conference, the authors revised their papers for publication in this volume. Under the direction of Lorraine Eden, who presided over the conference and served as General Editor for the volume, the revised papers and rapporteurs' comments now comprise the third volume in the Industry Canada Research Series.

Earlier volumes in the series emphasized issues linked to globalization and investment: *Corporate Globalization through Mergers and Acquisitions*, edited by Leonard Waverman; and *Foreign Investment, Technology and Economic Growth*, edited by Don McFetridge. The present volume, *Multinationals in North America*, serves to mark the transition from the former Investment Canada Research Series to the publications program of Industry Canada. The Industry Canada publications program, which also includes a Working Paper series and an Occasional Paper series, provides a forum for informed debate on a wide range of issues related to the work of Industry Canada. This new department is involved in micro-economic policy and analysis and thus the publication program is designed to allow the department to contribute to the policy-making debate in this area.

The research assembled in this volume is mostly the product of work undertaken outside the department by academic researchers from Canada, the United States, Mexico and England. Industry Canada staff, however, sponsored and managed the project, and offered comments on each of the papers. Nonetheless, the papers ultimately remain the sole responsibility of each author, and do not necessarily reflect the policies or opinions of Industry Canada or the Government of Canada.

I would like to take this opportunity to thank all of the authors for their work, particularly Lorraine Eden in her capacity as both author and General Editor. I know that this volume will be of interest to the policy-making community as well as to the wider public interested in economic issues here in Canada and abroad.

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Multinationals in North America: An Introduction to the Issues

INTRODUCTION

MULTINATIONALS IN NORTH AMERICA examines the policy choices and actions of the largest business corporations and the three national governments in North America (defined as Canada, the United States and Mexico) as they respond to the enormous changes in technology and trade policies that began in the early 1980s and have continued into the 1990s. The volume focuses on MNEs and nation states in North America in the context of regional free trade (the Canada-U.S. Free Trade Agreement or FTA, and the proposed North American Free Trade Agreement or NAFTA) and technological change, as the underlying technology paradigm shifts from mass production to lean or flexible production. The core idea is that multinationals and nation states are actors faced by change and, at the same time, are agents of change. In this volume, we examine the strategic options and interactions of MNEs and nation states as they attempt to manage their activities in a globalized world economy.

The largest firms in each country are best placed to anticipate and to take advantage of on-going changes in trade policies and technology. How these firms make strategic decisions in the North American environment can act as a bellwether for medium-sized and small multinationals. Large multinationals are in the forefront of the movement towards a free trade area uniting Canada, the United States and Mexico. MNE crossborder flows of investment, technology, goods and services are hampered by international barriers; hence large firms have an interest in reducing barriers to trade and investment.

Multinationals are already heavily involved in the three economies. Over 50 percent of all Canada-U.S. trade and over 30 percent of Mexico-U.S. trade occurs among related affiliates. Approximately 25 percent of the non-financial capital stock in Canada (45 percent in manufacturing) is owned/controlled by foreigners, 9 percent in the United States and less than 10 percent in Mexico. The United States is the heaviest investor, controlling US$ 68 billion or 70 percent of the stock of foreign direct investment (FDI) in Canada and US$ 17 billion or 63 percent in Mexico in 1989. Japanese and

European multinationals are also large investors in all three North American countries.

Policy-makers are also actively involved in the creation of a North American free trade area. The Canada-U.S. Free Trade Agreement (FTA), which came into force in January 1989, will eliminate tariff barriers between the two countries over a ten-year period. Nontariff barriers are similarly being eliminated, reduced or harmonized. The FTA is much broader than a traditional free trade agreement because it also includes investment provisions and some liberalization of movement of professional workers. In addition, the three governments have negotiated a North American Free Trade Agreement (NAFTA), which is currently before the U.S. Congress for ratification. If, as proposed, the NAFTA comes into effect on January 1, 1994, an understanding of its likely effects on the organizational and locational decisions of MNEs is crucial for policy-makers. Even if a deal is not signed, the impetus for reduction of intra-North American trade barriers is likely to continue.

Investment policies among the three countries have already changed substantially since the 1980s. Canada and Mexico have both significantly relaxed their regulations on inward FDI; Mexico through investment and sectoral decrees, Canada through the 1985 restructuring of the Foreign Investment Review Agency (FIRA) into Investment Canada (now Industry Canada) and the investment chapter (e.g. national treatment) in the FTA. The United States, on the other hand, has increased its regulations on inward FDI in the past few years, partly due to the enormous increase in inflows over the 1980s. In 1988 the Exon-Florio amendment was passed, giving the President authority to disallow foreign takeovers on national security grounds. A screening process was set up under the Committee on Foreign Investment in the United States (CFIUS). In addition, the U.S. government has imposed new disclosure and taxation requirements on foreign firms. Thus, while all three countries have a relatively open attitude toward FDI, informal barriers remain and, in the case of the United States, formal barriers are increasing.

While trade and investment policies are more closely linking the three economies, there are on-going changes in process and product technologies — characterized in the terms "lean production", "flexible specialization" or "post-Fordism" — that are also influencing MNE organizational and locational choices. Firms are adopting less labour- and resource-intensive production methods, developing tighter linkages with suppliers and buyers, and adopting the new Japanese managerial methods such as just-in-time production and delivery and quality circles. Canadian businesses are being forced by globalized markets to downsize and grow leaner as they face increasing competition for shares of the world market.

