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STUDY NO. 14:

Effect of enhanced trade on investment: survey evidence.
(Dept. of External Affairs. October 1985).

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EFFECT OF ENHANCED TRADE ON INVESTMENT: SURVEY EVIDENCE

EXECUTIVE SUMMARY

- The magnitude and destination of direct investment flows into and out of Canada depends ultimately on decisions by individual firms. This paper analyzes four recent surveys which investigated the main determinants of investment in Canada by US firms and of investment in the United States by Canadian firms. Analysis was focused on two questions: one, what is the relative importance of trade barriers on investment decisions?; two, what is the likely impact of their removal on investment flows?

- Surveys conducted by the Conference Board of Canada and DEA on the determinants of investment in Canada found that the great majority of firms surveyed did not consider trade barriers as a governing factor on future investment decisions.

- In addition, the DEA survey found that two-thirds of the US firms included believed a continuation of the status quo or some rationalization, to be the most likely outcome of a trade liberalization agreement. Only one fifth believed removal of trade barriers would have a profound impact on their Canadian operations.

- Surveys conducted by the C.D. Howe Institute and the International Business Council of Canada on the determinant of recent Canadian investment in the United States, found that trade barriers were a governing factor for a substantial and growing minority of firms.

- For the majority of Canadian firms which chose the United States in order to serve that market more efficiently or to diversify product lines or operations, the foreign investment appears to have had a neutral to mildly positive impact in the Canadian economy, in terms of net exports gained on jobs created. In the growing minority of cases were ease and security of access were significantly involved, however, there seems to be a net loss to the Canadian economy.

- Hence, removal of trade barriers under a comprehensive trade agreement appears to have a neutral effect on US investment in Canada and a mildly negative impact on Canadian investment in the United States. Bilateral investment flows are thus expected, in the short to medium term, to shift more in Canada's favour. The overall impact will be slight since the factors found as most influential in investment decisions are highly insensitive to the elimination of trade barriers.

- As far as the fate of American subsidiaries in Canada is concerned, trade liberalization is likely to result in no change or further rationalization in the large majority of cases. It must be remembered, however, that substantial rationalization in the operations of subsidiaries has already taken place under the Kennedy and Tokyo Rounds.

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EFFECT OF ENHANCED TRADE ON INVESTMENT: SURVEY EVIDENCE

The magnitude and destination of direct investment flows into and out of Canada depends ultimately on decisions by individual firms. In analyzing the impact of trade liberalization on investment, two questions are of significance: one, what is the relative importance of trade barriers in the investment decisions of U.S. and Canadian firms?; two, and consequently, what is the likely impact of their removal on investment flows?

Importance of Trade Barriers on Investment Decisions

Several recent surveys have analyzed the main determinants of investment in Canada by American firms and of investment in the United States by Canadian companies. Since Canadian investment in the United States could conceivably have remained in Canada, it may be argued that such outflows constitute as much of a reduction to domestic capital formation as a decrease in net foreign investment. Consequently, the behaviour of both American and Canadian firms must be analyzed in order to arrive at a complete understanding of the likely effect of trade liberalization on investment in this country.

Attitude of Foreign Firms Toward Investment in Canada - In April 1984, the Conference Board of Canada published the results of a survey based on responses to questionnaires sent to nearly 7,500 potential foreign investors in 19 countries. The study attempted to elicit views of Canada's attractiveness as a host country for investment.

There were 645 usable responses to the questionnaire; another 97 firms replied in letter form, for a usable response rate of 9.9%. Such a response rate is considered excellent for an international survey. Of those who responded, 55.7% came from the United States, thus making the general results of this survey applicable to a study of investment intentions in Canada by U.S. firms exclusively.

Respondents were presented with 21 criteria which might have affected their most recent decision to invest or not to invest in Canada. Companies were then asked to evaluate the relative attraction of each criterion and then indicate which ones "most strongly influenced" their most recent Canadian investment decision. Table 1 gives a conceptual grouping of factors presented while Table 2 summarizes the results of company evaluations.

