRA's performance have been that the acceptance rate has risen, that many approvals included performance requirements (which are illegal according to GATT), that the threshold for investment review has risen and that the criterion has been reduced from significant benefit to net benefit (Kudrle 1994). In the 1980 election, the Liberals pledged to expand FIRA's powers, but a combination of US pressure and declining investment levels aborted that initiative. The Government, however, did go ahead with the National Energy Program, which was widely disliked by the US oil industry.

### **Trying to Do Two Things at Once — Screen and Promote: 1985-1994**

The Conservatives, under Brian Mulroney, came to power in 1984 determined to improve relations with the United States. Elsewhere we have called the Conservative national policies market liberalism, a package based on the commitments to liberalize, privatize, deregulate and downsize (Eden and Molot 1993a). As part of creating a warmer climate for FDI, the Tories eliminated the National Energy Program and, in 1985, replaced FIRA with Investment Canada.<sup>11</sup> Mandatory reviews of all new investments were eliminated. Investment Canada emerged with a new mandate: to promote foreign direct investment. Thus, for a period of time, Investment Canada had a double mandate: to screen FDI and to promote FDI, i.e., an open-door policy for most inward investments with a narrow screening window for sensitive areas such as biotechnology (Connaught Laboratories) and cultural industries (book publishing). Officials inside Investment Canada were also actively involved in negotiating the investment sections of CAFTA and NAFTA (see below).

The situation changed in 1993, when the Conservative Government placed Investment Canada within the newly revitalized and enlarged Department of Industry. In the spring of 1994, Investment Canada disappeared as an independent agency. The screening function still exists, but is now subsumed under the broader departmental mandate of industry promotion and development. Thus, like most countries, Canada has significantly liberalized its regulation of FDI over the past decade. FIRA, once the bane of the US government and its MNEs, exists only as a memory for a few FDI scholars and government bureaucrats.

### **The Investment Provisions of CAFTA and NAFTA**

Between May 1986 and October 1987, the Canadian and US governments went through protracted negotiations resulting in the adoption of CAFTA on January 1, 1989. Chapter 16 deals with investment. The key commitment was a national treatment obligation requiring Canada and the United States to treat each other's investors in the same manner as domestic investors. Export and production-based performance requirements, such as those FIRA used to require for new entry, were disallowed. Investment Canada's function as a screening agency was also severely curtailed. There would be no screening of new US investments; screening of acquisitions could still occur but the floor for screening was raised from \$5 to \$150 million (with an inflation adjustment). Kudrle (1994, p. 411) notes that the average size of an acquired firm in 1988 was \$400 million, so that the screening function could still be applied to most US takeovers of Canadian firms.

No sooner was the ink dry on CAFTA than the two governments began negotiations to extend the free trade agreement to Mexico.<sup>12</sup> NAFTA has the most extensive regulations on investment of any free trade agreement, excepting perhaps that of the European Community, and certainly much more rigorous than anything in the new GATT Uruguay Round package.<sup>13</sup>

The key commitments in the investment chapter are to non-discrimination defined as national treatment (NAFTA partners must be treated at least as well as domestic investors) together with most-favoured-nation treatment (NAFTA investors must be treated at least as well as any foreign investor) for all North American investments and investors, including firms controlled by non-North Americans.<sup>14</sup> The agreement extends the list of proscribed performance requirements and mandates that most existing requirements be phased out over 10 years. NAFTA forbids restrictions on capital movements, including all types of payments and profit remittances, except for reasons of balance of payments. Expropriation is outlawed, except for a public purpose and on a non-discriminatory basis, and full and prompt payment of fair compensation is required (Eaton et al. 1994a; Kudrle 1994).

Investors can seek binding arbitration against a host government for violations of NAFTA obligations, using either the World Bank's International Center for the Settlement of Investment Disputes (ICSID) or the United Nations Commission on International Trade Law (UNCITRAL).<sup>15</sup> Thus, a new trilateral dispute settlement process has been introduced into three countries which traditionally have held that all disputes involving FDI should be settled in domestic courts (Hufbauer and Schott 1993, p.82).

We turn now to the impact of these CAFTA and NAFTA trade and investment provisions on MNE behaviour within North America, focusing on their impact on decisions by MNEs about organization and location.

## **MNES AND REGIONAL INTEGRATION: WHO DOES WHAT AFTER NAFTA?**

One important policy factor, at the regional level, which has influenced trade and investment patterns is the proliferation of regional trading agreements such as the 1989 CAFTA and the 1994 NAFTA. A recent book (Eden 1994b) explores the impact of free trade agreements on MNEs' locational and organizational decisions in North America, looking in particular at CAFTA and NAFTA.

*Multinationals in North America* examines the policy choices and actions of the largest business corporations and the three national governments in Canada, the United States and Mexico as they respond to the enormous changes in technology and trade policies that have been occurring since the early 1980s and 1990s. The book focuses on MNEs and nation states in North America in the context of regional free trade (CAFTA and NAFTA) and technological change, as the underlying technology paradigm shifts from mass production to lean or flexible production. The book examines the strategic options and interactions of MNEs and nation states as they attempt to manage their activities in a globalized world economy.

This section of the report expands on the main ideas emerging from the book in terms of regional integration; in the next section the focus is on MNEs and technological change. The purpose is not to summarize the book, as that has been already done (see Eden 1994b, Chapter 1), but to pull together some of the underlying ideas to see the implications for new policy directions.

### **MNE Location and Organization Choices**

To predict the impact that regional integration will have on plant location, it is critical to understand the concept of the MNE's value chain, i.e., the range of value-adding activities involved in the production of a good or service, from the initial research and development stage through sales and service to the final consumer (Eden 1991a,b; 1994c). We can split these value-adding activities into primary functions (e.g., resource extraction and processing, fabrication, assembly, distribution, sales and service) and support or overhead functions (e.g., strategic management, technology development, support services such as finance, accounting and purchasing).

Not all the activities in the value chain must be performed within the multinational enterprise. Some will be conducted inside, some contracted out; some activities may be performed both by subsidiaries and also by arm's length subcontractors. Vertical integration occurs when different stages of the value chain are performed by different plants with intrafirm transfers between them; for example, one plant may extract bauxite, another process it into alumina, a third is an aluminum smelter and a fourth makes the aluminum cans. Horizontal integration occurs when different plants produce the same or similar product lines with intrafirm trade occurring to fill excess demand or product-line niche markets, for example, auto plants specializing in different product lines. A firm becomes a multinational when it has a foreign affiliate engaging in one or more of these value-adding activities.