Understanding how multinationals are responding to trade and technology in terms of investment, production and trade strategies changes is of critical importance to our understanding of the political economy of a NAFTA. Studies that focus on general equilibrium econometric modelling of regional

trading blocs assume the firms that are trading are unrelated to one another, a clearly unrealistic assumption. Given the importance of MNEs in all three economies, it is therefore crucial that international trade studies of North American economic integration are accompanied by studies of the reactions of multinational enterprises to this integration. To date, most published works on the NAFTA have focused on its international trade aspects; this volume is different because it focuses closely on the strategic management of MNEs (i.e., their international production and investment decisions) and their implications for policy making in an evolving North American free trade area.

Structure of the Book

Multinationals in North America contains 18 chapters on different aspects of MNEs and governments in North America written by leading experts in the field. The first versions of the papers were presented at an Ottawa conference organized and funded by Investment Canada (now Industry Canada), with the assistance of the Centre for Trade Policy and Law, in May 1993. My own paper, and the one prepared by Knubley, Legault & Rao of Industry Canada, were used as background papers to the conference. Also included in the volume is a revised version of the opening address to the conference given by C. Fred Bergsten, Director, Institute for International Economics, with comments by Sylvia Ostry, Director, Centre for International Studies, University of Toronto. Following two full days of sessions consisting of presentations by the authors, comments by invited discussants, roundtable discussions, and a concluding session with three Rapporteurs, the papers were revised for inclusion in this volume.

The volume is divided into four parts: *Theory*, *Evidence*, *Policy*, and *Lessons and New Directions*.

Part I, *Theory*, contains chapters by Vernon on the roles of MNEs and nation states in NAFTA; Eaton, Lipsey & Safarian in two chapters, the first on the theory of plant location in a free trade area, and the second on agglomeration and disagglomeration effects, both with application to the NAFTA; Rugman & D'Cruz on business networks as a new business organizational structure in North America; and Kogut on the importance of history and institutions as factors affecting MNE reactions to NAFTA.

Part II, *Evidence*, consists of seven chapters. The first, by Knubley, Legault & Rao, looks at multinationals in North America from a macro perspective (foreign direct investment patterns) and a micro perspective (activities of the largest 1,000 MNEs). The second chapter is my own study, which focuses on the location strategies of the veterans (the U.S. multinationals) while the third chapter by Westney looks at the immigrants (Japanese MNEs) in North America. The fourth (Dunning) and fifth (Encarnation) chapters contrast MNE trade and investment strategies in North America and the European Community. The last two chapters, by Unger and Niosi, examine FDI patterns since 1980 in Mexico and Canada respectively, and speculate about the impact of the NAFTA on these patterns.

In Part III, *Policy*, the studies center on government initiatives and responses regarding MNEs in North America. The first chapter, by Bergsten, with comment by Ostry, examines the need at the multilateral level for a new approach to regulating multinational investment. Kudrle provides an overview of national and sectoral regulation of MNEs in North America. The next three papers focus on particular policy areas: Frost & Graham on national security issues, Graham & Warner on competition policy, and Mayer on labour and environmental policies.

Part IV, *Lessons and New Directions*, draws together the lessons and new directions from the other chapters, as seen by the three Rapporteurs at the conference: Christopher Maule, Murray Smith and Alan Nymark.

Main Themes

Three themes run through *Multinationals in North America*.

- How multinationals in North America, both domestic and foreign, have been, are and will be reorganizing themselves — in terms of both locational choices and organizational structures — as trade barriers fall within North America and as technological changes such as lean production alter the most efficient ways of doing business. This includes topics such as decisions on plant location and function, ownership, strategic alliances, clustering of firms, in- and out-sourcing of parts, whether low wages and polluting activities will shift to Mexico, whether R&D activities will be decentralized, how Japanese MNEs will respond to NAFTA, and so on. These issues are addressed primarily by the authors in Parts I and II of the volume, and in the Rapporteurs' comments.

- How nation states in North America are changing the policy environment that affects MNEs. Here the general issue of regulating MNEs *per se* — both domestic and foreign — is important, together with policy issues where MNEs are important influences on the outcome, areas such as competition, labour and environmental issues, taxation, national security, sovereignty, and so on. Will MNEs create pressures for deeper integration of the three countries? How are the three countries likely to respond? What are the sensitive policy issues with respect to regulating MNEs likely to be? What should governments be doing? These issues are addressed primarily in Parts I, III and IV.

- The changing nature of MNE-state relations in North America. Both MNEs and nation states are key actors in NAFTA. How are their relationships changing, and likely to change, after NAFTA? Will policy stances towards MNEs be more or less confrontational in the future? What does this mean for the role of U.S. MNEs and the U.S. government within North America? How do the two small countries, Canada and Mexico, fit within MNE locational and organizational choices? What policy options are available to their governments? What are the likely contentious issues and how should they be resolved? What is the emerging policy agenda? These issues are addressed throughout the volume.