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Table 1

Investment Criteria Presented

Market Factors	Competitive Factors	Environmental Factors
Market Growth	Potential Market Share	Labour Costs
Diversification into New Markets	Technological Expertise	Quality of Labour Force
Industry Profitability In Canada	Managerial Expertise	Influence of unions
Tariff and non-tariff barriers	Product Image	National Resource Endowment
	Capital Costs	Government Regulation
	Expected Profitability of Investment	Government Incentives
		Foreign Investment Controls
		Taxation Factors
		Energy Availability
		Transportation Networks
		Political Stability

Source: The Conference Board of Canada, Study No.81: "A fit place for investment?" by Duncan McDonald, p.12.

Table 2

Relative Attraction of Investment Criteria in Decision to Invest in Canada*

Positive	Neutral	Negative
Market Growth	Taxation Factors	Government Regulation
Potential Market Share	Capital Costs	Foreign Investment Controls
Expected Profitability	Energy Availability	
Industry Profitability	Influence of Unions	
Diversification into New Markets	Natural Resource Environment	
Technological Expertise	Government Incentives	
Managerial Expertise	Labour Costs	
Product Image	Transportation Networks	
Political Stability	Tariff/Non-tariff Barriers	
	Quality of Labour Force	

* Criteria listed in order of importance.
Source: Id., p. 30

Besides the conclusion that market factors seem to provide the greatest incentive to invest in Canada, it is significant to note that tariff and non-tariff barriers were rated on the aggregate as having a neutral impact on investment. Fifty-four percent of the respondents believed trade barriers had exerted a neutral impact, twenty-four percent saw them as a positive influence and twenty-two percent as a negative influence.

In addition, tariff and non-tariff barriers ranked quite low (11 of 21) as the most important and next most important criteria (14 of 21) for investment decision, as shown in the following tables.

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Table 4

Respondents' Assessment of Most Important
Criterion Affecting Decision to Invest in Canada

Criteria	% of Respondents*
Expected Profitability of Investment	17
Market Growth	15
Foreign Investment Controls	12
Diversification Into New Markets	11
Potential Market Share	10
Natural Resource Environment	6
Government Regulations	6
Industry Profitability in Canada	4
Technological Expertise	4
Political Stability	3
Tariff and Non-tariff Barriers	3
Capital Costs	2
Government Incentives	2
Transportation Networks	1
Managerial Expertise	1
Product Image	1
Influence of Unions	1
Taxation Factors	1
Energy Availability	1
Labour Costs	1
Quality of Labour Force	1

* Total number: 276

Source: Id. p. 28

Table 5

Respondents' Assessment of Next Most Important Criterion Affecting Decision to Invest In Canada

Criteria	% of Respondents*
Expected Profitability of Investment	15
Potential Market Share	14
Market Growth	11
Government Regulation	8
Diversification Into New Markets	8
Natural Resource Environment	6
Political Stability	6
Product Image	4
Foreign Investment Controls	4
Industry Profitability in Canada	3
Technological Expertise	3
Capital Costs	3
Management Expertise	3
Tariff/Non-tariff Barriers	2
Quality of Labour Force	2
Government Incentives	2
Taxation Factors	2
Labour Costs	2
Energy Availability	1
Influence of Unions	1
Transportation Networks	1

* Total Number: 234

Source: Id. p. 29

It is noteworthy as well that market and competitive factors were considered as the most significant criteria by respondents to this survey.

Thus, foreign firms in this survey which seriously considered investing in Canada did not consider tariff and non-tariff barriers as very important criteria and rated their presence as having a neutral impact on their decision.

To further refine these findings, the Department of External Affairs recently conducted a survey of some 200 large US corporations having Canadian subsidiaries. The purpose of the survey was again to ascertain the impact of trade liberalization on corporations with a Canadian presence. A three part questionnaire was prepared inquiring on: 1) the factors determing direct investment during the next five to ten years; 2) the importance of tariff and non tariff barriers as a factor in determining investment in Canada or the United States during the next five to ten-years; and 3) the impact of tariff elimination in future investment plans. At the time of writing, 122 firms had replied, some through letters and the rest through interviews with trade personnel at Canadian consulates in 13 US cities.