We can classify foreign affiliates according to the four basic motives the MNE parent has for setting up a foreign plant: to find raw materials (resource seeking), to manufacture parts and assemblies at lowest cost (cost reduction), to gain access to foreign markets (market access) and to provide support services to other parts of the MNE group (support services). The choice of affiliate location depends on which of the general motives for FDI is involved, the relative attractiveness of various host locations and the availability or cost of alternative contractual arrangements. Locational or country-specific advantages are the key to determining which countries will become host countries for the MNE, depending on whether the basic nature of the investment is resource seeking, cost reduction or market access.

How is regional integration likely to affect the organizational and locational choices of MNEs? We argue that before integration each MNE established its own configuration of value-adding activities in domestic and foreign plants, based on the historical "blocks" national governments had positioned on the North American "chessboard" (Eden 1994c). With governments removing these blocks, the underlying economic factors will have more impact on MNEs' locational and organizational decisions. Because MNEs are international oligopolists, concerned about their shares of global markets, they will change the configuration of their activities so as to increase their international competitiveness. Thus plant functions and locations — through decisions on new and re-investments — can both be expected to change over time.

The key to investment decisions in response to CAFTA and NAFTA is the reduction in policy risk for firms because of increased security of access to the markets of member countries provided by these agreements (Eaton et al. 1994a; Vernon 1994). CAFTA and NAFTA eliminate tariffs among member countries over a 10- to 15-year period, but only reduce non-tariff barriers. Therefore security of US market access for Canadian firms is improved by the elimination of tariffs. On the other hand, risk reduction may be more apparent than real for non-tariff barriers, depending on the probability of firms in one country being harassed by non-tariff barriers erected by the other member country.

### **Insiders, Outsiders and Domestics**

The strategic responses of firms to CAFTA and NAFTA are partly determined by such factors as whether the firm is headquartered inside or outside the area; whether the firm has significant investments inside the region; and the industry, or industries, in which the firm competes.

Following Eden (1994c) and Vernon (1994), we identify three categories of firms that are likely to have different responses to regional integration:

- *veterans* (well-established multinationals located inside a free trade area with significant investments in the partner countries prior to the agreement);
- *outsiders* (foreign firms outside the area, which may have been exporting into the area or may have investments inside the area); and

- *domestics* (local firms inside the area without significant investments in the other partner countries; they may or may not already be exporting to these countries).

The responses of each group should clearly vary. Dunning (1994), for example, argues that firms inside the region see benefits from lower intraregional barriers and will rationalize product lines (horizontal integration) and production processes (vertical integration) to exploit economies of scale and scope. Firms outside the region may be induced to become insiders. There should be both a short-run response as MNEs engage in locational reshufflings in response to the falling trade barriers, and a long-run response. In the short run, firms are likely to shift their activities to the United States, but, in the longer term, this tendency should be reversed (Vernon 1994).

### *The Insiders*

Eden (1994c) asserts that US MNEs are the firms best placed to take advantage of the falling tariff and non-tariff barriers that CAFTA and NAFTA will bring because they are already located in all three countries. After NAFTA, these veterans — or insiders — will locate, close or expand their plants with the whole North American market in mind. In terms of the value chain of primary activities (resource extraction and processing, assembly, distribution), these reshufflings should lead to reduced numbers of product lines in various plants and increasing horizontal trade among plants. MNEs are also likely to segment their production process among plants so that more vertical intrafirm trade takes place. As a result there should be more cross-border vertical and horizontal intrafirm trade flows taking place. Certain product lines, industry segments and plant functions will shift among the three countries, and this will cause job losses and plant closures in certain locations. Which ones will depend on a complicated array of factors some of which are exogenous to the firms involved (such as element prices and transportation costs) and others which are firm specific (such as the nature of the products produced and the ingenuity and energy of the individuals involved).

In terms of the support activities in the value chain (head office, research and development, support services), veteran MNEs engaged in integrated production on a North American basis are likely to centre such activities in one head office. With the reduction in tariff and non-tariff barriers, there is less need for a fully autonomous and large national head office; in fact, such an office can be non-productive in a centralized, regionalized MNE. Thus, the headquarters functions of US multinationals in the Canadian and Mexican spokes will probably become less important over time as their activities are centralized in their US parents (Eden 1994c).

In many ways, what we are predicting has already happened in the auto industry as a result of the 1965 Auto Pact. Production is organized on a continental basis (defined, until NAFTA, as Canada and the United States) with assembly plants responsible for individual product lines, exchanging models with each other to fill out the product range, and with a wide variety of parts and components plants supplying inputs to the assembly operations. The Canadian head offices of the Big Three are small, little research and development are done here, and key decisions are made in the United States (*see* Eden and Molot 1993b). This process of vertical and horizontal rationalization, as a result of CAFTA and NAFTA, will now occur in other industries.

Veteran multinationals that are resource seeking are likely to use CAFTA and NAFTA to relocate extractor and processor affiliates where resources are relatively more abundant and capital and energy costs lower. Cost-reducing affiliates may be induced to relocate to North American countries with lower unit labour costs. Market-driven affiliates are likely to rationalize production in existing plants, creating more vertical integration through source factories and more horizontal integration through focused factories. MNEs that have not yet opened up branch plants in potential NAFTA members may do so. Therefore the responses of parents and affiliates will involve relocation and expansion, taking advantage of lower trade and investment barriers to develop a more integrative regional strategy. In the short run, existing plants are unlikely to be closed but, in the longer term, economic efficiency will determine locational decisions within North America. The key here is rationalization of demand, for the regional market as a whole, and of supply to capture specialization and economies of scale (Eden 1994b).

Encarnation (1994) looks specifically at US parents and their majority-owned foreign affiliates (MOFAs) in Canada, Mexico, Japan and the European Community in terms of intrafirm trade. Once established, Encarnation finds that MOFAs tend to sell primarily in the host market, with smaller amounts of exports to the parent network. Regional integration leads to tighter integration of the MNE family and to greater intrafirm trade flows in both directions. The choice between production and distribution appears to vary considerably by country of origin of the MNE, with wholesaling activities being very important for Japanese MNEs, for example, but less important for US and European MNEs. Intrafirm trade dominates MNE trade flows, particularly in the auto industry. Encarnation argues that NAFTA will encourage the development of regional integration strategies by MNEs in North America. He predicts NAFTA will cause firms in Canada to increase their exports, FDI and local sales in the United States; a similar deepening of economic linkages should happen with US MNEs. This should be seen as a positive contribution to economic growth and national welfare.

### *The Outsiders*

Westney (1994) looks at the outsiders — Japanese transplants in North America — as they deal with the challenges of coping with the rising yen-dollar exchange rate, political and social pressures from host countries to become "insiders" and pressures to open up the *kieretsu* structure in Japan. She suggests that Japanese MNEs are moving toward a three-region, rather than a multicountry, organizational structure, with regional, semi-autonomous headquarters in Asia, Europe and North America. This structure may create conflicts between the goals of the parent firms for interdependent units and the desire of host countries for locally autonomous transplants.