Brief Summaries of the Chapters

Multinationals and Governments: Key Actors in the NAFTA

In this, the first chapter in Part I, *Theory*, Raymond Vernon argues that two groups will play dominant roles in determining the consequences of the NAFTA: the three signatory governments and the multinational enterprises operating in the area.

Looking first at MNEs, the NAFTA should reduce risks for business firms, with short-run and long-run effects on MNE location decisions. In the short run, U.S. multinationals (which comprise the bulk of the MNEs within North America) will engage in "locational shufflings" of plant functions among the three countries. Where unexploited economies of scale or agglomeration economies exist within the U.S. parent's operations, there will be a short-run tendency to close out smaller plants in Canada and Mexico and shift production to the larger U.S. facilities. This reshuffling is likely to be reinforced by the declines in truck transport costs the NAFTA will also bring. Activities of Canadian and Mexican MNEs, and of MNEs from outside North America, may also be drawn to the United States in the short run. In addition, the new technologies of production require suppliers to locate close to their downstream customers; lean production therefore provides another reason for increased agglomeration of investment activity within the United States as a short-run response to the NAFTA. Vernon argues that long-run adjustments are likely to work in the opposite direction, causing investments to disperse to Canada and Mexico, as economies of scale are exhausted and congestion increases.

With respect to MNE-state relations, Vernon asserts that the tendency for progressive integration of MNE activities within the free trade area will exacerbate some old problems and create new ones. In this chapter, he focuses on two difficult issues: the regional allocation of taxable MNE profits, and the regional content of MNE products. How are governments likely to respond? Vernon notes first that ambitious international agreements generally come from great political changes affecting all the member countries. Such was not the case with the NAFTA, nor with the FTA. As a result, he argues that the NAFTA lacks centralized institutions so that its effectiveness will depend on its interpretation by national officials, each with their own parochial interests. Vernon compares the institutional political structures within the three countries and finds the probability for inconsistent and uncoordinated government policies in administering the NAFTA to be quite high, especially in the United States.

Therefore, since the NAFTA does not directly acknowledge and deal with the existence of multinational enterprises and the difficult issues raised by their integrative behaviour, Vernon — even though he supports passage of the NAFTA — concludes that it may face a troubled future once ratified. He recommends that the NAFTA be modified to focus more attention on MNE-related issues and to develop a stronger institutional, supra-national framework.

The Theory of Multinational Plant Location in a Regional Trading Area

This, the first of two chapters by Curtis Eaton, Richard Lipsey and Edward Safarian, explores two issues: the determinants of investment decisions, and the effects of the policy framework on foreign direct investment flows.

The authors first review the literature on the impact of free trade agreements on investment flows, finding that these agreements tend to generate increased intra-industry FDI. As a result, adjustment effects (e.g. on employment) are smaller because adjustment takes place within industries rather than between industries. The key to investment decisions under the FTA and the NAFTA is the reduction in policy risk due to increased security of market access. The FTA and the NAFTA eliminate tariffs among member countries, but only reduce nontariff barriers. Therefore security of market access is improved by the elimination of tariffs, but may be more apparent than real for nontariff barriers, depending on the probability of firms in one country being harassed by nontariff barriers erected by the other member country. Comparing the welfare ranking of alternatives for Canada, the authors find that Canada's order of preference is: 1) the FTA only, 2) the NAFTA only, 3) the FTA plus a Mexico-U.S. FTA, 4) no bilateral FTAs, 5) a Mexico-U.S. FTA and no FTA. The authors argue that NAFTA is unlikely to create a North American trading block because both the FTA and the NAFTA lack the essential ingredient of a trading block, that is, a common commercial policy facing nonmember countries.

The Theory of Multinational Plant Location: Agglomerations and Disagglomerations

This chapter by Eaton, Lipsey and Safarian is a companion piece examining the economic geography of (dis)agglomerations of investment. It focuses in particular on the geographic location of R&D in multinational networks.

The authors 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) and transportation and communication costs (discouraging concentration). Restrictive trade policies can encourage agglomeration; the reverse, however, does not necessarily follow. The authors conclude that the probable effects of the FTA and the NAFTA on agglomeration are unclear since scale economies and asset specificity discourage quick dissolutions, and thus have opposite effects to falling trade barriers. In addition, the new technologies of production have both reduced the importance of labour and transport and communications costs and increased the need for supplier firms to locate proximate to their downstream customers. As a result, lean production may lead to increased diversity in patterns of industrial location. In terms of the location of research and development activities in MNE networks, there are strong forces favouring the centralization of R&D at the parent firm's headquarters. However, significant decentralization of R&D has occurred for some countries and industries over the past 10 years as the knowledge base becomes more geographically dispersed. If free trade areas encourage rationalization of firm activities and reduce the autonomy of foreign manufacturing subsidiaries, the authors conclude that the production of local R&D by subsidiaries may also be reduced.

A Theory of Business Networks

This chapter by Alan Rugman and Joe R. D'Cruz argues that business networks are a hybrid form of business organization between markets and hierarchies. Global competition means that firms cannot excel in all business areas. As a result, successful North American multinationals are specializing in parts of the "value chain" where they have core competence, and are then linking with other entities to create business networks which can compete globally in many business areas.