For purposes of analysis, replies to the first question were grouped according to the classification used by the Conference Board study; namely factors related to market, (including tariff and non-tariff barriers) factors related to competitiveness and factors relating to environment; and then the frequency in which these were mentioned tabulated. Results are given in Table 6:

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Table 6

Significant Factors Influencing Investment Decisions

		Frequency	
Market related			
Easier market access		32	
Market size		15	
Market growth potential		21	
Trade barriers:			
Government procurement	5		
Intellectual property	7		
Other	40	52	
Total market related factors			120
Competitiveness related			
Return on Investment		20	
Cost factors			
Labour	22		
Transportation/distribution	14		
Raw materials	7		
Utilities/energy	5		
Capital	4		
Not specified	15	67	
Exchange rates		15	
Miscellaneous*		9	
Total competitiveness related			111

*modernization, consolidation, better capacity utilization, pricing freedom

Environment Related

- Political/regulatory			
Incentives to investment	17		
Taxation	16		
Regulations on business activity	11		
Political stability	11		
Favourable business climate	11		
Barriers to labour movement	4		
Controls on foreign investment	8		
Total political regulatory		78	
- Economic			
Availability of skilled labour	18		
Availability of raw materials	10		
Infrastructure	4		
Generally	9		
Other	5		
Total economic		46	
- Social			
Labour relations/ work ethic		12	
Total environment related			136

Source: External Affairs Survey

As may be observed, political/regulatory factors, cost considerations (particularly labour costs) and trade barriers, in that order, were the most frequently mentioned reasons of significance to the investment decision. In addition, some particular variables such a market access and labour relations seemed to loom large in corporations' minds.

In order to gain greater insight into the relative importance of trade barriers on investment decisions in Canada, replies to the second question were analyzed, as shown in Table 7. Given the structure of the question, which did not always allow a purely objective distinction between trade barriers as a "significant" or a "decisive" factor, such distinction was made on the basis of the general tenor of the firm's reply. For instance, if a firm made no linkage between its future investment plans in Canada and the presence or absence of a particular trade barrier, this reply was categorized as 'not decisive'. If, on the other hand, the firm specifically described its investment intentions as being closely connected with the presence or absence of a trade barrier, then that reply was categorized as "decisive".

Table 7

Relative Importance of Trade Barriers
On Investment Decisions

	Yes (% of firms)	No No (% of firms)	No answer (% of firms)	Total (% of firms)
Significant	67 (55)	53 (43)	2 (2)	122 (100)
Decisive	30 (24)	90 (74)	2 (2)	122 (100)

Source: External Affairs Survey

Hence, although more than half of firms surveyed considered trade barriers of some importance in determining future investment, only one quarter believed the removal or maintenance of barriers would result in changes to their present investment stance. This is noteworthy in that it provides some evidence rebutting the assumption that tariff and non-tariff barriers constitute an important incentive or deterrent to investment in Canada. In fact, this seems to be the case with relatively few firms on this sample thus suggesting that a enhanced trade regime will have minimal direct impact on the investment plans of US companies presently established in Canada.

Analysis of answers to the third question provide further substantiation to the above hypothesis. Replies received were grouped in five categories: firms classified as "positive" indicated that free trade would lead them to increase their Canadian presence; those classified as "neutral to positive" believed that removal of trade barriers would be beneficial to their present activities and might result in increased investment; those classified as "neutral (rationalization)" stated that trade liberalization would result a greater intracorporate specialization which might or might not result on increased investment in Canada; those classified as "neutral (status quo)", saw little or no change in their investment plans as a result of trade liberalization or gave no indication that such change would occur; finally, those categorized as "negative" stated unequivocally that removal of trade barriers would have serious detrimental impact on their present and planned investment in Canada. Results are shown in the following table.

