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FOREIGN DIRECT INVESTMENT TRENDS: A CANADIAN PERSPECTIVE

Ram C. Acharya and Someshwar Rao,
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Working Paper 2008-13

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Abstract

Multinational enterprises are playing an increasing role in the world economy by globalizing all aspects of their economic activity. The stocks of global inward and outward foreign direct investment (FDI) have increased by about 16-fold in the last 25 years, reaching over US$10 trillion in 2005. Canada too has actively participated in the corporate globalisation process. Canada is a major exporter and importer of FDI, and, more importantly, a net exporter of capital. Like other advanced economies, Canada too is currently in the rising phase of another large FDI cycle, which as usual, is dominated by cross-border mergers and acquisitions, driven by low interest rates, rising stock market prices and increased participation by private equity. In this phase, like others before, Canadian companies are being acquired by foreign firms, and Canadian companies are acquiring foreign companies in Canada and abroad. There is little empirical evidence of hollowing-out in Canada in terms of movement out of Canada of key corporate headquarter functions. Available research in Canada and other countries suggests that the long-term economic benefits from FDI, including cross-border mergers and acquisitions, outweigh any possible short-term economic adjustment difficulties in host countries, provided they have a competitive business climate and flexible and dynamic factor and product markets.

Key words: foreign direct investment, mergers and acquisitions, hollowing-out, head office functions

Résumé

Les multinationales jouent un rôle de plus en plus important dans l'économie mondiale en raison de la mondialisation de toutes leurs activités. Les stocks d'investissement direct étranger (IDE) entrant et sortant sont environ 16 fois plus élevés qu'il y a 25 ans. Ils atteignaient 10 billions de dollars américains en 2005. Le Canada a lui aussi activement participé au processus de mondialisation des entreprises. Il est à la fois un importateur et un exportateur majeur d'IDE et, fait encore plus important, un exportateur net de capital. Comme d'autres économies développées, le Canada se trouve actuellement dans la phase de croissance d'un grand cycle de l'IDE, qui est, comme d'habitude, dominé par les fusions et les acquisitions, tiré par les bas taux d'intérêt, les prix à la hausse des valeurs mobilières et une participation accrue sous forme de capitaux propres. Dans cette phase, comme dans le passé, des entreprises étrangères font mainmise sur des entreprises canadiennes, et des entreprises canadiennes font l'acquisition d'entreprises étrangères au Canada et à l'étranger. Peu de données empiriques permettent de conclure que l'économie canadienne souffre de la perte de sièges sociaux canadiens importants au profit de l'étranger. Les études existantes laissent croire que les bienfaits économiques à long terme de l'IDE, y compris les fusions et les acquisitions étrangères, dépassent de loin toute difficulté économique à court terme due à l'ajustement dans le pays hôte, à condition que celui-ci présente un environnement d'affaire concurrentiel et qu'il possède un marché des produits et un marché de facteurs flexibles et dynamiques.

Mots clés : investissement direct étranger, fusions et acquisitions, perte de sièges sociaux, fonctions, fonctions des sièges sociaux

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1 Introduction

Foreign direct investment (FDI) and other activities of multinational companies have increased dramatically in the last two decades all over the world. Available research suggests that the long-term economic benefits from FDI outweigh possible short-term economic adjustment difficulties in host countries, provided they have a competitive business climate and flexible and dynamic factor and product markets. Nations around the world acknowledge the positive influence of foreign investment on a country's economy, and virtually all countries now compete to attract or retain global enterprises. Canada too has actively participated in the globalization of FDI both as a major source and destination of FDI.

The objective of this report is first to review global and Canadian trends in FDI and to identify the major factors that shape these trends (e.g., rules, changing economic environments) in the first two parts. A third part focuses on the hollowing-out debate and describes the current state of play in Canada. The fourth part provides a review of the economic impacts from FDI to host economies, and is followed by summary conclusions.

2 Global Trends in Foreign Direct Investment (FDI)

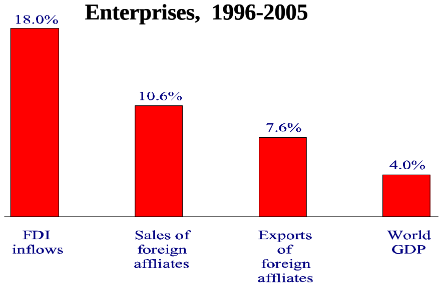
FDI, as defined by the Organisation of Economic Cooperation and Development (OECD), involves an entity in one economy (the direct investor) obtaining a lasting economic interest in another enterprise in a foreign economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise in a foreign country and entails a significant degree of influence on the management of the enterprise. FDI can take one or more forms: greenfield investment, cross-border mergers and acquisitions and re-investment of retained earnings.

Firms are motivated by the following four factors in their corporate strategies to grow globally:

- Access Market: utilize FDI to overcome trade and distance barriers to distribute goods/services to other markets;
- Seek Resources: acquire key inputs to production including human and physical capital, and natural resources;
- Seek Efficiencies: allocating key elements of value chain to the most efficient location;
- Obtaining Strategic Assets: acquiring new technologies, skilled employees and organizational capabilities.

