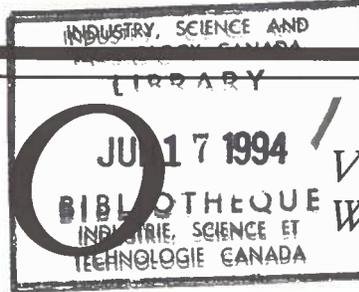


MICRO

The Micro-Economic Research Bulletin



Vol. 1, No. 1
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Introducing . . .

Welcome to the first issue of *MICRO*, Industry Canada's *Micro-Economic Research Bulletin*.

The report will be distributed to readers four times a year as part of the department's Research Publications Program.

MICRO will keep readers abreast of research projects and reports within Industry Canada. Among other items it will provide:

- Summaries of new or recent publications;
- Advance notice of research-related events such as roundtables and conferences;
- Announcements and updates on research projects;
- Listings of publications together with information on how to obtain them; and
- Short expositions on issues related to Canada's micro-economic performance and outlook.

We welcome comments and suggestions from readers.

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Industry Canada's Research Publications Program

To distribute its analytical work and encourage debate among Canadians on micro-economic issues, Industry Canada is launching a Research Publications Program. This program produces Working Papers, Occasional Papers, and Research Volumes.

Forthcoming papers in the program will turn a micro-economic lens on a wide range of issues including the international business environment, science and technology policy, infrastructure, competition policy, investment and globalization.

The Program will be operated in consultation with experts outside the department and with other interested Canadians.

The mandate of Industry Canada is to help ensure that Canada enjoys a healthy economy with growth and jobs in the 1990s by fostering business development, efficient markets and competitiveness. The Research Publications Program will support that mandate by focussing on the analytical micro-economic policy analysis which will provide the foundation for policy and program development in the department.

This publication is printed quarterly. Information on all publications can be obtained by phoning the Publications Officer at (613) 947-2068 or by fax at (613) 991-1261. Specific purchasing information can be found on Page 8 of this publication.

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***Multinational Enterprises in
North America***

**General Editor: Lorraine Eden
University of Calgary Press**

When multinational corporations (MNEs) decide where to put their next overseas plants, what factors govern their choice of country? labour costs? proximity of materials? political stability? environmental regulations? workforce training?

These are some of the questions addressed in *Multinationals in North America*, a forthcoming research volume from Industry Canada. The book was developed from papers presented last May by Canadian, American and Mexican economists at a two-day conference organized by Industry Canada with assistance from The Centre for Trade Policy and Law, Carleton University.

Multinationals in North America begins with an introduction by its editor, Lorraine Eden of Carleton University, which provides an overview of the book and summarizes each of its chapters. Although the papers cover a variety of topics, the issues they address fall into four broad categories:

***Theories of Multinational Plant Location
and Organization***

Raymond Vernon of Harvard University argues that two main groups of actors will play dominant roles in determining the consequences of the NAFTA: the three signatory governments and MNEs operating in the area. Although generally favourable to the agreement, Vernon sees possible difficulties that stem from the fact that NAFTA does not directly acknowledge and deal with MNEs and the difficult issues raised by their integrative behaviour.

Curtis Eaton and Richard G. Lipsey of Simon Fraser University and A. Edward Safarian of the University of Toronto argue that the NAFTA is unlikely to create a North American trading block because it lacks a common commercial policy vis a vis non-member countries, and they set forth a theory of agglomeration which explains the geographical concentration of business activity as the outcome of

two forces pushing in different directions: economies of scale at the plant level (which encourage concentration) and transportation and communication costs (which discourage it). The authors conclude that the impacts of the FTA and the NAFTA are difficult to predict since scale economies and the specific nature of assets which can prevent their rapid transformation for other purposes, both generate pressures that run counter to each other.

Bruce Kogut of the University of Pennsylvania argues that history matters — that countries have different historical industrial structures and processes, and that MNEs tend to reflect the national organizing principles of their home countries. He notes that foreign direct investment (FDI) has become the means by which these organizing principles are transferred between countries.