Rugman and D'Cruz hypothesize that a business network consists of five partners. The network is led by a multinational enterprise, called a "flagship firm", which competes in global markets. The flagship firm has four partners: suppliers, customers, competitors, and the non-business infrastructure; the last includes the government sector. Strategic management of the network comes from the flagship firm while the five partners share in successful operations; thus the relationship between the MNE and its partners is asymmetric. The authors describe two examples of business networks: Benetton, the retail clothing MNE, and the Bell/Stentor telecommunications network.

The authors outline three implications of business networks for Canadian public policy. First, since the relationship among the partners is asymmetric, governments can only play a supporting, not a leadership, role in business networks; second, the implications for competition policy are unclear;

and third, government regulations can have (and have had) substantial effects on the formation and structure of business networks.

An Evolutionary Perspective on the NAFTA

In this, the final chapter in Part I, *Theory*, Bruce Kogut draws together several of the key points in the earlier chapters, and provides an important bridge to the chapters in Part II, *Evidence*. Kogut argues that countries have different historical industrial structures and processes. MNEs tend to reflect the national organizing principles of their home countries (a type of country-specific advantage). These organizing principles diffuse more easily between firms than between countries, and even more easily between affiliates of a multinational enterprise. Therefore foreign direct investment is the means by which MNEs act as agents of change or "investment bridges" in transferring home country organizing principles to host countries. Incumbent or veteran firms in the host country will vary in the speed at which they adopt new technologies. Generally, there will be resistance to adopting new technologies due to inertia, lack of information, and the costs of switching. As time passes, however, these technological changes diffuse and firm-specific advantages play a more important role in determining competitiveness.

Kogut 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. For Kogut, Japanese MNEs are the current investment bridges, diffusing lean production techniques throughout North America and Europe. In the case of lean production, a highly trained workforce is a critical country-specific advantage influencing the rate of adoption of these new work practices. Faced with the threat of Japanese competition, U.S. 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. He concludes that firms may be reluctant to switch, at least in the short run, and are thus trapped in low-wage strategies.

When governments move to introduce the NAFTA, a free trade area encompassing both rich and poor countries, at the same time as rapid technological change is taking place, incumbent MNEs are faced with a decision: either keep their historical practices or shift to new ones that may or may not succeed. Kogut suggests that some firms will 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. Kogut concludes that the NAFTA should be seen as nested within a period of enormous technological change and severe international competition for North American industry. Whatever is done, he believes the "decisions made at this time will have, due to the particular juncture of history, long-lasting and irreversible consequences". If the behaviour of North American firms appears to be driven by short-run considerations, there may be a role for governments, if the NAFTA passes, in facilitating the transition to the new technological paradigm.

Multinationals and Foreign Direct Investment in North America

This first chapter in Part II, *Evidence*, by John Knubley, Marc Legault and Someshwar Rao is divided into two parts: first, a macroeconomic analysis of foreign direct investment and trade patterns in North America since 1980, and, second, a microeconomic study of the structure, performance and characteristics of the top 1,000 multinationals in North America.

In the macroeconomics part, the authors focus first on world trends in trade and FDI, and then analyze trade and FDI linkages among Canada, the United States and Mexico, and their commercial relations with Japan and the European Community. Using 1991 data, the authors document the "hub-and-spoke" nature of this trade and investment; examine inward and outward FDI in Canada over the period 1980 to 1992; and conclude with an analysis of the industrial composition of U.S. trade and investment with Canada, and with Mexico.

In the microeconomics part, the authors created a data base of the top 1,008 firms in North America, based on sales in 1991. The sample includes 823 U.S.-based, 158 Canadian and 27 Mexican companies. Of the 158 located in Canada, 39 are foreign-controlled; in addition, most of the Mexican firms are U.S. subsidiaries. The authors determine which industries the firms are in, calculate national indexes of revealed comparative advantage, and investigate the productivity, growth and R&D performance of these top firms. Finally, data on the average size and outward orientation of the firms are provided.

The authors present five main findings.

1) Both inward and outward FDI in Canada have diversified away from the United States and into Europe.

2) Canadian MNEs have a revealed comparative advantage in resources and resource-intensive manufacturing and financial services; U.S. MNEs in technology-intensive manufacturing and services; and Mexican MNEs in resources, and in the commercial services; and Mexican MNEs in resources, and in the low-skill parts of resource-intensive and technology-intensive manufacturing.

3) The labour productivity of Canadian MNEs is high, relative to firms in the United States, for foreign-controlled firms and for Canadian-controlled firms in the construction, utilities, trade and financial sectors, but low for Canadian-controlled manufacturing

firms. Labour productivity is significantly lower in the Mexican top firms.

4) On average, R&D-to-sales ratios in Canada are considerably below U.S. levels; but Canadian levels are higher in mining and labour-intensive manufacturing.

5) The top U.S. firms, 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.

The authors conclude that increased economic integration within North America should cause the largest firms, and the three countries, to increase further their specialization along the lines of their revealed comparative advantage, generating pressures on Canadian firms to rationalize and restructure their operations.

WHO DOES WHAT AFTER NAFTA? LOCATION STRATEGIES OF U.S. MULTINATIONALS

THIS CHAPTER BY LORRAINE EDEN asks: Will there be massive job losses and plant closures as U.S. multinationals shift their operations to Mexico to take advantage of cheaper labour costs? Based on analysis of the NAFTA and theory of MNE plant location strategies, together with a statistical analysis of the majority owned foreign affiliates (MOFAs) of U.S. multinationals, the paper concludes that there is both a simple answer and a complex one to this question.