Dramatic reductions in transportation and communication costs, rapid advances in product and process technologies, fierce international competition for markets and factors of production and increased liberalization of trade and investment regimes in all countries are driving the organization of firms' economic activities on a global basis. Multinational enterprises (MNEs) are playing an increasing role in the world

Chart 1. Average Annual Growth Rates of Selected Activities of Multinational Enterprises, 1996-2005



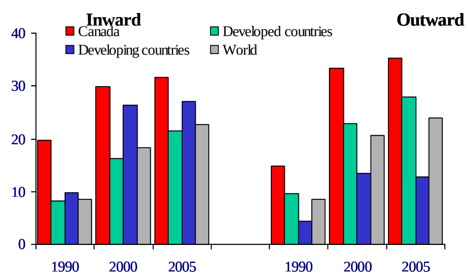
Source: World Investment Report, 2006

economy. The stock of global inward FDI increased from about US$642 billion in 1982 to over US$10 trillion in 2005 (all values are in nominal terms).

Over time MNEs have become more globally integrated firms. In 1990 there were 37 thousand MNEs with a total of 170 thousand foreign affiliates. After 14 years, in 2004, there were about 70 thousand MNEs, with more than 690 thousand foreign affiliates. During this period, the number of MNEs doubled, while the number of foreign affiliates almost quadrupled. Furthermore, half of the affiliates are now located in the developing world, as a result of growing global production networks. Their activities increased at a considerably faster pace than world GDP over the past decade (Chart 1).

Sales and exports of MNE foreign affiliates in 2005 were over US$22 trillion, compared to under US$3 trillion in 1982. MNEs employ over 60 million people all over the world and currently account for over one third of global trade, primarily through intra-firm trade. The activities of MNEs are concentrated; the top 100 global MNEs accounted for between 11 to 16 percent of the estimated foreign assets, sales and employment of all MNEs operating in the world in 2004.

Chart 2. Share of FDI Stock in GDP (Percent)



Source: World Investment Report, 2006

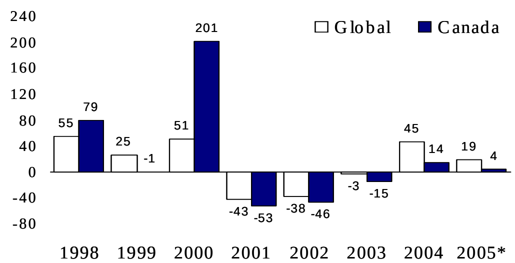
About 90 percent of MNEs are from developed countries, but the share of emerging economies has been rising steadily. For instance, the share of emerging economies in global outward direct investment stock increased from 4.3 percent in 1985 to 11.9 percent in 2005.

In both developed and developing countries, the importance of FDI steadily increased over the last two decades. The ratio of inward FDI stock to GDP of developed countries increased from 8.5 percent in 1990 to 22.7 percent in 2005 (Chart 2).

In developing economies, the ratio of inward FDI stock in their GDP increased from 9.8 percent in 1990 to 27 percent in 2005. Developing economies are also becoming exporters of capital. The ratio of outward FDI stock to GDP in these countries increased from 3.8 percent in 1990 to 12.8 percent in 2005. According to the United Nations Conference on Trade and Development (UNCTAD), developing countries accounted for 42% of world FDI flows in 2004, the highest figure in two decades (except for 1994, when it was the same).

Mergers and acquisitions (M&As) is the preferred strategy for firms interested in gaining entry into a foreign market. Acquisitions are preferred over greenfield investments when the speed of entry is of the essence, such as to exploit a particular innovation or management practice which is soon likely to be copied by others. The regulatory environment can also sway the mode of entry towards cross-border mergers and acquisitions. For example, restrictions on factors of production, such as the availability or mobility of skilled employees, may contribute to making acquisitions more attractive than greenfield investments.

Chart 3. **Growth in Mergers and Acquisitions (percent)**



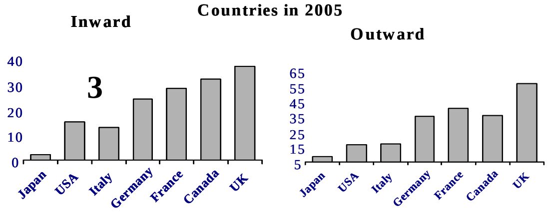
Source: KPMG, Global M&A Annual Survey (based on completed M&A data from Dealogic).
*First 11 months.

According to ATKearney, cross-border M&As represent an estimated 80% of total global FDI flows amongst OECD economies. Completed global M&A deals were valued at US$2.1 trillion in the first 11 months of 2005, up 19% from 2004 and the highest level since 2000 (Table 1, 2 and Chart 3). Low worldwide interest rates, high corporate profits, and high business confidence contributed to global mergers and acquisitions growth in 2004 and 2005. The increase in M&A is broad-based across regions (U.S., Europe and Asia-Pacific) and across sectors.

Developing countries attracted half of the more than 9000 greenfield investment projects undertaken in 2004; if central and eastern Europe is added, this percentage rises to more than two-thirds. If greenfield investment is a good barometer, developing countries are receiving increased attention from international investors, although the interest is highly concentrated in a few Asian countries. The most dynamic part of the global MNE activity has been in emerging economies such as India and China motivated largely by low wages, market expansion opportunities and access to skilled labour.

