

Impact of Trade Liberalization on Investment:
The Adjustment Process

This topic presents formidable analytical difficulties in its attempt to link the expected macro-economic impact of trade liberalization with the decisions of individual firms. Although some work exists concerning the likely impact of free trade on the Canadian economy (the 'adjustment' issue) and there is substantial literature on the nature of factors influencing investment decisions, almost none of these are of direct assistance in estimating changes in the magnitude and destination of investment flows resulting from the removal of tariff and non-tariff barriers between Canada and the United States.

Given the lack of such material, the next best approach is to estimate the nature of changes in investment patterns by reference to studies on the nature of the adjustment process and to surveys dealing with investment decisions at the individual firm level. This paper and a companion piece on survey evidence address these two topics.

The Adjustment Process

Manufacturing - Practically all work on the effects of enhanced trade in the Canadian economy has focused on the manufacturing sector. This is not surprising, given the high relative level of protection enjoyed by this sector and the accompanying debate on the wisdom of such policy which have existed since the time of Confederation. Contemporary proponents of protection for Canada's manufacturing industry point toward the small size of the domestic market as the root cause for Canada's uncompetitive situation. In their view, removal of trade barriers would inevitably result in the wholesale disappearance of domestic firms under the onslaught of cheaper imports, the phasing out of American subsidiaries and the transfer of production facilities and jobs to the United States.

The observed experience of adjustment by manufacturing sectors to trade liberalization as well as recent results of academic research on the subject, cast grave doubts on the validity of this view. The European Community scheduled significant tariff reductions amongst its members in the 1958 Treaty of Rome; at the time it was thought entire industries located in particular countries would disappear. In fact, each country tended to specialize in particular product lines within an industry which could supply the entire European Community. National adjustments to trade liberalization were so much lower than expected, that it was decided in 1960 to accelerate tariff reductions from 10% to 20% per year and to eliminate all quotas by 1961.

Substantial trade liberalization took place in Canada during the 1966-80 period as a result of the phasing in of tariff reductions negotiated in the GATT's Kennedy and Tokyo Rounds. The following patterns