3. Trade and Investment

3.1 Trade and Investment Linkages: Causality

On a theoretical basis, it is very difficult to distinguish between direct investment, bond and equity holdings, loans, debentures and other long-term and short-term capital. In fact, no known study simultaneously analyses the relationship between any two of these capital flow types and trade flows. Rather, it is most common to analyse the relationship between a single foreign capital flow and trade and the majority of these analyses is between direct investment and trade.

This problem is related to the definitional difficulties that exist at the statistical level. In balance of payments and other statistical sources, the distinction between foreign investment which results in foreign control of firms in recipient economies and other capital movements (e.g., loans) resulting in no control is clear. However, the distinction between direct and portfolio investment is less clear, depending on the degree of ownership control or influence that is exercised by the foreign investor. Furthermore, the degree of control used to distinguish portfolio and direct investment differs among economies and for that reason direct investment figures may mean very different things in different economies.[2] As a general definition, however, foreign direct investment (FDI) can be viewed as any expenditure by a corporation or person which results in the ability to influence an operation abroad.

There are many reasons to distinguish among direct investment, portfolio investment, and other flows. The primary economic reason stems from differences in the effects of different types of capital flows. In particular, theory suggests that the characteristics and behaviour of multinational firms differ from other firms in a number of important ways. Thus FDI by multinationals is likely to impart different effects than investment by domestic firms or by foreign holdings of portfolio investments which do not usually result in the ability to influence firm behaviour. With respect to FDI's effects, especially those in host economies, the importance of the technology, marketing know-how, and other intangible assets the foreign firm introduces into the recipient economy is often stressed. Furthermore, the benefits of such transfers accrue, not only to recipient firms but to competitors and input suppliers who may benefit from technological spillovers. Indeed, it is sometimes asserted that the primary benefits of FDI are imparted through the transfer of intangible assets such as technology and that the transfer of financial capital, per se, is of relatively little importance.

[2] *Statistics Canada defines direct investment as the value of debt and equity of a corporation by owners who hold more than 10 percent of the outstanding voting equity of the corporation. If the ownership of voting equity is less than 10 percent then the holding is classified as portfolio investment. Control of a corporation is defined as the potential to make the strategic decisions of a corporation. In most cases, control is the result of owning more than 50 percent of the voting shares (majority voting ownership). In addition, effective control or minority control can result from ownership of the largest block of voting shares. Statistics Canada defines effective control as the ownership of a block of equity which has at least 33 percent of the voting rights and which exceeds the sum of the next two largest blocks.*