Another recent development is the increasingly active global investment strategies of a new class of investors such as hedge funds and private equity capital companies.

Chart 4. Share of FDI Stock in GDP for G-7 Countries in 2005



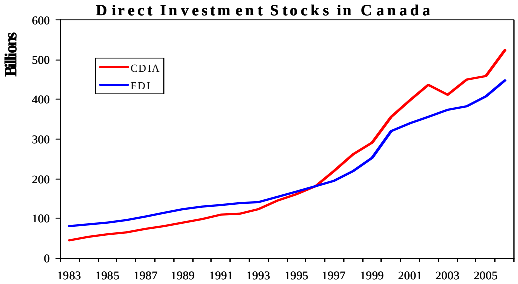
Source: Compilations based on OECD data

Canadian FDI Trends

Canada is no exception to global FDI trends. Canada's inward and outward orientations are higher than for many other OECD countries. Inward orientation is defined as the accumulated inbound investment by foreigners (or FDI stock) as a share of GDP, and outward orientation is the accumulated Canadian direct investment abroad (or CDIA stock) also as a share of GDP.

Canada is more oriented towards inbound foreign investment than many other OECD

Chart 5. Canadian Direct Investment Abroad and Foreign Direct Investment Stocks in Canada

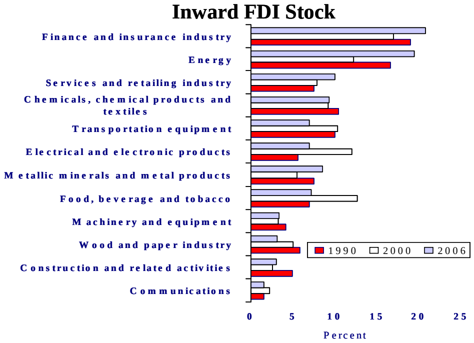


Source: Statistics Canada

countries. In 2005, Canada's inward orientation was 32 percent. The only major OECD countries which had larger orientation were Netherlands, Switzerland and the UK. In outward orientation, Canada is at the middle of the pack at 35 percent. Among G-7 countries Canada is the second most-outward-oriented after the UK in inward FDI stock and third-most-oriented after the UK and France in outward FDI stock (Chart 4).

Since 1996, Canada has been a net exporter of FDI, as its outward stock has been consistently larger than its inward stock (Chart 5). Inward FDI stock in Canada increased from $112 billion in 1990 to $448 billion in 2006, whereas in 2006 Canada's outward FDI stock was $523 billion.

Chart 6. Industry Distribution of Canada's Inward FDI Stock



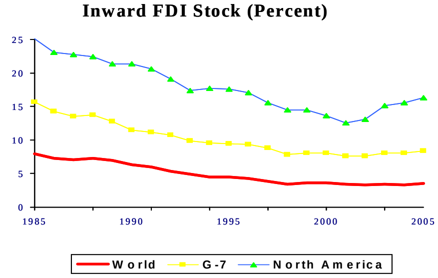
Source: Statistics Canada

In 2006, more than half (55%) of FDI to Canada was in the goods industries (Chart 6). This share was down from 59% in 2000. Mining and oil and gas extraction accounted for 16% of the total, double the share in 2000. In 2006, Canada's services sector accounted for about 30 percent of total inward FDI stock.

The U.S. share of Canada's inward FDI stock has declined to 61% in 2006 from its share of 64% reported for the last few years. Canada's leading sources of FDI after the United States is the United Kingdom (9%), France (6.5 percent) and the Netherlands (5 percent).

The U.S. is still the main recipient of Canadian direct investment abroad (CDIA), but its share declined steadily in the last 15 years. On the other hand, the share of all other countries more than doubled, reaching over 55 percent in 2006. Canadian investment in China and India has also increased but remains insignificant at 0.2 percent of CDIA in 2005.

Chart 7. Canada's Share of World Inward FDI Stock (Percent)



Source: World Investment Report, 2006

In spite of impressive growth in the level of inward FDI stock, Canada's shares of global and G7 FDI stock, have declined steadily between 1990 and 2004, with a slight rebound in 2005 (Chart 7). In 2005, Canada's share of global inbound FDI stock at 3.5 percent was slightly higher than its share of global GDP at about 3.1 percent. Canada's growth in M&A activity was also slower than international levels in 2004 and 2005.

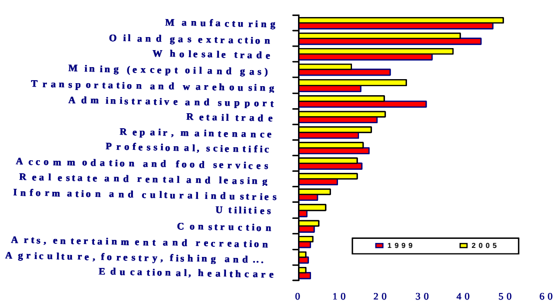
The increase in FDI inflows is mainly the result of acquisitions of major Canadian firms by foreign companies. During the period 2000-2005, cross-border foreign M&A activity in Canada (sales) averaged US$31.2 billion, compared to Canadian M&A activity in foreign countries (purchases) of US$27.4 billion. Canada accounted for about 3 percent of global cross-border M&A activities in 2005. It is interesting to note that the rate of increase in M&A activities (sales) between 2004 and 2005 in Canada at 37% was significantly smaller than in the world (88%) and in the US (62%) (Table 2).