As non-North American MNEs that have already established transplant operations within North America, if not deterred by investment barriers, they are likely to also expand and rationalize their investments to take advantage of the larger market size. Under the tighter rules of origin in NAFTA, in order to meet North American content, the transplants may be forced to upgrade production and to find a local source for inputs. Thus parts plants may be induced to follow distributors and assembly plants. Outsiders that are currently exporting to North America may shift to foreign direct investment. They are likely to be drawn to the larger market, the US market or the hub, unless cost differentials make location in the spokes more attractive or interregional barriers are completely eliminated. In

terms of Canada, Westney (1994) notes that the regional strategy of the transplants has really been a one-country strategy centred on the United States. She concludes that Canada needs to articulate a clear role for itself in a North American regional strategy to attract new investments from Japan.

### *The Domestic*

For domestics — firms without established links to other potential NAFTA members — a free trade area will be seen as both an opportunity (new markets, access to lower cost inputs) and a threat (more competition). Such firms, with encouragement, may start or increase their exports within North America and possibly open up distributors or offshore plants where market size or cost warrants. They will, however, have to face the difficult task of breaking into established distribution networks of domestics and MNEs in the North American markets. Such firms may also be ill-equipped to cover the financial and personnel costs of penetrating the US and Mexican markets.

### **The Tendency to Cluster**

Where are North America firms likely to invest as a result of CAFTA and NAFTA? In addition to being affected by country-specific factors, location is also partly dependent on agglomeration economies or the advantages of firms clustering in one location. Assume several locations (cities, regions) demand a particular product. Where should firms supplying this product be located?

Eaton et al. (1994b) develop a theory of agglomeration which explains geographic concentration of business activity as the outcome of two opposing forces: economies of scale at the plant level (encouraging concentration of activities in one location) and transportation and communication costs (encouraging dispersion of activities). Where transport costs dominate economies of scale, we should expect to see horizontally integrated MNEs manufacturing the same product in several different plant locations (as the Big Three auto MNEs did in the United States until the 1970s).

High tariffs and non-tariff barriers can function like transport costs, encouraging dispersion of activities. High Canadian tariffs, for example, historically led to US MNEs establishing miniature replicas of themselves north of the 49th parallel. Tariff jumping FDI is widely believed to be one of the long-run causes of the non-competitiveness of the Canadian manufacturing sector. Will regional integration — taking down the blocks on the chessboard — cause a massive exodus of these tariff factories? If tariffs cause dispersion, does free trade cause agglomeration?

The reverse does not necessarily follow, according to Eaton et al. (1994b). They conclude that the probable impact of CAFTA and NAFTA on agglomeration is unclear since scale economies and asset specificity discourage quick dissolutions, and thus have opposite effects to falling trade barriers. In addition, they argue that the new technologies of production (now called "lean production") have both reduced the importance of labour, transport and communications costs and increased the need for supplier firms to locate near their downstream customers. As a result, lean production may lead to increased diversity in patterns of industrial location.

Some MNE activities, in particular research and development, have traditionally been highly concentrated in the home country. Regarding the location of research and development, Eaton et al. (1994b) find that there are strong forces favouring centralization at the parent firm's headquarters; however, significant decentralization of research and development has occurred over the last 10 years for some countries and industries as the knowledge base becomes more geographically dispersed. If CAFTA and NAFTA encourage rationalization of firm activities and reduce the autonomy of foreign manufacturing subsidiaries, the authors conclude that the production of local research and development by subsidiaries in Canada and Mexico may also be reduced.

### **Some Evidence on MNE Responses to Regional Integration**

A recent study by the Conference Board of Canada (Krajewski 1992) provides interesting evidence on how MNEs in Canada are adjusting to free trade. The Board conducted a voluntary survey of 250 Canadian parents (PARS) with US subsidiaries and 750 Canadian subsidiaries (SUBS) with US parents. The survey found that the following factors were important motivations behind MNE decisions vis-à-vis their Canadian activities:

- overall MNE corporate strategy,
- their strategy for organizing production,
- rationalizing MNE activities on a worldwide and regional basis,
- reorganizing plants along product lines,
- cost advantages,
- the existence of internal supply lines, and
- CAFTA.

Over three quarters of the firms had undergone significant changes since 1989, with PARS rationalizing through changes in marketing techniques (43 percent), looking for new market opportunities in the US market (34 percent) and changes in product specialization or sophistication (29 percent). SUBS had rationalized primarily through changes in scale of production (44 percent). Both sets anticipated significant further rationalization. Almost 40 percent of PARS anticipated a change in scale of production and one third expected a change in plant location. SUBS anticipated continued rationalization through economies of scale, marketing and new opportunities.

Thus CAFTA can be seen as the primary driver, in addition to the globalization of markets in general, that is causing multinationals in Canada to rationalize their production and sales. CAFTA and NAFTA have shaken up the traditional FDI patterns between Canada and the United States. Canadian MNEs now have new market opportunities and feel that they must compete globally to survive. They have a more open door to the US market through CAFTA and to Mexico through NAFTA. The Conference Board argues that Canadian firms need to be more aggressive, both to protect the Canadian market and to penetrate the US market.

The unspoken fear in the report is that rationalization may mean relocation of PARS to the United States in the long run. Canadian subsidiaries with US parents are being continually re-

evaluated in terms of the MNEs' need to keep manufacturing in Canada. The days of "copy cat" or miniature replica plants in Canada are gone. A Canadian plant has to fit into the existing structure of the MNE by playing a role in its overall strategy. US subsidiaries in Canada are now in a critical position; they have to carve out and justify their existence as an integral component of the MNE. The responsibility to maintain manufacturing operations lies within the company itself; the subsidiary has to justify its existence and place within the MNE.

## **LEAN PRODUCTION: WHO DOES WHAT IN THE NEW ECONOMY?**

North American free trade is not the only change in the North American playing field affecting firms in Canada. In addition, a fundamental shift in the underlying technology of production is in progress as information technologies and microelectronics revolutionize the workplace.<sup>16</sup> Firms that are already having difficulty adapting to the pressures of globalization and regional integration are faced with the additional costs of technological upgrading, costs for which they may be ill prepared.

### **The Shift from Mass to Lean Production**

Historically, US multinationals built their success on mass production techniques: the use of simple interchangeable parts, the division of labour and specialization of tasks, the assembly line, the stocking of inventory and the substitution of capital for labour (Womack et al. 1990). The search for ever lower costs led to large plants built to achieve minimum efficient scale, with the upstream ones close to the source of raw materials and the downstream ones close to the consumer. The middle stages, where footloose, were located where costs were the cheapest. Thus MNEs engaged in large volumes of intrafirm trade, primarily in intermediate products being shipped around the world for further processing in low-cost locations prior to their final sale, mostly in the developed market economies (Eden 1991a, 1994a).