The simple answer is "no", the NAFTA will not cause a massive exodus of plants from Canada and the United States to Mexico. An examination of U.S. MOFAs shows that wide differentials exist in average employee compensation between MOFAs in the same industry but in different countries. However, unit labour costs are much more homogeneous, reflecting the fact that highly productive workers are paid better; in some industries unit labour costs for U.S. MOFAs were higher in Mexico than in Canada. Therefore widespread closures of U.S. branch plants in Canada, in order to move to Mexico, are unlikely.

The complex answer to the question, according to Eden, is that there will be major plant reorganizations throughout North America. These are likely to be much greater than econometric trade models predict because the NAFTA is much broader than a simple tariff-removal exercise. As regulatory and trade barriers fall, liberalization will lead to reorganization and rationalization of MNE activities within each country and between countries. U.S. MNEs are the firms best placed to take advantage of the falling tariff and nontariff barriers that the FTA and the NAFTA will bring because they are already located in all three countries. These veteran MNEs can be expected to locate, close and/or expand their plants with the whole North American market in mind. This should lead to reduced numbers of product lines in various plants and increased horizontal trade among plants. MNEs are also likely to segment their production process among plants so that more vertical intra-firm trade takes place. As a result there should be more cross-border vertical and horizontal intra-firm trade flows. Eden concludes that low wages, for most U.S. MNEs, are a minor consideration in these location decisions. Rationalization of plant functions, to accommodate horizontal specialization in particular product lines and vertical specialization in particular processes, is much more likely than plant flight to Mexico.

JAPANESE MULTINATIONALS IN NORTH AMERICA

THIS CHAPTER BY ELEANOR WESTNEY focuses on the new multinationals — the Japanese transplants — in North America. Westney argues that the influx of Japanese MNEs in the 1980s was largely for defensive reasons, to protect exports threatened by U.S. protectionism and the rising value of the yen. The rapidity of the growth in Japanese FDI in North America, however, has caused both a general backlash by the public and a growing debate among academic scholars as to whether Japanese MNEs are different from Western MNEs and, if so, what explains this difference.

Westney first examines macroeconomic patterns of Japanese FDI in North America from 1980 to 1992, documenting its "extraordinary compression"; two-thirds of the FDI occurred between 1986 and 1989. Since 1990, Japanese FDI has fallen rapidly and she concludes that this slowdown is not a temporary phenomenon as Japanese MNEs appear to be shifting their FDI activities from North America to Asia. Westney concludes that the Canada-U.S. FTA had no discernable effect on Japanese FDI in Canada and, similarly, there is no apparent interest by Japanese MNEs in the NAFTA.

Turning to the question of whether Japanese MNEs are different from Western MNEs, Westney notes that Japanese transplants in North America: 1) employ a high proportion of home country managers in key positions; 2) depend more heavily on the parent firm for decision making and support activities; 3) tend to re-create the home-country organization set (the *kieretsu* structure of a small, core firm in a network structure with a pyramid of subsidiaries) in the host country; 4) earn relatively low profits; and 5) are more likely to create multiple subsidiaries within major markets, for example, setting up independent R&D subsidiaries, rather than the single "country subsidiary" organizational structure preferred by Western MNEs.

Westney reviews the challenges facing Japanese transplants in North America in the 1990s as Japanese firms face the effects of their internationalization. These challenges are: 1) coping with the rising yen-dollar exchange rate; 2) political and social pressures from host countries to become "insiders"; and 3) pressures to open up the *kieretsu* structure in Japan.

She suggests that Japanese MNEs are moving towards a three-region, rather than a multi-country, 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.

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

MNE Activity: Comparing the NAFTA and the European Community

In this chapter John Dunning looks at the strategic responses of multinationals to regional integration in North America and in the European Community, pre- and post-1992. He first outlines the similarities and differences between the proposed North American Free Trade Agreement and the current level of economic integration in the European Community. Dunning then theorizes about the likely effects of regional integration on foreign direct investment, distinguishing between the initial effects of integration (on the costs of supplying goods and services from various locations) and the secondary effects (from restructuring of production and markets, new opportunities for insider firms, and incentives to innovation and technological change). He argues that the effects will be industry- and country-specific.

Dunning then addresses the effects of MNEs on regional integration, distinguishing between intra-regional FDI and extra-regional FDI. He argues that there are four main kinds of MNE activity: market-seeking, resource-seeking, efficiency-seeking, and strategic-asset-seeking, and that the effects of regional integration on each activity differ. Firms inside the region see benefits from lower intra-regional barriers and will rationalize product lines (horizontal integration) and/or production processes (vertical integration) to better exploit economies of scale and scope. Firms outside the region may be induced to become insiders.