In 2006, only about 8 percent of Canada's FDI outflows was through foreign acquisitions; the remaining 93 precent was contributed by greenfield investments and investment of retained earnings. However, if taken in a longer perspective, the share of foreign acquisition in total Canada's FDI outflows has risen to 33 percent during 2001 and 2006 period from 22 precent in 1994-1999 period. In 2000, it was unusually high at 73 percent. In terms of Canada's FDI inflows in 2006, about 71% was through acquisitions of Canadian companies by foreigners, an increase from 63% realized a year before.

In 2006, the total value of acquisitions of Canadian companies by foreigners was unusually higher than the value of acquisitions of foreign companies by Canadians. However, the case was reverse in 2003 and 2004. Much of the recent M&A activity in Canada is in the resource sector and is largely driven by high equity prices, relatively low interest rates and increased participation by private equity. In theory there is no reason for a strong link between the exchange rate movements and the cross-border M&A activity and the empirical evidence is largely consistent with this hypothesis (Schembri, 2002).

The vast majority of 1.2 million corporations doing business in Canada in 2005 are Canadian-controlled: in only 7,929 corporations, assets were controlled by foreigners. But, on average, they are much larger than Canadian-controlled companies. As a result, they accounted for 21.2 percent of total corporate assets and 29.9 percent of corporate operating revenues. The share of foreign-controlled assets in Canada remained relatively stable between 2004 and 2005. The state of foreign asset control in Canadian industries for the period 1999-2005 is given in Table 3.

Chart 8. Share of Assets under Foreign Control in Non-Financial Industries



Source: Statistics Canada

Most of the foreign control in Canada is in the non-financial sector, which has increased since 1988 at the expense of the financial sector. Foreign ownership in manufacturing was 49 percent in 2005 (a slight increase over 2004). By contrast, foreign ownership in oil & gas extraction decreased from 43 percent in 2004 to 39 percent in 2005. Foreign ownership in mining (except oil and gas) substantially decreased from 29 percent in 2004 to 13 percent in 2005 (Chart 8). Contrary to the popular perceptions, the rise in commodity prices (metals and oil and gas) has not increased the share of foreign ownership in Canada in these classes of assets.

The share of foreign affiliates in total value-added is about 48 percent in the manufacturing sector (the highest in the G7 countries) and about 22 percent in the service sector (the second highest in the G7 countries).

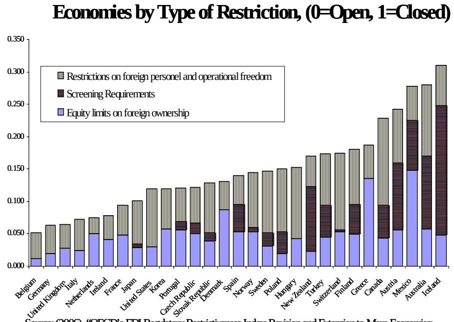
4 Formal and Informal Barriers to FDI in OECD Countries

Attracting FDI has become an integral part of the national development strategies in many economies, as it is generally believed that economic benefits from FDI outweigh any potential costs. But, FDI is still far less liberalized than international trade in goods. Recent studies undertaken at the OECD show that barriers to inward FDI are still widespread in OECD countries although they declined significantly since 1980s. Accordingly to the OECD's methodology, Canada is one of the OECD countries with highest restrictions on inward FDI.

In 2006, the OECD released revised research which examined regulatory policies affecting international investment based upon more up-to-date description of countries' FDI regimes. In the revised index, Canada ranked as the 5th most restrictive economy amongst OECD economies.

Canada's restrictiveness is largely due to 'other restrictions' (i.e. Board of director/Manager requirements, temporal limitations on the movement of people, and input and operational restrictions such as domestic content requirements) which represented 59% of Canada's overall restrictiveness score. Equity limits represented 19% and screening and approvals: 22% (see Chart 9).

Chart 9. FDI Regulatory Restrictiveness in OECD Economies by Type of Restriction, (0=Open, 1=Closed)



Source: (2006), "OECD's FDI Regulatory Restrictiveness Index: Revision and Extension to More Economies:, OECD Working Party of the Investment Committee.

It is possible that the economic impact of different types of FDI restrictions (such as screening vs equity vs others) differs. But, OECD research and research done in other countries show that reductions in FDI restrictions in general increase FDI stock in host country significantly and contribute positively to the economic performance.

Table 4 highlights that Canada is more restrictive than the 42-country average (29 OECD countries and 13 non-member countries) for all sectors with the exception of electricity and significantly more restrictive than the US (our key competitor for investment) in all sectors except for finance. Canadian ownership restrictions in financial services discriminate equally between foreign and domestic firms, so they are not counted in the OECD analysis, but they nonetheless pose entry barriers to FDI.