"Fred Bergsten ... is right ... the lack of investment rules will likely move investment issues to the forefront of a post-Uruguay round." Alan Nymark

Alan M. Rugman and Joseph R. D'Cruz of the University of Toronto examine business networks. They conclude that since the relationship among the partners in a network is asymmetric, governments can play only a supporting role; that the implications for competition policy are unclear; and that government regulations have a substantial impact on business networks.

Actions of Multinational Enterprises in North America - The Evidence

A paper by Industry Canada staff presents an analysis of foreign direct investment and trade patterns in North America since 1980. The authors conclude that increased economic integration within North America should cause the largest firms, and the three countries, to further increase their specialization along the lines of their revealed comparative advantage.

Lorraine Eden of Carleton University examines the question of whether the NAFTA will lead U.S.

multinationals to shift their operations to Mexico to take advantage of lower labour costs. She concludes that, for most U.S. MNEs, low wages are a minor consideration in locational decisions. More likely than plant flight to Mexico she believes, will be a rationalization of plant functions.

Eleanor Westney of the Massachusetts Institute of Technology focuses on the new multinationals on the North American block — the Japanese transplants. Her paper shows that Japanese MNE operations abroad are characterized by a preference for home country managers, components and modes of organization. She concludes that Japanese MNEs follow a regional strategy for North America that centers on the United States.

John Dunning of Rutgers University and the University of Reading looks at the strategic responses of multinationals to regional integration in North America and the European Community. He concludes that the consequences for FDI will be comparable but will be less intensive in the NAFTA. However, in both the distribution of FDI is likely to be uneven. The largest gains are likely to be recorded by countries or regions offering the most cost effective locations.

Dennis J. Encarnation of Harvard University also draws on the European experience and notes that regional integration causes closer integration of MNE parents and affiliates, and increases intra-firm trade in both directions. He predicts that the NAFTA will cause firms in Canada to increase their exports, FDI and local sales in the U.S.; he also predicts a similar strengthening of linkages with U.S. firms.

Kurt Unger of Mexico's Centro de Investigacion y Docencia Economicas traces the evolution of FDI in Mexico. He suggests that regional integration under the NAFTA will lead to an increased vertical integration of Mexican plants into U.S. multinationals.

Jorge Niosi of the Université du Québec à Montreal examines the changing role of Canada as both a host and source country of FDI. He documents the diversification of the geographical sources of FDI and the declining share of U.S. FDI in Canada. He also examines Canada's foreign technical alliances and finds that Canadian firms

concluded more alliances with European partners than with American.

Government Responses: Policies and Initiatives Regarding Multinationals

Fred Bergsten of the Institute for International Economics discusses the changing international climate for regulating FDI. He believes that the need for international rules will move investment to a higher place on the multilateral agenda in the wake of the post-Uruguay Round. In comments on Bergsten's paper, Sylvia Ostry of the University of Toronto says that the Uruguay Round is too much too late and deals with issues of the 1970s rather than of the 1980s and 1990s. As a result, some issues that should be on the multilateral table of GATT are being discussed bilaterally between the United States and Japan; and, bilateral negotiations among the superpowers tend to favour the powerful countries at the expense of the non-powerful ones, especially in the area of investment.

"As globalization has accelerated, system friction has arisen because of system divergence. But ... these issues should be tackled multilaterally." Sylvia Ostry

Robert T. Kudrle of the University of Minnesota presents a detailed examination of North American policies towards MNEs, focusing on general policies and sectoral restrictions. He argues that Canada and Mexico have significantly liberalized their regulation of MNE activity and inward FDI since 1980, in order to encourage closer economic linkages with the U.S. economy.

Ellen Frost and Edward Graham of the Institute for International Economics argue that in some countries, and in particular the United States, traditional definitions of national security have been widened to encompass what used to be classified as economic security concerns. They suggest that Canada, like all other G-7 countries, should equip itself with the authority to block acquisitions on national security grounds.

Edward Graham and Mark Warner of the Institute for International Economics advocate that because of the increased multinational make-up of business firms, what may be needed now is a trilateral North American Competition Commission. The existence of such a body, armed with the power to issue court-enforceable decrees, would ease the task of harmonizing country procedures, and diminish the present reliance on national trade remedy laws.