Dunning argues that the EC's regulatory framework affecting intra-regional and extra-regional FDI has increasingly become more liberal, which should cause an increase in efficiency- and strategic-asset-seeking FDI in the future. After reviewing the literature on the effects of Mark I integration (1958-70) with Mark II integration (EC 1992) on FDI, he compares both forms of integration with the NAFTA and concludes there are similarities and differences. Tariff removal has similar effects in all three cases, but the failure to establish a common external tariff under the

NAFTA has distinctive consequences. Differences also arise in the case of EC 1992 where the removal of intra-regional non-tariff barriers is more extensive and thus the effects on efficiency- and strategic-asset-seeking FDI are likely to be greater.

Intra-firm Trade in North America and the European Community

In this chapter Dennis Encarnation compares and contrasts the trade and FDI patterns of multinationals in North America and the European Community as these MNEs seek to secure market access through FDI. The paper examines: 1) the impact of majority versus minority affiliates on intra-firm trade patterns; 2) the MNE's choice of supplying overseas markets through foreign investment or international trade; 3) the relative importance of domestic versus export markets; 4) whether foreign subsidiaries are primarily engaged in offshore production or distribution; 5) the importance of intra-firm versus arm's length trade for the MNE; and 6) the implications for public policy.

Encarnation argues that MNEs see wholly-owned affiliates as the preferred method for gaining and maintaining market access. Where FDI is new, or host country regulation constrains ownership, the levels of minority ownership are higher. For the United States, overseas sales of U.S. MNEs have exceeded U.S. exports for several decades; in other countries where MNEs are of more recent origin, the ratio of overseas sales to exports is smaller but still generally greater than one. Once established, foreign subsidiaries tend to sell primarily in the host market, with smaller amounts of exports to the parent network. Regional integration, however, leads to tighter integration of the MNE family and greater intra-firm 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 U.S. and European MNEs. Intra-firm trade dominates MNE trade flows, particularly in the auto industry. Finally, Encarnation argues that the NAFTA will encourage the development of regional integration strategies by MNEs in North America. He predicts the 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 U.S. MNEs. This deepening should be seen as a positive contribution to economic growth and national welfare.

Foreign Direct Investment in Mexico

In this chapter Kurt Unger examines the changing role of Mexico as host country for foreign direct investment, particularly since the 1982 debt crisis, focusing on macroeconomic and sectoral changes in FDI. The Unger chapter first presents a statistical portrait of inward FDI for 1980-92, documenting the difference between FDI approvals and actual investments, the recent rise in FDI in services and the stock market, and the importance of the United States as the key investor. He then chronicles the shift in Mexico's balance of payments from a surplus in 1982-88 to a growing deficit in 1989-92, showing that trade is concentrated in a few products and a few firms, and that the import propensity of foreign firms has risen as the Mexican government has relaxed its trade balancing restrictions. Examining the nature of maquiladora operations, he finds that maquila exports have grown more rapidly than exports of manufactured goods or total Mexican exports, but that the basic function of the maquilas — as assemblers of imported inputs — has not changed.

Based on his analysis, Unger argues that new FDI in Mexico has been more limited than the official numbers suggest; that new FDI has gone mostly into the stock market and services rather than into manufacturing; and that the new FDI is encouraging imports into Mexico from U.S. plants with excess capacity. He suggests that regional integration under the NAFTA will lead to a rationalization of the activities of multinational firms on a continental basis. Since many U.S. firms have excess capacity and Mexican manufacturing firms are producing close to their capacity limits, he expects new growth in the Mexican market to be supplied from imports of finished goods rather than from new investment in Mexico. The MNE activities located in Mexico that will survive international competition are mature products or segments of industries reliant on imported inputs; as a result, more of the Mexican economy may become like the maquiladora firms, assembling imported, intra-firm parts and components for domestic or foreign sale. Thus the deficit on the balance of trade should grow, while FDI growth in existing MNE-dominated sectors such as autos will stagnate; the combination will worsen Mexico's balance of payments and constrain Mexican growth rates. In a separate Appendix, Unger reviews recent legal and institutional changes in Mexico's FDI policy regime.

Foreign Direct Investment in Canada

In this last chapter in Part II, Jorge Niosi examines the changing role of Canada as a host and home country for foreign direct investment since the early 1980s. He documents the country composition of the inward stock of FDI for Canada from 1950 to 1991, showing the declining share of U.S., and the rising share of EC, FDI in total FDI, and in manufacturing FDI. The same pattern is apparent for U.S. inward FDI, both total FDI and in manufacturing; that is, Canada's share declines and the EC share rises. Niosi then looks at Canada's foreign technical alliances in 1990-91 and finds that Canadian firms concluded more alliances with European partners than with U.S. partners. His general conclusion, based on these statistics, is that Canada and the United States are investing less heavily in one another.

Most of the economic forecasts of the effects of the FTA, and of the NAFTA, have argued that intra-industry and cross-border FDI flows should increase between Canada and the United States, as both are developed market economies with similar economic structures. However, each country's share in the other's FDI stock — that is, cross-investment — has continued to decline over the past ten years in spite of the FTA and possible NAFTA. What can explain the difference between the theoretical predictions and the data?

There are several possibilities. Some reasons focus on the responses of Canadian and U.S. MNEs to North American pressures.