Kogut (1994) argues that the current decade is witnessing a period of enormous technological change as a new set of organizing principles — lean production — transforms firm strategies and structures. The key characteristics of lean production are demand-driven production, minimization of downtime, pull-through work flow, inventory reduction, zero defect components, total quality control and knowledge-intensive production (UNCTC 1988). A lean-production strategy uses skilled labour, flexible technology and economies of scope to shift up the value chain into higher value products. The emphasis is on achieving both low cost and higher quality in a product that closely meets consumer needs.

For Kogut, Japanese MNEs are investment bridges, diffusing lean production throughout North America and Europe.<sup>17</sup> The shift to lean, or just-in-time, production is changing the configuration of MNE activities and, thus, the pattern of intrafirm trade. A lean-production strategy means the firm must be located near the consumer, and this draws in first- and second-tier suppliers close to the downstream activities of the MNE. The result is that some of the footloose stages of production, allocated under a mass production strategy to low labour-cost countries in East Asia and Latin America, return to the country of final sales. The MNE should rely less on offshore and source factories in export processing zones, and more heavily on focused and lead factories and research and development outposts.

Economies of scale at the plant level become less important so that plants of different sizes can be equally efficient; economies of scale at the firm level, however, can become more important due to the high overhead costs of upgrading technology. Since the costs of robotics and information technology necessary to achieve market success at the regional or global level are high, firms may

engage in selling off unrelated activities (i.e., become lean enterprises) and use strategic alliances or outsourcing to first-tier suppliers to increase their flexibility and ability to manage change.<sup>18</sup> Multinationals are segmenting activities among their affiliates on a regional or global basis; creating complex investment, production and intrafirm trade linkages among countries; joining with other multinationals in strategic alliances; and tightening links with suppliers and buyers in business networks (Eden 1991a, b; Rugman and D'Cruz 1994; UNCTC 1993, Chapter V).

As a result, intrafirm trade in intermediate products, both goods and services, is likely to increase in lean production enterprises. The UNCTC (1993) argues that MNEs are now moving to integrated international production strategies, a form of complex integration where MNEs are "willing to locate various functional activities — not just production, but also research and development, finance, accounting, etc. — wherever they can best be done to fulfil the firm's overall strategy" (UNCTC 1993, p. 121). Foreign affiliates will be more closely tied into the overall enterprise, producing intermediate products for internal sale to other MNE affiliates rather than acting as stand-alone affiliates selling only to local customers. Thus, the autonomy and national responsiveness of these affiliates are likely to decrease.

### **Multinationals in Canada: How to Handle Change**

When governments move to introduce NAFTA, a free trade area encompassing both rich and poor countries, at the same time as technology is changing rapidly, incumbent MNEs are faced with a decision: either keep their historical practices or shift to new ones that may or may not succeed. Faced with the threat of technological competition from Asian competitors, North American firms can respond by hiring high-skilled labour and adopting lean production techniques, or by continuing to employ low-skilled labour and mass production techniques. Firms may be reluctant to switch, at least in the short run, and are thus trapped in low-wage strategies.

Kogut (1994) suggests that firms are likely to be driven by short-run considerations and to respond by searching for low-wage sites (e.g., move to the southern United States, to Mexico or offshore), others will cluster their investments in core industrial districts in the United States. These low-cost strategies may be successful in the short run, but do not deal with the underlying differences in technology paradigms.

It is too soon to tell how MNEs in Canada will react to the potent mixture of NAFTA and lean production. Will they adopt short-run strategies or engage in major technological upgrading? The answer to this question is not clear, but history may provide some insight. Technological change and regional integration have been a fact of life in the auto industry since the late 1950s. How did the Big Three auto producers (General Motors, Ford and Chrysler) respond?



## **Lessons from the North American Auto Industry**

The responses of the North American auto industry to technological competition from Japanese auto producers have changed significantly over the last 40 years. Eden and Molot (1994) show that the Big Three auto MNEs responded to competition from Japanese auto imports, and later from transplant production, in three distinct phases.

In the first period, roughly 1955-1973, during which the foreign share of the North American auto market rose from approximately zero to 15 percent, the Big Three tended to ignore the import threat, responding only with such short-run strategies as increasing the number of platform sizes and developing corporate twins. During this period, Canada and the United States negotiated the Auto Pact, facilitating integration and rationalization of auto plants on a continental basis by the Big Three.

In the second period, 1973-1982, when the foreign share rose to 27 percent, the firms began to rationalize their activities through downsizing vehicles, plant closures, sourcing captive imports from Asian auto firms and seeking political solutions such as the Chrysler bailout and the 1981-1982 voluntary export restraint program. The Big Three (particularly General Motors) spent extraordinary amounts of money on computer equipment, retooling and upgrading, generally with little impact on productivity.

It was only with the movement to North America by the Japanese producers (the first Honda Civic made in North America rolled off the assembly line in 1982 and was quickly followed by several other Japanese auto assemblers) that the Big Three realized the nature of the competitive threat posed by the Japanese MNEs: lean production. In this third period, although the US producers continued their rationalization strategies, they slowly began to adopt lean-production techniques. In addition, the Big Three lobbied hard for policies that would benefit themselves at the expense of their competitors (e.g. the auto provisions in CAFTA and NAFTA), and have used these free trade agreements to further rationalize production on a Canada-US-Mexico basis. In the meantime, Japanese autos (imports plus transplant production) continued to gain market share, reaching some 35 percent by 1992.

Most recently, however, the Big Three's share has begun to climb, bolstered by the rise in the yen-dollar exchange rate, increased plant efficiency and higher quality auto products, and the end of the US recession. Whether or not this means the Big Three have finally become competitive with the Japanese auto producers is not clear. All three firms continue to shift to lean-production methods while still retrenching and downsizing. At the same time, the Japanese firms are responding to their financial difficulties by shifting production from Japan to lower-cost locations in Asia and to North America. As a result, in the next few years, one or more of these Japanese MNEs (probably led first by Honda) will achieve domestic content levels as high as the Big Three.

Kenney and Florida (1993), after studying several Japanese and US manufacturing industries at the plant level, conclude that the eventual technology paradigm that will dominate North American manufacturing industries such as autos, steel and consumer electronics will be a form of information-mediated production whereby the lean-production methods of Japanese MNEs adapt to the differing

institutional environment (e.g., labour markets, distribution networks, antitrust regulation) in North America. In the end, the Japanese and US auto MNEs may look very much alike, although it will have taken 50 years from the first import competition for lean production to diffuse fully in this North American industry.