In summary, Canadian formal restrictions to FDI include:
- Restrictions on foreign ownership in select sectors

- Exclusive domestic ownership applied to select natural resource sectors
- Obligatory screening and approval procedures through the Investment Canada Act
- Stipulations that foreign investors must demonstrate economic benefits, increasing the cost of entry and discouraging the inflow of foreign capital
- Prior approval of FDI over a certain threshold
- Constraints on the ability of foreign nationals either to manage or to work in affiliates of foreign companies and other operational controls on these businesses
- Stipulations that nationals or residents must form a majority of the board of directors
- Restrictions on the employment of foreign nationals
- Operational requirements, such as the restrictions vis-à-vis non-members on cabotage (trans-shipment of goods within one country by a foreign country)

Quite aside from the formal barriers to FDI, there are a range of mechanisms within economies that alter the inflows of FDI. Such informal barriers include: limited role of stock markets (i.e., France, German and Italy have fewer listings on their stock exchanges making it more difficult for foreign investors to acquire control through stock purchases); concentrated ownership (high concentrated pattern of stock ownership in France and German); the role of institutional investors (i.e., Japan where banks, insurance companies and manufacturers are linked to one another through cross-shareholdings); restrictions applying to recently privatized firms; authorized restrictions in voting rights, and use of antitrust policy to vet FDI. However, in Canada too, despite a relatively active stock market, many companies are, in fact, controlled by either a single shareholder or a small group of shareholders (family ownership).

Some have argued that Canada's rating on barriers to inward FDI is relatively high because of the presence of formal and transparent restrictions while other countries restrict FDI through less transparent means (such as the nature of corporate governance, economic and social policies). At this time however, there is no systematic analysis of these other potential barriers to investment flows.

5 Is Corporate Canada Hollowing-out?

Hollowing-out refers to the movement out of Canada of key corporate headquarter functions from Canadian-owned companies and foreign subsidiaries, including headquarters, executives and high-value personnel, and value-added activities or decision-making power.[2] Specifically, the headquarter functions include the following activities: management planning, market research, research and development control, sales control, public and investor relations, human resources management, financial management, international operations and information systems. Hollowing-out is not restricted to increased foreign ownership or foreign takeovers of Canadian companies: hollowing-out can occur in Canadian-owned MNEs as well as in foreign-owned firms.

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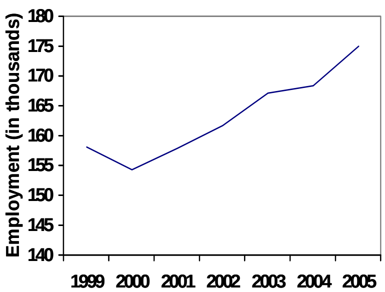
[2] In a 2002 public debate, the definition of hollowing out extended to financial markets. The decrease in Canadian stocks listed on Canadian stock exchanges has been interpreted as a form of hollowing out.

The positive externalities of head offices are expected to stem from the research and development (R&D) and the skilled employment associated with head office functions. A recent study by Statistics Canada (2005) shows that both Canadian-controlled MNEs and foreign subsidiaries are more likely to engage in ongoing R&D in Canada than purely domestic-oriented Canadian firms. This suggests that it is not the ownership per se, but the nature of the firm that determines R&D activities. Moreover, R&D is increasingly internationalized, and the head office effect on R&D is weakening considerably. The available evidence from OECD countries on the impact of cross-border mergers and acquisitions on R&D in host countries is mixed. Available research suggests that the overall business climate in host countries is a key determinant of R&D activities by domestic and foreign MNEs. Since R&D and skilled employees are complements, the availability of skilled employees and competitive market framework policies will be crucial for attracting and retaining R&D activities of domestic and foreign MNEs.

Chart 10. Head Office Equipment in Canada



Source: Statistics Canada

Few Canadian studies address empirically the extent and nature of hollowing-out in corporate Canada. A recent Statistics Canada study "Head Office Employment in Canada, 1999 to 2005" shows that hollowing-out, a decline of head office function in Canada, is not happening.[3] According to the report, such functions continue to grow in Canada, measured in terms of either counts of head offices or employment in head offices. Indeed, between 1999 and 2005, the number of head offices grew by 4.2 percent and that of head office employment (Chart 10) by 11 percent, slightly less than the growth in business sector jobs over the same period (14 percent). However, there is no information on the nature of jobs that were created.

There is great interest in the potential link between foreign control and hollowing-out of Canadian corporations. In particular, there are concerns that as Canadian firms are taken over by foreign firms, the management functions of these firms are being moved abroad, resulting in the loss of head offices and head office employment. Statistics Canada's report, however, shows that foreign-controlled firms are the dominant force driving growth in the number of head offices and head office employment in Canada between 1999 and 2005. Over this period, the number of head offices of Canadian-controlled firms