- The removal of tariffs together with unexploited economies of scale have led to rationalization of activities on a continental scale by existing U.S. and Canadian MNEs, and thus to plant closures and the replacement of FDI by exports from the remaining plants.
- Intense competition in their domestic market from foreign trans-plants has forced U.S. MNEs to consolidate their domestic operations, close Canadian plants and serve the Canadian market from exports.
- Canada may be a less attractive environment for U.S. investment due to the recession, higher costs, less developed infrastructure, currency risks, and political uncertainties.

Other factors stress the attraction of extra-North American locations.

- EC 1992 has attracted new U.S. and Canadian FDI to shift from North America to Europe.
- Canadian MNEs have a large stock of FDI in the United States already and thus are diversifying into new markets such as Europe, while U.S. MNEs are diversifying into Europe and Asia.

Other arguments focus on the behaviour of foreign investors.

- The FTA and NAFTA have attracted offensive, export-substituting investments by EC and Asian firms and this has diversified investment partners for Canada and the United States.
- Canada has liberalized its inward FDI stance while the United States is adopting more protectionist policies, thus providing an additional motivation for North American investments to go to the United States rather than to Canada.

Having demonstrated the paradox and outlined some explanations, Niosi leaves it up to other researchers to investigate which of these explanations best fits the facts. He does believe that the relative decline in Canada-U.S. cross-investment is likely to continue for the foreseeable future.

New Rules for International Investment

In this first chapter in Part III, *Policy*, Fred Bergsten discusses the changing international climate for regulating foreign direct investment, arguing that there has been substantial unilateral liberalization of investment rules. At the same time, trade and investment have become inextricably linked, illustrated by the impact of the *kieretsu* structure on trade imbalances between Japan and the United States. The prospects for an international investment regime depend on what happens to the Uruguay Round and the views of the Clinton administration on managed trade. Bergsten believes the NAFTA will pass the U.S. Congress and be beneficial to the three countries. However, the NAFTA is widely disliked by the Pacific Rim countries because it is seen as the first move toward "Fortress North America". He concludes that the world trading system is characterized by even more uncertainty than usual; if the Uruguay Round concludes successfully, investment issues will move to the center of the multilateral agenda.

Sylvia Ostry's comment on Bergsten's paper focuses on the problems in setting rules for international investment. She sees the Uruguay Round as too much, too late; it deals with issues of the 1970s, such as TRIMs (trade-related investment measures) rather than issues of the 1980s and 1990s. Since the early 1980s, trade policy has been used as investment policy so IRTMs (investment-related trade measures) should be on the agenda. In addition, investment-related industrial policy measures (IRIPs) have emerged to link FDI and industrial policy in the high-tech area. For example, national security has been used to justify the exclusion of foreign MNEs from high-tech consortia. IRIPs are also not on the Uruguay Round agenda. Another system friction is the asymmetry of market access through FDI between Japan and the other OECD countries. All of these new issues are being discussed bilaterally by Japanese and U.S. officials. The United States therefore appears to have rejected the multilateral, rules-based route to creating an international investment regime. Ostry argues that this is a mistake since bilateral negotiations among the super powers tend to favour the powerful countries at the expense of the non-powerful ones. A multilateral approach to setting investment rules would be better for Canada and other small and middle-sized countries.

Regulating Multinational Enterprises in North America

In this chapter Robert Kudrle provides a detailed examination of North American policies towards multinational enterprises, focusing on general policies and sectoral restrictions.

The chapter first reviews the history of restrictions on MNE activity and inward FDI in the United States, Canada and Mexico. While the United States has no general restrictions against inward FDI, both Canada and Mexico do. Kudrle reviews the Foreign Investment Review Agency (later Investment Canada) in Canada and the Comision Nacional de Inversion Extranjera (CNIE) in Mexico, and the effect of the NAFTA on these institutions. He then turns to a discussion of sectoral restrictions in each country, looking at finance, culture, telecommunications, energy, and transportation sectors, and the impact of the NAFTA on these regulations.

Kudrle argues that Canada and Mexico have both substantially liberalized their regulation of MNE activity and inward FDI since 1980 in order to encourage closer economic linkages with the U.S. economy. Such linkages were seen as the only way for small, open economies to ensure their competitiveness, prosperity and long-run growth potential. Security motivations do not appear to have been a factor in their policy shift. Autonomy considerations have, however, been a factor in the continued closure of certain sectors (e.g. culture in Canada, petroleum in Mexico).

Kudrle then compares MNE policy in the three countries in terms of openness, discrimination and asymmetry, finding that: 1) even after the NAFTA is fully phased in, Mexico will be less open than its partners; 2) the NAFTA does contain features discriminating in favour of member country investors; and 3) asymmetry at the sectoral level in terms of openness remains a continuing feature of North American economic relations.

Assessing the prospects for further liberalization after the NAFTA, he finds possibilities for unilateral liberalization based on interest-group demands and for co-operative liberalization in the area of competition policy.

Finally, Kudrle discusses North American regulation of MNEs in a global context, situating the NAFTA within the multilateral GATT negotiations on TRIMs and TRIPs and "system friction" issues such as competition, R&D and FDI policies. He concludes with an analysis of the prospects for the NAFTA's passage within the United States, stressing the important role domestic politics plays in U.S. attitudes towards MNEs and inward FDI.