Since the auto industry is much more globalized than most others, adaptation to lean production may take even longer in other industries and in other locations. Based on the experience of this one industry, we conclude that Canadian firms may take a long time to adapt to the potent combination of lean production and regional free trade.

## SETTING A NEW POLICY DIRECTION FOR CANADA

What does all this mean for Canadian policy toward multinationals? As we have shown above, Canadian policy has historically dealt only with inward FDI, and has been concerned with restricting foreign access to certain sectors and with ensuring that there are net benefits to Canada from FDI. Since 1985, Investment Canada has had a dual responsibility: screening large acquisitions and promoting investment. In 1993, it was rolled into the Department of Industry and, in the spring of 1994, Investment Canada ceased to exist as a separate entity, although the screening function remains in NAFTA. Whither Canadian FDI policy in the late 1990s?

We argue for a new policy toward multinationals in Canada. The traditional Canadian focus on restricting inward foreign direct investment (FDI) is now mostly gone. In a world where countries are scrambling to attract MNEs, the policy of discouraging foreign entry is a clear signal for firms to take their business elsewhere. We recommend a new focus on *multinational enterprises as investment bridges to the global economy* and as *agents of change within the Canadian economy*. This recommendation involves a fundamental shift away from the historical, macro-economic focus on the benefits and costs of, and the need therefore to regulate, inward FDI, to a new focus on:

- multinational enterprises as market-making firms in a globalized world, facing cross-cutting pressures from their simultaneous involvement at the international level (linked through the MNE network to international markets, and to affiliates and countries outside Canada) and at the domestic level (as firms involved in domestic markets with production, sales and employment in Canada);
- the positive effects of MNEs as investment bridges between economies, as windows to what is going on in production, technology and marketing elsewhere in the world, bringing new ways of organizing production to Canada and carrying Canadian national organizing principles to other countries; and
- the positive effects of MNEs as agents of change within Canada, increasing the competitive pressures on domestic firms, and demonstrating and diffusing new techniques throughout the Canadian economy.

The specific directions we propose to implement this new policy on MNEs in Canada are the following:

- (i) a new national policy centered on strategic integration of Canada into the global economy — this is the broad, overarching policy umbrella for our other recommendations;
- (ii) getting the basics right;
- (iii) moving from confrontation to co-operation with MNEs in Canada;
- (iv) securing access to the US market;
- (v) reducing state aids to business; and
- (vi) upgrading to best-practice technology.

### **A New National Policy: *Strategic Integration***

As a result of CAFTA and NAFTA, north-south economic linkages are creating a continental market. Canada is fragmenting along regional lines in economic space, with trade and investment flows increasingly north-south rather than east-west.

This same problem challenged the Fathers of Confederation and was handled by Sir John A. Macdonald through the First National Policy, *defensive expansionism* (1867-1940), based on three prongs: a high Canadian tariff to protect domestic manufacturing, a national railway system to provide the means to move goods across the country and rapid immigration to populate the country (Eden and Molot 1993a). This national policy was later replaced by the Second National Policy, *compensatory liberalism* (1941-1981), based on a commitment to the GATT postwar liberal-trading order, Keynesian macro-economic policies and the construction of a domestic social welfare net. Our current national policy, *market liberalism* (1982-1994), begun under the Conservatives, relies on continental free trade and a commitment to market-based policies and fiscal restraint. In 1994, what we see under the new Liberal administration of Jean Chrétien is both a continuation of market liberalism and a renewed attention to employment, labour upgrading and social policies.

Market liberalism ignores the enormous changes taking place around the world which we identified earlier: globalization, the end of the Cold War, the rise of the Asia Pacific and lean production. Canada needs a coherent set of policies that position the country better relative to its major trading and investment partners. Such a strategy we call *strategic integration* because it would be designed to integrate Canada strategically into the global economy (Eden and Molot 1993a). This new national policy would be based on dynamically engineering Canada's long-run competitiveness in a world of lean production and regional trading blocs. The three components of this national policy would be:

- international and interprovincial free trade, building on CAFTA and NAFTA (i.e., the reversal of the original high tariff policy);
- a national telecommunications network based on development and diffusion of information technology and lean-production techniques (the 1990s version of the coast-to-coast railway); and
- human capital development through a national educational and retaining policy to help Canadian workers deal with the Information Revolution (a commitment not to more labour but to higher-quality labour).

The goal of this national policy would be to achieve long-run national competitiveness, defined as high and rising productivity levels, in a knowledge-intensive world.<sup>19</sup> A policy of strategic integration means a renewed emphasis on removing tariff and non-tariff barriers to trade and investment within Canada and within NAFTA, a commitment to the knowledge-based economy with its focus on innovation, competition and sustainability, and a focus on a national educational policy that prepares our children for 21st-century jobs.

The first prong, free trade, we have discussed above under CAFTA and NAFTA. In addition, the federal government should continue to pressure the provincial governments to implement the Canadian economic union. The recent federal-provincial accord is a step in the right direction, but north-south trade is still freer under NAFTA than east-west trade is within Canada. Unless the many remaining domestic internal barriers to trade are removed, the hub and spoke pattern of trade and investment will continue to strengthen. Cross-border economic regions such as Cascadia in the west and the Golden Triangle linking New York, Michigan and Ontario in the centre of the country can only grow stronger as benefits of agglomeration coincide with removal of north-south trade barriers. High interprovincial trade and investment barriers can only exacerbate this tendency.

The second prong, transportation infrastructure, will be as important in the 21st century as it was one hundred years ago when the national railway was established. However, the 21st-century equivalent will be based on the marriage of computers with telecommunications. The United Nations is already encouraging the establishment of infoports or teleports as central nodes for exchange and transmission of information around the world. A teleport "is like an airport or seaport but transports a new economy, weightless cargo: voice, data, text and video" using broadband facilities, satellites, fibre-optic networks and microwave hubs (McQueen 1994, p. 7); more sophisticated centres are called smart parks and intelligent cities. More than 100 teleports are in operation or under development around the world, many set up as export processing zones with no duties or taxes. Canada has no policy focus or national programs in this area, and should develop one or be left behind.

The third prong, labour policies, implies a renewed commitment to labour quality and productivity. The information revolution is already widening the wage differential between knowledge workers and McJobs, with high rents going to knowledge-intensive professionals. This trend will continue, so it is critical that Canadian labour market policies (education, retraining, unemployment, welfare) be co-ordinated in this regard.