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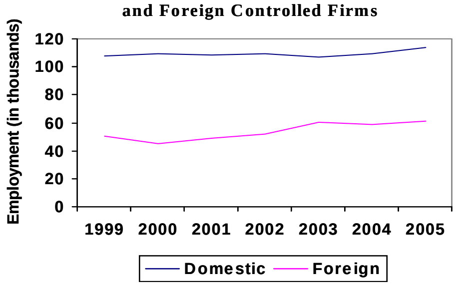
[3] The study is conducted using Statistics Canada's Business Registry (BR) which keeps track of Canada's companies and their respective production units. The paper concentrates only on the business sector. For each production unit, the BR also keeps track of employment levels. In the Business Registry, a production unit is considered as a head office only if it is located in a separate physical location. A head office that is co-located with a production unit (e.g., a manufacturing plant) would not be counted as a separate unit. Since most enterprises in Canada are small, they do not have a separate head office. Therefore, the analysis in the paper is essentially based on large multi-unit enterprises.

fell slightly, while counts of head offices in foreign-controlled firms rose. In addition, head office employment of foreign-controlled firms increased by 21%, while the corresponding figure for Canadian-controlled firms is only 6% (Chart 11).[4]

Chart 11. Head Office Employment by Domestic and Foreign Controlled Firms

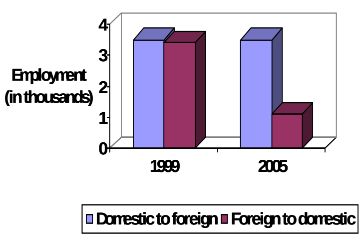


Source: Statistics Canada

Furthermore, the study also shows that as a result of a change from domestic to foreign control, head office employment actually increased. Employment in continuing head offices that switched from domestic to foreign control between 1999 and 2005 increased slightly over the period. In contrast, those firms that switched from foreign to domestic control experienced a fall in head office employment (Chart 12).

Another recent study undertaken by the Institute for Competitiveness and Prosperity, looked at Canadian-owned globally competitive companies, defined as Canadian firms that rank in the top five of their industries worldwide in revenues earned in their industry globally. There were 72 such firms in Canada at the end of 2006, a fall from a 2003 peak of 86, due to foreign takeovers. By similar counts, Canada had only 33 firms as global leaders in 1985, and they were smaller on average. These findings suggest that corporate Canada is not being hollowed-out by the increased cross-border merger and acquisition activities worldwide. However, there was a great deal of churning of Canadian-owned global companies; only 16 of the 33 companies existed in 1985 continued operations in 2006. This trend also holds true for US owned companies.

Chart 12 Employment in Head Offices of Continuing Firms that Changed Control Status



Source: Statistics Canada

In the same vein, in a recent Globe and Mail article, Martin and Nixon list 39 Canadian companies with more than $1 billion revenue as of December 2005 (Table 5). Although six leaders identified in 2003 were taken over by foreign interests, 25 of 39 were global leaders in 2005, compared to only 11 in 1985. Martin and Nixon's count of global leaders is smaller than that of the Institute for Competitiveness and Prosperity because the former count only firms with revenue only $1 billion.

[4] Data are not sufficiently disaggregated to permit an analysis of what types of jobs were created.

Empirical research of Finance Canada (2002) shows that U.S. multinationals actually increased employment and assets in Canadian subsidiaries following trade liberalization, rather than shifting Canadian operations to the United States. Further, data on the number of new plants and expansions announced by firms operating in Canada are not consistent with a shift of R&D facilities to the U.S.

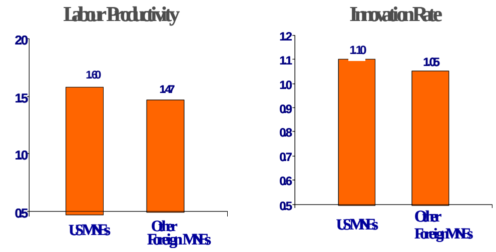
Using a detailed survey of senior managers of 62 MNEs operating in Canada during the post-NAFTA period, including both foreign-owned and Canadian-owned, the Conference Board (2007) concludes that many foreign-owned subsidiaries in Canada have become strategic leaders in their company's global network, in contrast to the fear that they might move out of Canada making Canada a "warehouse economy".

6 Economic Benefits from FDI to Host Countries

A recent comprehensive review of the evidence of existing research by the OECD concludes that the macroeconomic benefits of inward FDI in most cases outweigh the costs.

> "Based on empirical studies so far it is fair to conclude that inward direct investment generally help host countries raise total factor productivity and, in consequence, their GDP. The main channels through which this takes effect are, first, direct impacts through (1) enhanced access to international trade through the link-up with the investor's international networks; (2) corporate restructuring and enhanced governance in the targeted enterprises; and (3) the effect on host country competition. Most of these impacts are present in empirical evidence of the effects of M&As' on individual companies. Secondly, important indirect effects ("externalities") are possible, chiefly in the form of (4) technology spillovers; and (5) the diffusion of human capital and knowledge. OECD (2002) not only found evidence of each of these channels but also concluded that inward direct investment generally leads to a higher economy-wide factor productivity and, in consequence, GDP." (OECD, 2007)

Chart 13. Labour Productivity and Innovation Rate in Manufacturing Plants in Canada (Canadian-controlled =1)



Source: Baldwin, John R. and Gu, Wulong, "Multinationals, Foreign Ownership and Productivity Growth in Canadian Manufacturing", Statistics Canada, 2005

Source: Baldwin, John and Hanel, Petr, "Multinationals and the Canadian Innovation Process", Statistics Canada, 2000

The OECD found that given the appropriate host-country policies and a basic level of development, FDI investment triggers technology spillovers, assists in human capital formation, contributes to international trade integration, helps create a more competitive business environment and enhances enterprise development.