"... all must marvel at the evolution of transnational corporations and the extent to which governments today are receptive to them."

Frederick Mayer of Duke University examines the changing relationship between MNEs and labour and environmental standards in North America. The author argues that lower social regulatory standards have had little effect on business locational decisions. He expects the NAFTA to raise labour and environmental standards.

Lessons and New Directions

The book concludes with comments from the three conference rapporteurs. Christopher Maule assesses the contribution of the papers to the theory of multinationals and industrial organization. Maule suggests that the evidence regarding restructuring is mixed and that future research should concentrate more on examining individual corporations on a case-by-case basis, using a sample of MNEs of different nationalities operating within the three countries.

Murray Smith identifies lessons and new directions at the multilateral level and considers whether the changing roles of MNEs and nation states provide any clues to how Canada can solve its current account imbalance.

Alan Nymark observes that all must marvel at the evolution of transnational corporations and the extent to which governments today are receptive to them. He notes that for the past decade, multinational enterprises have led the process of globalization, and that while the exchange of goods and services once dominated the process of international integration, this is no longer the case.

Capital Budgeting in the Public Sector

Jack Mintz and Ross S. Preston, Editors

John Deutsch Institute

In recent years some of Canada's provincial governments have come to suspect that their traditional budgeting practices — which treat capital expenditures as current expenditures — may be discouraging investment in public infrastructure. To solve this problem, some of these governments have considered setting up separate capital budgets and accounts.

This trend and its implications are the subject of a new research volume *Capital Budgeting in the Public Sector* published by Industry Canada and the John Deutsch Institute of Queen's University.

Edited by Jack Mintz of the University of Toronto and Ross Preston, the volume comprises papers presented at a jointly-sponsored conference held at Queen's University in May 1993.

The report notes that in the traditional mode all government spending is lumped together in one accounting framework, making it impossible to isolate the full benefits of infrastructure spending and other investment. Use of a soundly-conceived capital budget could be a very effective remedy for this problem. In this approach, government investment aimed at increasing economic growth, jobs and other benefits would not be combined with spending that is, effectively, the public sector equivalent of consumption.

"As a policy instrument, a capital budget might induce policymakers to think more about long-term capital spending in light of the debate as to the optimum level of the public capital stock."

The report covers several major issues related to capital budgeting including those that flow from significant differences in definitions of the term among economists and accountants. Other problems addressed include how to determine the social as

opposed to the monetary value of public assets and how to measure assets and depreciation. And some participants in the conference were concerned that a capital budget could be misused to justify more deficit spending.

In publishing the report, Industry Canada and the John Deutsch Institute hope the volume will draw the attention of policy-makers and researchers to this area and stimulate further analytical work on the issues.

Capital Budgeting in the Public Sector was released in January 1994. Details on obtaining a copy are available on page 8 of this publication.

***Economic Integration in North America:
Trends in Foreign Direct Investment and
the Top 1,000 Firms***
Industry Canada Staff

Our first Working Paper, *Economic Integration in North America: Trends in Foreign Direct Investment and the Top 1,000 Firms*, was written by Industry Canada Staff and was released in February 1994. The main objectives of this study are threefold: to provide an overview of integration among the three North American economies; to analyze the structure, performance and characteristics of the top North American firms; and to examine the role of the top North American firms in the North American economy. A sample of the top 1,008 firms (based on total sales) was compiled including 823 American corporations, 158 Canadian-based firms and 27 Mexican companies. Collectively, they play a crucial role in shaping the comparative advantage and competitive positions of the three countries. Since the top firms are dominant players in the North American economy, their decisions, strategies and activities will no doubt play critical roles in shaping the future competitive positions of the three countries.

Increased economic integration among the three NAFTA countries will likely lead to further specialization by firms and countries. Canada is expected to increase its specialization in resources, resource-intensive manufacturing and financial service industries. The United States, on the other hand, will further increase its specialization in the technology-

intensive manufacturing and commercial services industries. Mexican firms will likely concentrate on the low to middle parts of the value-added chain in the manufacturing sector, and their growth could be spectacular as they catch up to their industrialized counterparts.

"... large firms shape the pattern of trade and direct investment flows and the competitive position of the three [North American] countries."