### **Getting the Basics Right**

MNEs are worried about the economic and political insecurities in Canada. Firms dislike risk, particularly policy risk; Japanese MNEs dislike policy risk more than most multinationals (Westney 1994). Debt for all three levels of government now approximately equals Canada's Gross Domestic Product. Instability in the Canadian dollar is increasing due to investor fears about the debt overhang and the possibility of Quebec secession from Canada. For example, a new study by DRI Canada Ltd. suggests that the Canadian dollar would fall and interest rates rise substantially, costing the country 20,000 jobs because of lost investment, during a Quebec referendum (Little 1994). These factors, regardless of any Canadian policy toward MNEs, will discourage MNEs from expanding their operations in Canada.<sup>20</sup>

These domestic macro-economic and political problems are having an impact on investment in Canada. Oxford Analytica (1994) recently noted that "[a] growing lack of investment interest in Canada itself has created a net outward flow of funds....Canada will run a deficit in direct investment

likely to exceed \$3 billion (four percent of GDP) in 1994." Oxford Analytica attributes the weakness in investment to the small Canadian market with its restricted provincial trade; unfavourable corporate income tax rates, especially on export earnings; high capital costs due to high real-interest rates; low after-tax returns to capital due to government overheads in the form of tax and regulatory compliance costs and higher import costs due to devaluation of the Canadian dollar; and growing concern about the inability of the federal and provincial governments to lower budget deficits without large tax increases, and about the political future of Quebec and Canada. The consulting group concludes that this net deficit on investment is likely to continue for 1994 and 1995, so that overall investment growth remains weak.

During this period of political and economic instability, the federal and provincial governments should not lose sight of the fundamental proposition: get the basics right. This means a commitment to reducing the federal and provincial debt overhangs and keeping the focus on a sound macro-economic policy for the long run. It also means reducing the paperwork and regulatory barriers that discourage investment, and avoiding waste and duplication of activities within the three levels of government. The budget deficits should be fought with reduced government spending, not with higher taxes.

### **From Confrontation to Co-operation**

Multinationals now function in a global, political economy: global because borders are disappearing between markets, political because national politics and policies still matter (Eden 1993). Since the late 1960s, MNE–state interactions have slowly shifted from primarily conflictual (where governments sought to reduce anticompetitive behaviour by firms) to co-operative (where states now see MNEs as the means by which national competitive advantage can be generated and sustained) (Dunning 1993a).

Most countries have historically treated inward and outward FDI flows as unrelated economic phenomena and developed policies only to regulate the former. Governments sought to remove or lessen the perceived adverse effects of oligopolistic foreign MNEs, such as transfer price manipulation and anticompetitive behaviour. This was also true in Canada where FIRA, key sector policies and preferential procurement policies were biased against foreign investors.

However, most developed market economies, Canada included, are now both inward and outward investors. Multinationals are also more mobile within, and between, national economies. The increased competitiveness of firms as they contend for shares of the world market has forced nation states to reconsider their policies vis-à-vis multinationals and foreign direct investment.

Governments have moved from confrontation to co-operation with the MNEs in their midst, from regulating to encouraging entry, from taxing to subsidizing, from opposition to FDI to partnership with multinationals. Governments now facilitate the competitiveness and innovation capabilities of their domestic firms, regardless of ownership, playing a positive and co-ordinating role in upgrading industry resources and capabilities. Inward and outward FDI are now seen as

complementary to domestic investment, so that governments are developing policies to encourage inward FDI and to improve the competitive advantages of their own MNEs in foreign markets. A fundamental reorientation of the role of government appears to be occurring, one that changes MNE–state relations from confrontation to co-operation. The politics of national economic competitiveness in the 1990s means that MNEs and nation states must now be seen as partners in the race to engineer competitive advantage (Eden 1993).

This positive, proactive attitude toward multinationals as agents of change should be a fundamental component of a new Canadian policy toward foreign direct investment, one that focuses on co-operation not confrontation. This does not mean abandoning a policy on inward FDI, but rather adopting one that is strategic, for example, a policy that attempts to attract MNEs which will build upon and upgrade Canada's competitive advantages, that removes internal barriers to trade and investment, that encourages access to foreign markets for Canadian investors and so on. Nor does it mean a completely open door to all types of FDI. There may be non-economic arguments (sovereignty, culture, national security) for restricting levels of foreign investment in sensitive industries, and most countries, including the United States, have such restrictions (Kudrle 1993).

On the other hand, to promote a country internationally as an investment location, most countries now have an investment promotion agency (Wells and Wint 1993). These agencies act as central locations, providing information about doing business, setting up firm-to-firm contacts, streamlining the investment process for the new entrant and so on. With the demise of Investment Canada, the mandate to promote FDI is now diffused within the broader departmental objectives of Industry Canada. A single agency has visibility, potential investors know where to go, and the staff are trained. Setting up an agency to promote Canada as a "one-stop shopping" investment location (i.e., re-establishing the second half of Investment Canada's "screen and promote" double mandate of the 1985-1994 period) should be considered.

### **Securing Market Access**

For most Canadian firms, access to the US market is critical for their long-run success. We take it for granted that the hub and spoke economy within North America is a *fait accompli*. Canadian firms are inexorably tied to the US economy, and no Third Option is going to change this. We can diversify our trade patterns somewhat, e.g., the West Coast can develop its Asia-Pacific links, but the key economic relationship in Canada is south of the 49th parallel. We should, therefore, see this as an advantage, not a threat (after all, most businesses would be delighted if their country were next door to the US market).

The Canada–US Free Trade negotiations were designed to secure, protect and enhance such access. While both CAFTA and NAFTA phase out tariffs, reduce non-tariff barriers, cover goods, services and factor markets, and develop a far-sighted investment-policy regime based on non-discrimination, secure access to the US market has not been achieved. US firms can still harass Canadian exporters through countervailing duties (CVD), antidumping duties (ADD) and temporary safeguard measures.<sup>21</sup> The NAFTA dispute-settlement procedures are still based on national laws that

focus on subsidies and dumping by foreign competitors, while ignoring subsidies and dumping by domestic firms. In addition, the procedures are cumbersome, expensive and time consuming; their principal beneficiaries so far have been trade lawyers. Thus, as Eaton et al. (1994a) argue, policy risk still exists and market access, while improved, is not secure.

How can we secure this access? Two solutions are possible. One is to renegotiate the NAFTA rules to substitute a trilateral system of dispute settlement, based on continental rules that take account of the *net* subsidies available within North America and ask the question: how level is the playing field? For the United States to cede sovereignty in this manner to its much smaller Canadian and Mexican partners does not appear likely, so we do not offer much hope for this solution. However, competition policy offers another alternative.