Multinationals and North American Security

In their chapter Ellen Frost and Edward M. Graham investigate the linkages between national security, multinational enterprises and government policy in North America. The authors argue that national security concerns, especially in the United States, are becoming economic security concerns, interpreted either as certain activities must be carried out at home rather than offshore or that certain sectors are closed to foreign investment. Competition from European defense and high-tech MNEs is seen by U.S. officials as unfairly subsidized; increasing import penetration of leading edge technologies is also of great concern. As a result, U.S.

policy-makers are widening the definition of national security to focus on economic issues.

Frost and Graham then look at national security legislation in North America. All G7 countries except Canada have the authority to block or limit FDI inflows on national security grounds. In the United States, certain sectors (e.g. coastal shipping, air transport, broadcasting) that are seen as vital to national security are closed to FDI; in addition, the Exon-Florio amendment allows the U.S. President to block an acquisition or takeover of a U.S. firm on national security grounds. In Canada, the *Investment Canada Act* allows Canada to screen inward FDI; this screening power will be reduced for U.S. and Mexican investments under the NAFTA. However, Canada cannot block acquisitions on national security grounds. Mexico has recently announced that it will create an authority with powers to block inward FDI on national security grounds. The authors argue that Canada should have the authority to do so, similar to the Exon-Florio amendment, and suggest how this national security function might be established.

Multinationals and Competition Policy in North America

In this chapter Edward M. Graham and Mark Warner examine the external dimensions of competition policy, linking it to trade and FDI in North America. 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. In the European Community, on the other hand, competition policy covers both types of regulation. The NAFTA does not create a trilateral competition policy, rather it requires each country to have its own competition laws and the countries to co-operate in enforcement of domestic laws. The authors ask two questions: Should the NAFTA explicitly contain competition policy provisions? Is the case for such provisions strengthened by the presence of multinational enterprises? They answer both questions in the affirmative.

Why should the NAFTA have its own trilateral competition policy? The authors provide five reasons.

1) At present, private barriers to trade can offset the gains from the NAFTA.

2) Some competition policy issues have a North American dimension, in particular, intra-North American mergers and acquisitions; national policies, however, may be parochial and ignore this North American dimension.

3) Competition laws in the three countries are not fully harmonized so there are potential conflicts between the regulations. A supranational authority is not necessary or sufficient for harmonization but may play a catalytic role.

4) A trilateral competition policy would logically replace trade remedy laws, especially anti-dumping duties, countervailing duties and safeguard measures. These less-than-fair-value (LTFV) measures can turn into disguised backdoor protectionism for domestic firms. A trilateral competition policy would remove the pro-business bias of these LTFV policies.

5) A trilateral competition policy could be used to regulate governments, (including sub-federal) in terms of state aid to firms.

The authors then provide a detailed discussion of what a trilateral North American Competition Commission (NACC) should look like and what its functions should be. Two detailed Appendices conclude the chapter, one on merger review rules in the three countries, and a second on predation/price discrimination laws.

The NAFTA, Multinationals and Social Policy

In his chapter Frederick Mayer examines the changing interrelationships between MNEs and labour and environmental standards in North America. Mayer looks at two issues. First, have MNEs adjusted their location decisions to take advantage of differences in social regulation in North America? Second, how are governments responding to these perceived adjustments and thus changing the playing field for the MNEs in North America?

Mayer finds that differences in social policies have had some effect on business location decisions but that, with a few exceptions, the effects are small. Mexico's social regulatory environment has traditionally been more lax and much FDI has flown into Mexico in previous years, but the two events are not necessarily connected; that is, the primary motivation for FDI does not appear to have been differences in regulatory costs.

The perception of Mexico as a social-hazard haven, however, mobilized interest groups in Canada and the United States. Mayer examines the domestic political responses to the NAFTA negotiations and categorizes them as either reactive, strategic or symbolic. Labour and environmental groups believed their interests were threatened by the NAFTA and thus reacted by seeking ways to either block its passage or modify its effects. However, the responses were more than simply reaction. Mayer argues that interest groups, particularly the environmentalists, behaved opportunistically, attempting to hold the NAFTA hostage for ransom to be paid in terms of their own issues. Labour unions lobbied less strategically and, as a result, were less successful than the environmental groups in having their demands met. The side accord on the environment is widely seen as being broader and more restrictive than that on labour standards. Mayer also argues that the NAFTA was treated by some detractors as a political symbol of "big business against the people". Mayer concludes, somewhat ironically, that the NAFTA was a catalyst for the political response in the United States. As a result of that response, the long-run impact of the NAFTA may be exactly the reverse of its opponents' charges. That is, the NAFTA may lead to increased regulatory co-operation among the three countries, raising the social regulatory standards of Mexico, and initiating a recapture of power by nation states, albeit at the regional rather than the national level.

LESSONS AND NEW DIRECTIONS

PART IV, *LESSONS AND NEW DIRECTIONS*, presents three reviews by the Rapporteurs at the conference. Christopher Maule assesses the contribution of the papers to the theory of multinationals and industrial organization; Murray Smith looks at lessons and new directions at the multilateral level, and Alan Nymark assesses their policy implications for Canada.

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Lorraine Eden
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ENDNOTE

1 Statistics are from *The Opportunities and Challenges of North American Free Trade: A Canadian Perspective* (Investment Canada Working Paper #7, April 1991).