These results are not surprising. Nevertheless, other dynamic factors should be taken into account when interpreting them. In Canada's case, supplementary data show the fastest-growing firms to be relatively small and not in the top 1,008. They also tend to be in the technology- and knowledge-intensive areas.

It should be noted that while this study shows that the productivity gap in manufacturing between Canada and the United States remains substantial, recent data suggest room for more optimism. Canadian manufacturers have taken several measures to improve their productivity and cost performance during the last three years. The preliminary data also suggest that Canadian manufacturing productivity grew at a significantly faster pace than American productivity in 1993. Better productivity performance, lower value of the Canadian dollar, and lower wage growth has resulted in closing some of the Canada-U.S. manufacturing cost gap, possibly by as much as 35 percent.

Pressures on Canadian firms to rationalize and restructure their operations further and to become even more cost competitive will persist. The NAFTA can enable Canadian firms to grow and overcome the possible size disadvantages, to reap the benefits of scale and scope economies and to improve their relative productivity performance. Vertical linkages and alliances with Mexican firms could also help them to improve their relative cost and productivity performance.

Distinguished Speakers Series

In an effort to bring leading micro-economic economists to Industry Canada, the Micro-Economic Policy Analysis Branch has designed a Distinguished Speaker series. The intent of this series is to provide Industry Canada staff with the opportunity to hear directly from these leading thinkers and to enable them to focus on the micro-economic issues of the new Department's mandate.

The series also ties in directly with the Research Publications Program. As leading economists are engaged in the Program, they will be invited to make presentations on their work to the entire department.

The series began on November 2 with Marcel Côté, of Groupe SECOR, Montréal, whose presentation focused on how the economies of the industrialized countries are suffering the effects of a Shumpeterien shock as a result of information technology. Mr. Côté believes that a profound industrial restructuring is submerging the workforce. In his view, industrial policies must be written within this reality. On one hand, emphasis must be placed on the workforce; on the other, the creation of new activities which take advantage of these emerging information technologies.

Mr. Peter Howitt, Professor of Economics at the University of Western Ontario, continued the series in the New Year (January 11) with a broad discussion on the nature of endogenous growth theory and specifically on its implications for economic welfare and policy. In his view, many of the apparent policy conclusions from older growth models are no longer valid once one takes into account a central fact that technological change creates economic losses as well as gains. Mr. Howitt concluded that endogenous growth theory has extended neoclassical economics in useful directions, and has opened up exciting new possibilities for the development of economic theory.

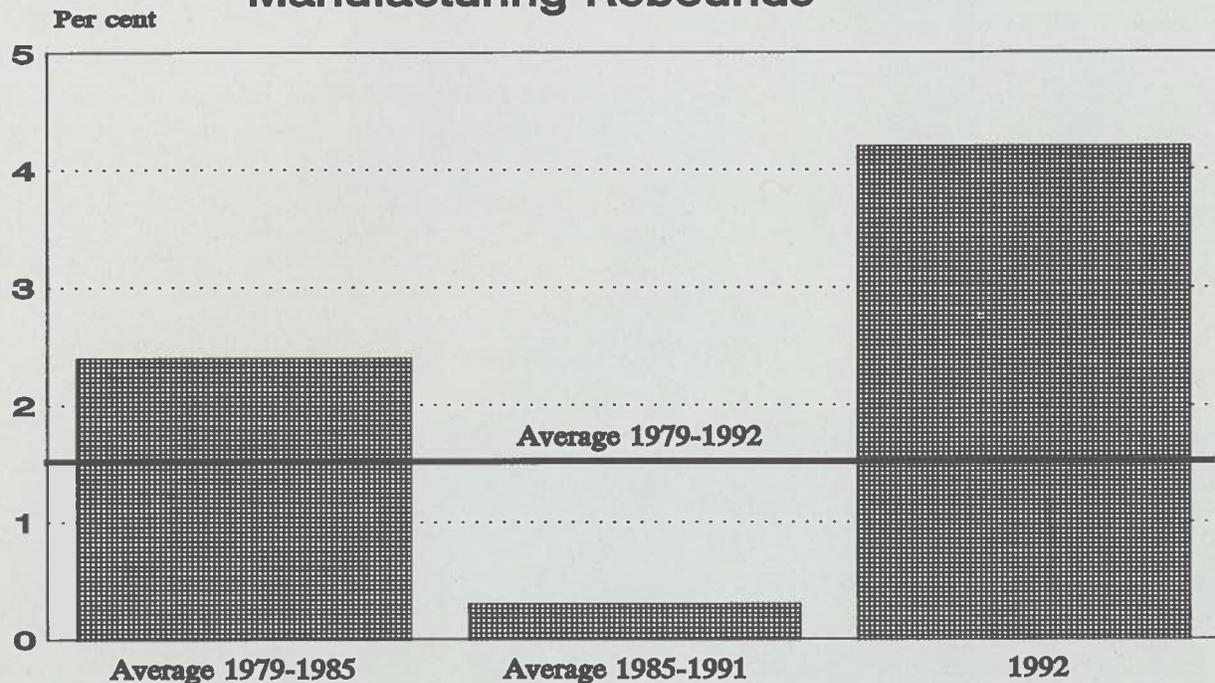
On January 25, Pierre Fortin, Professor of Economics and Research Associate of the Canadian Institute for Advanced Research presented his views on unemployment and debt. His presentation centered on how Canada has now almost eliminated inflation, but is still struggling with slow productivity