Competition policy includes the regulation of market monopolization (antitrust policy) and state aids to industry (state-aids policy). In North America, each of the three governments has its own antitrust policy but not a formal state-aids policy. NAFTA requires each country to have its own competition laws and the countries to co-operate in enforcement of domestic laws. Graham and Warner (1994) argue, however, that NAFTA should explicitly contain competition policy provisions, and that MNEs strengthen the case for such a policy. The authors provide five reasons:

- barriers to trade can offset the gains from NAFTA;
- some competition policy issues, such as continental mergers and acquisitions, have a North American dimension which will be ignored by national competition policies;
- national competition laws in the three countries are not fully harmonized so there are potential conflicts between the regulations;
- a trilateral competition policy would replace the CAFTA/NAFTA rules on ADD, CVD and safeguard measures,<sup>22</sup> which are now disguised backdoor protectionism particularly for US firms; and
- a trilateral competition policy could be used to regulate government subsidies to business, both at the federal and subfederal levels. The authors recommend a North American competition commission (NACC) be established in this regard, and this is also our policy recommendation.

### **Province/State Aids to Business**

A NACC could also have the advantage of regulating provincial and state aids to business. Given the size of the federal and provincial debt levels, Canadian governments cannot compete with the location subsidies offered by US states.<sup>23</sup> Such government largesse can be a way of attracting assembly firms, which then generate a second-round inflow of parts suppliers, such as happened with the Japanese and European auto investments in the middle and late 1980s (Rubenstein 1992). As a result, although the up-front costs in subsidies and tax holidays may be high, the net benefits to the local economy may exceed these costs — at least, governments tend to assume there are net benefits and to rationalize the subsidies in this manner.



The problem, as is well known, is one of externalities: if the investment would have been placed there anyway, the subsidy represents a transfer from taxpayers to the firm and its shareholders. If the investment would have been placed somewhere else but within national boundaries, one region gains but at the expense of another, and resources are misallocated at the national level. In addition, competition among states for investment has significantly increased the size of the grants to new investments, thus reducing the possible net gains to the region. In this way, there are benefits from constraining state aids to business, and, in the case of the smaller, poorer partner (Canada), the benefits are high.

As part of the CAFTA negotiations, the US and Canadian governments agreed to address the issue of subsidies. These negotiations were postponed until Prime Minister Chrétien secured a commitment from presidents Salinas and Clinton to discuss the subsidy issue, as part of Canada's agreeing to sign the NAFTA treaty in December 1993. Since a three-part subsidy code (green, yellow, red) is part of the Uruguay Round package, it is likely that these talks, which are now ongoing, will result in the adoption of the GATT subsidy code, or some modification, as part of NAFTA.

If the Canada-US subsidy talks fail, Canada should consider adopting the free trade zone strategy which is now heavily used in the United States (Rubenstein 1992). This federal policy allows designated regions to declare themselves as foreign trade zones for the purposes of importing parts for assembly with the final product being exported. In the United States, tariff rebates, tax holidays and subsidies can all be part of the package; most US auto plants now enjoy these privileges. Canada has a few international banking centers (Montréal, Vancouver), but no other equivalent.<sup>24</sup> A new foreign trade zone policy would operate in a similar fashion but could be set up primarily to benefit manufacturing and high tech activities (such as a teleport). Such Canadian zones should be restricted to removal of tariffs and quota regulations alone (since Canadian tariffs on US products are disappearing under NAFTA, this primarily applies to imports from elsewhere); tax incentives and other business subsidies should be avoided as inefficient and expensive. If tax incentives are judged to be necessary, an export tax incentive such as the US government gives to its firms (the foreign export sales corporation or FSC) that provides a lower tax rate on profits from export sales could be considered.

### **Moving Up to Best-Practice Technology**

In the knowledge-based economy of the 21st century, Canadian firms will only be competitive on world markets if they operate at international standards of quality and best-practice technology. For example, ISO 9000 standards are now required by the European Union for many imports; the standards are diffusing widely through the auto industry (Eden and Molot 1994); and the need for quality control in lean production is causing manufacturers to insist on their first-tier suppliers also meeting the standards. Unless Canadian firms can satisfy international quality standards, their products will be blocked from the US and foreign markets.

In addition, technology standards are continually being upgraded. Firms without a window on foreign competition lack the information necessary as a benchmark for their performance against international levels. Without the motivation or knowledge to upgrade their activities, best-practice technologies spread slowly throughout the economy.

A policy of attracting best-practice multinationals to Canada would change this. Japanese MNEs, with their process and product technologies, offer the best investment bridges to, and windows on, lean-production techniques. An aggressive policy of seeking Japanese manufacturing firms and their first-tier suppliers is recommended. More Asian investment in Canada would diffuse these best practices among Canadian firms through competition, the demonstration effect and supplier networks (Kenney and Florida 1993). Given the attitudes within the United States to Japanese MNEs ("Japan bashing") it may be possible to attract incoming investments to a Canadian, instead of a US, location. Weighted against this, however, are the deep pockets of US state governments, the Japanese perception that investing in the United States can be used to offset the US–Japan trade balance and the lack of a clear sense of Canada by Japanese MNEs (Westney 1994). We suggest that an inviting and open-door policy toward Japanese MNEs be adopted so that these firms are encouraged to see Canada as a good place to do business, a place where they are welcome. The west coast, with its trade and investment links to the Pacific Rim, is a natural location for such firm-to-firm contacts. Spillovers to Canada, in technology, are critical.

Japanese firms are not the only firms that can offer lessons to Canadian business. In the retail sector, the entry of such US firms as Wal-Mart Stores Inc. is already shaking up the hidebound Canadian retail sector. Canadian consumers should benefit from better service at lower prices as US techniques diffuse through Canadian businesses.

The inflow of US and Japanese MNEs is both a benefit (better technology, lower prices, more choice) and a threat (more competition, domestic firms going out of business). Domestic firms, faced with technological competition, as we saw above, can respond by intensifying their current strategies, rationalizing their activities or upgrading technology. The most likely response to change is a short-run one of cost cutting, downsizing and outsourcing (perhaps to Mexico), rather than the needed technological upgrading. Domestic firms need to be encouraged, perhaps through loans (not subsidies), to take the long-run approach of learning from these new competitors and moving up to best-practice technologies. In addition, Canadian firms should be encouraged to invest abroad and to form strategic partnerships with best-practice firms. Their foreign-affiliate activities can be filtered through the parent firm to other Canadian firms. Outward investments should also be seen as investment bridges and windows on foreign competition, as ways of gaining access to the global marketplace. Some of this is already happening as a result of CAFTA and NAFTA; mergers and acquisitions by Canadian firms in the United States are expected to set a five-year record in 1994 (Haggett 1994); much of the activity has occurred in the financial services and communications and media sectors.

## CONCLUSIONS

The adjustment of Canadian firms to CAFTA and NAFTA is occurring within a rapidly changing international environment. Since 1989, we have witnessed EC 1992 and Maastricht in Western Europe, the disintegration of the Soviet Union, the boom in China and the collapse of the speculative bubble in Japan. What does this mean for multinationals in Canada and for the development of a new policy on foreign direct investment?