According to recent research undertaken by Statistics Canada (2005), foreign-owned firms on average, have a 50 percent labour productivity advantage over Canadian-controlled non-MNEs and pay higher wages. A recent Industry Canada study (Rao and Tang, 2005) finds that the total-factor productivity (TFP) level of foreign-controlled firms is 20 percent higher than that of Canadian-controlled firms after controlling for firm and industry characteristics. Foreign-controlled firms are more trade oriented and more innovative than Canadian-controlled non-MNEs (Chart 13). US studies with the Census of Manufacturing data have shown that firms that export more are generally more productive and pay higher wages than non-exporting firms.

Research done for Industry Canada (2002) suggests that FDI inflows increase domestic capital formation and raise TFP. On average, a dollar of additional inward FDI will increase capital formation by about 40 cents. Recent Industry Canada's research also suggests that a 10 percent increase in the inward FDI stock will raise TFP by 0.1 percent ($1.4 billion). This conclusion is based on the experience of OECD countries over the period 1981-2004.

According to OECD research, the long-term economic benefits of inward FDI to host countries do not depend on the form of the FDI – the benefits from cross-border M&As are similar to the benefits from greenfield investments. The anticipated short-term advantages of greenfield investments over M&As – job creation and the building of export capacities – do not figure prominently among the long-term economic benefits of FDI.

Statistics Canada (2005) shows that Canadian-controlled MNEs, however, are as productive and innovative as foreign-controlled MNEs. While research suggests that foreign acquisitions of Canadian-controlled MNEs would bring lesser benefits, there is no evidence relating exclusively to this subset of firms. It is important to note that most of the studies on FDI do not distinguish between the types of cross-border M&As: foreign MNEs acquiring domestic MNEs versus non-MNEs, and greenfield investments. Nevertheless, historically, cross-border M&As dominated FDI flows in OECD countries and much of the M&A activity involved taking over of other MNEs.

7 Conclusions

- Canada, like other advanced economies, is currently in the rising phase of another large FDI cycle, which as usual, is dominated by cross-border mergers and acquisitions.

- All countries have significantly liberalized their FDI regimes over the past two decades. Against this back-drop, the challenge is to ensure that Canada is seen as an attractive location for investment, while providing assurance that there are benefits to those investments.

- Key findings from recent studies suggest there is little evidence of hollowing-out in Canada. There is no doubt that Canadian companies are being acquired by foreign firms, but that is not tantamount to hollowing out. It is important to note that Canadian companies are also increasingly acquiring foreign companies in Canada and abroad. Canada is a major net exporter of FDI and the gap between outward and inward FDI stocks is increasing.

- Available OECD research suggests that the long-term economic benefits from increased cross-border M&As outweigh possible short-term economic adjustment difficulties in host countries, provided they have a competitive business climate and flexible and dynamic factor and product markets.

- In addition to contributing to domestic capital formation, FDI brings more advanced technologies and superior managerial practices, increases competition and promotes innovation, and generates positive productivity spillovers to the host economy. Because the net economic benefits from FDI generally outweigh costs, it is important to ensure that policies developed in the public interest do not unnecessarily restrict FDI into Canada.

- Although we know a great deal about the potential economic impact of FDI in both home and host countries, company level evidence on the headquarter functions of the big Canadian companies as well as the skills composition of the employment after they are acquired by either foreign or other Canadian companies would provide valuable additional insights. Further empirical research on the impact of Canadian direct investment abroad on trade structure, physical investment, innovation and productivity in Canada would be also very useful.

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Tables

Annex A

Table 1. Cross-border Mergers and Acquisitions: Annual Purchases (billions of US dollars)

ECONOMY/ REGION	2000	2001	2002	2003	2004	2005	*Average of six years*
World	1,143.8	594.0	369.8	297.0	380.6	716.3	*583.6*
Developed economies	1,089.0	536.0	341.5	256.9	339.8	626.3	*531.6*
Canada	39.6	39.0	13.0	16.0	34.0	22.5	*27.4*
United States	159.3	96.0	78.4	82.4	110.0	170.1	*116.0*
Australia	10.9	32.5	8.8	14.5	10.5	32.3	*18.2*

Source: United Nations Conference on Trade and Development

Table 2. Cross-border Mergers and Acquisitions: Annual Sales (billions of US dollars)

ECONOMY/ REGION	2000	2001	2002	2003	2004	2005	*Average of six years*
World	1,143.8	594.0	369.8	297.0	380.6	716.3	*583.6*
Developed economies	1,070.9	504.9	322.5	244.4	315.9	598.4	*509.5*
Canada	77.1	41.9	16.3	5.2	19.6	27.0	*31.2*
United States	324.4	184.9	73.2	69.7	81.9	132.6	*144.4*
Australia	21.7	16.9	10.7	9.7	15.1	12.1	*14.4*