growth, high and persistent unemployment, and large fiscal and external deficits. His essay reviewed the identifiable causes and consequences of this evolution, and posed an approach to remedy the situation based on fiscal discipline, cooperative monetary discipline, and a fixed U.S.-Canadian dollar exchange rate.

On February 8, Fernand Amesse, Professor in tenure, Service de l'enseignement du Marketing et Centre d'études en administration internationale (CETAI) based his lecture on data collected from a survey of Quebec industries in 1988 and 1993. He offered evidence concerning the attitudes of managers vis-à-vis the FTA and NAFTA, the nature of positive and negative effects expected to be associated with these trade agreements, and the frequency with which companies have taken measures to benefit from or control these effects.

Upcoming speakers in the series will include: John Helliwell, who served as Rapporteur for the joint Industry Canada/John Deutsch Institute Conference on *Infrastructure and Competitiveness* speaking on Democracy and Economic Growth; Lorraine Eden, who served as General Editor for the forthcoming Research Volume entitled *Multinationals in North America* speaking on Who Does What After NAFTA? - Location Strategies of U.S. Multinationals; and Robin Boadway who will speak on Government Policy Towards Investment.

Canadian Productivity Growth in Manufacturing Rebounds



Source: U.S. Department of Labor, Bureau of Labor Statistics, December 1993.

- Productivity growth in Canadian manufacturing industries, measured by output per hour, increased 4.2 per cent in 1992.
- This growth spurt has been long-awaited. Productivity growth from 1985 to 1991 averaged only 0.3 per cent.
- It is a positive indication that Canadian business is well into a transformation to more efficient structures able to compete more effectively in the global marketplace.
- Among the G-7 economies this performance was exceeded only by the UK (which grew by 4.9 per cent) and the US (at 4.3 per cent).
- In comparison, Japanese productivity fell by 5.0 per cent and in Germany it grew by only 0.5 per cent in 1992.

PUBLICATIONS

NOW AVAILABLE

Industry Canada Working Paper Series

No. 1 - *Economic Integration in North America: Trends in Foreign Direct Investment and the Top 1,000 Firms*, Micro-Economic Policy Analysis Staff, January 1994.

Research Volume Series

Volume I - *Foreign Investment, Technology and Economic Growth*,
General Editor: D. McFetridge, 1991

Volume II - *Corporate Globalization Through Mergers and Acquisitions*,
General Editor: L. Waverman, 1991

Volume III - *Multinationals in North America*, General Editor: L. Eden, 1994

Joint Publications

Capital Budgeting in the Public Sector
(with the John Deutsch Institute)
Editors: Jack Mintz and Ross Preston, 1994.

FORTHCOMING

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Volume IV - *Canadian-based Multinational Enterprises*, General Editor: S. Globerman, 1994

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