In this paper we have demonstrated the hub and spoke nature of the Canada–US economic relationship, reviewed the history of Canadian treatment of foreign direct investment and outlined the impact regional integration (CAFTA and NAFTA) and technological change (lean production) are having on MNEs in Canada. It is too soon to tell how MNEs in Canada will react to the potent mixture of NAFTA, lean production, globalization and other changes such as the new markets and open-door policies of the transition economies, the incredible growth rates in the Asia Pacific economies and closer integration in Western Europe. What is clear is that change is pervasive at all levels, adjustment costs are high and the recent recessions have left Canadian firms without deep pockets to finance much upgrading.

We have also proposed a new direction for Canadian foreign policy with regard to multinationals. The old policy direction focused on restricting inward FDI flows. Our proposed new direction focuses on multinationals as market-making firms and as agents of change, acting as investment bridges to the global economy and as diffusers of technology within Canada. A new policy on foreign direct investment should not differentiate between inward and outward FDI, but seek to maximize the gains to Canada from MNE activities in both directions.

What does this mean for Canadian foreign policy? There is a well-known quote about the linkage between foreign policy and trade policy in Canada. Eaton et al. (1994a, p.71) perhaps summarize it best: "For the United States, as a super power, trade policy has always been an instrument of foreign policy.....For small countries such as Canada, however, foreign policy is an instrument of trade policy." In this paper, we have shown that a fundamental rethinking of Canadian foreign policy is required. In a world where multinationals are the key non-state actors, where almost half of all Canadian goods and services are traded inside the MNE and where more products are sold through foreign affiliates than through exports, Canada's trade policy must be about multinationals and their investments....and, therefore, Canadian foreign policy must be about investment policy.

## ENDNOTES

1. Another example is the recent US renewal of Most Favoured Nation (MFN) trade status for China, in spite of China's violation of human rights, on the grounds that trade and investment would do more to reform the Chinese economy than withdrawal of MFN.
2. Professor Jackson was speaking at a Centre for Trade Policy and Law conference on the Uruguay Round in May 1994 in Ottawa.
3. For example, the Bank of Montreal has been in the United States and Mexico for several years and is now aggressively expanding these operations, hoping to become the first truly North American bank (*Business Week* 1994). The article quotes Matthew Barrett, president of the Bank of Montreal, as saying the Canadian banks will "face a stark choice," adopt North American strategies or "resign themselves to becoming, over time, essentially regional banks" which would be open to takeovers by the emerging, and potentially much larger, US banks (p. 105).
4. The term "hub and spoke" is used in this paper as a metaphor for economic relationships among the three nations in North America. This is an apt description because one country (the hub, the United States) dominates the other two (the spokes, Canada and Mexico); the United States is the primary conduit through which the smaller partners are linked to one another; and the Canada–US and Mexico–US linkages are much larger than Canada–Mexico linkages. The term, however, has also been used by economists such as Richard Lipsey and Ronald Wonnacott to refer to a series of bilateral free trade agreements where the agreements all have one partner in common (e.g., the United States signs bilateral agreements with Canada, Mexico, Chile, Israel and so on) so the series of agreements look like a hub and spoke arrangement.
5. Note that the two lists are not directly comparable because the Industry Canada list is ranked by sales, while the *Business Week* list is ranked by market value; also by definition, the *Business Week* list is limited to Canadian firms. However, the overlap is significant. We do not have statistics on the percent of offshore activities (i.e., the degree of multinationality of the companies), however, most of the firms on the list are well known MNEs.
6. We do not use Canadian data because of the problems caused by mixing data from different countries' sources.
7. The only country with a significantly higher percentage of intrafirm trade is Japan, with intrafirm trade representing 66.9 percent of US exports to, and 84.5 percent of US imports from, Japan.
8. Two recent studies of Canadian merchandise imports (Covari and Wisner 1993, Mersereau 1992) find similar results. *See* the summary in Eden (forthcoming).
9. Certain sectors have been considered key sectors and FDI either prohibited or restricted (*see* Kudrle 1994). These restrictions have been gradually lifted, particularly since 1984.

10. *See* Kudrle (1994) for a good review.
11. They also substantially watered down compulsory licensing of pharmaceuticals (another policy disliked by US multinationals).
12. Mexican President Carlos Salinas de Gortari approached US President George Bush about a US–Mexico FTA in June 1990; the three governments launched trilateral talks in early 1991. *See* Eden and Molot (1992b).
13. *See* Hufbauer and Schott (1993, Chapter 4) for a good summary. A shorter summary is provided in UNCTC (1993, pp. 51-52).
14. There are exceptions: investments in financial services are covered elsewhere in the agreement; many existing federal measures, such as Canadian cultural industries, are exempt; the states and provinces have two years to provide a list of exemptions; public procurement and investment incentives are not included, nor are FDI restrictions on national security grounds (Hufbauer and Schott 1993, p. 82).
15. Recently, US lawyers have argued that the Canadian government's attempt to force the cigarette manufacturers to use plain packaging is tantamount to expropriation of intellectual property, and have threatened to sue the government for damages under the NAFTA.
16. Some authors (e.g., Christopher Maule) argue that the information technology revolution is not new, but that it is a continuation of a revolution starting in the 1850s with the telegraph, typewriter, camera, telephone, radio, cinema and television, with the latest stage being the computer and its linkage with telecommunications.
17. *See* Eden (1991b, 1994a), Kenney and Florida (1993), Kogut (1994) and Womack et al. (1990).
18. Shrinkage in the number of suppliers and closer linkages between designated suppliers and assemblers is already happening in the Canadian auto industry. *See* Eden and Molot (1993b) and Pritchard (1994).
19. Space prohibits more discussion of this topic. Note that we are sensitive to the financial and political constraints faced by the current government, but argue that nation building is an appropriate role for government policy. *See* Eden and Molot (1993a).
20. In particular, we do not anticipate any large Asian investments, either of manufacturers or their first-tier suppliers, at least until after the issue of Quebec separation is addressed, although smaller investments may occur.

21. The latest extraordinary challenge, this time in softwood lumber, is an example of the lengths US firms will go to protect their market from Canadian competitors (*see*, for example, *Oxford Analytica* [1994]).
22. As competition policy rules have replaced ADD/CVD rules within the European Community.
23. The provincial governments, however, have often tried with marked effects on their treasuries. Preferential procurement policies have much the same effect as subsidies.
24. Another somewhat similar program was the duty drawback and remission schemes available to designated auto and auto-parts firms under the Auto Pact. Under NAFTA these are being phased out, except for the Big Three, over the next few years (Eden and Molot 1993b).

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