Source: United Nations Conference on Trade and Development

Table 3. Share of Assets in Foreign-Controlled Firms in Canada

	1999	2000	2001	2002	2003	2004	2005
Total, all industries (excluding management of companies and enterprises)	**21.7**	**21.0**	**22.8**	**22.7**	**22.0**	**21.6**	**21.2**
Total finance and insurance industries	***18.5***	***16.4***	***16.3***	***16.1***	***15.0***	***15.2***	***15.1***
Non-depository credit intermediation	52.4	53.4	51.1	52.6	54.1	56.3	57.1
Insurance carriers and related activities	38.6	39.9	41.0	38.9	31.9	29.9	27.9
Other financial industries	11.7	13.4	13.0	14.2	13.4	13.3	11.5
Depository credit intermediation	11.1	7.3	7.6	7.0	6.9	7.7	7.8
Total non-financial industries (excluding management of companies and enterprises)	***25.0***	***25.4***	***28.8***	***28.7***	***28.7***	***28.0***	***27.2***
Agriculture, forestry, fishing and hunting	2.3	2.3	1.7	2.0	1.9	1.7	1.8
Oil and gas extraction and support activities	43.9	41.7	48.9	49.5	47.1	42.5	38.9
Mining (except oil and gas)	21.9	22.5	23.4	40.6	30.4	29.0	12.6
Utilities	1.9	2.2	5.7	5.4	6.6	6.1	6.6
Construction	3.7	4.6	4.2	4.8	5.5	4.4	4.9
Manufacturing	46.8	45.0	53.5	50.7	50.3	48.8	49.2
Wholesale trade	32.2	37.8	34.2	35.0	35.3	35.4	37.3
Retail trade	19.0	17.9	19.6	20.0	20.2	21.1	20.9
Transportation and warehousing	15.0	14.7	21.9	25.7	25.3	25.3	25.8
Information and cultural industries	4.4	4.3	4.2	4.6	6.5	6.8	7.5
Real estate and rental and leasing	9.3	14.0	13.2	11.8	13.9	13.8	14.2
Professional, scientific and technical services	16.9	18.7	17.3	14.2	16.5	14.8	15.5
Admin. & support, waste manag. and remediation	30.8	28.2	27.3	24.3	25.3	20.4	20.5
Educational, healthcare and social assistance	2.9	3.4	1.6	1.5	1.3	1.3	1.6
Arts, entertainment and recreation	2.8	4.4	3.7	3.1	1.3	2.3	3.3
Accommodation and food services	15.2	14.7	14.8	15.3	16.9	14.4	14.0
Repair, maintenance and personal services	14.4	na	9.4	18.9	19.0	19.4	17.6

Source: Statistics Canada

Table 4: FDI Restrictiveness Index for Competing Countries for FDI and Like Countries (1=closed, 0=open)

Sector	**Canada**	U.S.	Mexico	U.K.	France	Average OECD	Average 42 Countries
Business Services	**0.175**	0.038	0.206	0.02	0.083	0.175	0.16
Telecoms	**0.525**	0.025	0.356	0.02	0.072	0.223	0.185
Construction	**0.15**	0.025	0.125	0.02	0.022	0.098	0.08
Distribution	**0.15**	0.025	0.125	0.02	0.022	0.14	0.092
Finance	**0.219**	0.252	0.502	0.07	0.104	0.21	0.167
Hotels and Restaurants	**0.15**	0.025	0.125	0.02	0.022	0.071	0.071
Transport	**0.413**	0.346	0.428	0.256	0.171	0.305	0.302
Electricity	**0.35**	0.125	1	0.02	0.322	0.536	0.376
Manufacturing	**0.15**	0.025	0.125	0.02	0.072	0.119	0.086
Total	**0.228**	0.119	0.278	0.07	0.094	0.189	0.159

Source: OECD

Table 5. Canada's Current Global Leaders, Revenue - $1 Billion (December 2005)

Company	Revenue	Company	Revenue
CAE**	1,107	Linamar	2,161
Magna	27,624	Agrium**	3,989
Methanex**	2,008	Nova Chemicals**	6,801
Potash Corp**	4,732	Atco Ltd.*	2,860
SNC-Lavalin*	3,788	Manulife Financial	32,047
TD Waterhouse	1,018	Connors Brothers	1,084
Cott	2,126	McCain**	5,677
Weston Foods*	4,376	MDS*	1,489
Celestica*	8,471	CGI**	3,686
Northern Telecom (Nortel)	12,786	Research In Motion	2,473
Finning Tractor & Equip.*	4,835	Husky Injection Molding	1,067
Shawcor Ltd.	1,004	Cinram	2,541
Quebecor World**	7,728	Thomson Corp.	10,539
Alcan*	24,608	Barrick Gold	2,846
Cameco**	1,313	Fording(Elk Valley Coal)**	1,875
Tech-Cominco*	4,415	Abitibi-Consolidated*	5,342
Canfor**	3,788	Tembec*	3,082
CCL Industries	1,110	Couche-Tard**	10,216
Bombardier*	17,760	CHC Helicopter**	1,012
CN Rail**	7,240		

Source: *The Globe and Mail*

*   denotes global leader in 1985 and currently

** denotes global leader currently but not in 1985