Table 8

Effect of Trade Liberalization
On Investment Decisions

Response	No. of firms	(% of total)
Positive	12	(10)
Neutral to Positive	12	(10)
Neutral (Rationalization)	27	(22)
Neutral (Status quo)	50	(41)
Negative	14	(11)
Not answered	7	(6)

Source: External Affairs Survey

Only one fifth of the firms which replied to this question believed that trade liberalization would have a major impact on their investment decisions: positive and negative replies in this category were almost evenly split. This, incidentally, is very close to the results appearing in Table 7. By far the next significant statistic for purposes of this analysis, however, was the almost one-half of sample firms which foresaw no change in their investment posture and the one quarter which believed rationalization would be the likeliest outcome. These results appear to reafirm the finding of the Conference Board of Canada study that trade barriers are not a significant factor in determining investment in Canada; in addition, they seem to indicate that rationalization or very slight adjustments would be the likeliest reactions to trade liberalization from the great majority of US companies with direct investments in Canada.

At the same time, the survey underscores the theme that foreign firms consider government regulation, market access, tax regimes and government incentives as quite significant determinants of foreign investment, thus raising the prospect that these particular issues may be put on the table by the American side during comprehensive trade negotiations.

In summary, then, two recent surveys on the attitudes of foreign and particularly US firms towards investment in Canada have produced the following results:

- the great majority of foreign firms surveyed by the Conference Board did not consider trade barriers as a major criterion in making investment decisions;
- about half the number of US firms with investments in Canada surveyed by External Affairs did not consider trade barriers as a significant factor on future investment decisions;
- of the more than half which did consider trade barriers as significant factor, less than 50% of these believed them to be a governing factor in their future investment decisions;
- two-thirds of US firms surveyed foresaw a continuation of the status quo or rationalization as the most likely outcome of a trade agreement and only one fifth believed removal of trade barriers would have a profound impact on their Canadian operations;
- both surveys indicate foreign investors in Canada consider market access as well as government regulations of foreign investment and business activities as major criteria determining future investment. The survey of US firms also portrays some concerns about labour costs and relative exchange rates.

Attitude of Canadian firms towards investment on the United States - Since the mid-1970's, Canada has experienced a dramatic reversal in its traditional position as a net importer of direct investment capital. In addition, an increasing proportion of Canada's direct investments abroad is being directed to the United States.

Table 9

Flows of Foreign Direct Investment to and from Canada, 1960-84

(Can. $ millions)

	Foreign direct investment in Canada	Canadian investment	Net investment
1960-64	2,285	465	1,820
1965-69	3,326	850	2,476
1970-74	4,125	2,523	1,602
1975-79	1,660	6,745	-5,085
1980-84	-1,920	17,725	-19,645

Source: Statistics Canada, System of National Accounts, Quarterly Estimates of the Canadian Balance of International Payments, Cat. No. 67-001

Table 10

Canadian Direct Investment Abroad by Location of Investment, 1975-83

(Can. $ millions)

	All foreign countries	United States	United States as percentage of Total
1975	10,526	5,559	52.8%
1976	11,491	6,092	53.0
1977	13,509	7,116	52.7
1978	16,422	8,965	54.6
1979	20,027	12,104	60.4
1980	25,803	16,387	63.5
1981	32,37	21,832	67.1
1982	33,865	22,990	67.9
1983	35,833	25,027	69.8

Source: Statistics Canada, System of National Accounts: Canada's International Investment Position - Cat. No. 67.202

Although it is recognized that increased direct investment in the United States is a worldwide phenomenon, generally caused by high confidence in the American economy, the geographic proximity and relatively close integration of the two countries would conceivably lead Canadian firms to export rather than invest in the United States. The reasons why this has not happened throw considerable light on the role of trade barriers in Canadian direct investment south of the border.

In 1985, the C.D. Howe Institute conducted a questionnaire survey of some 700 Canadian controlled subsidiaries in the United States. The final sample consisted of approximately 11% of these firms, with assets totalling some 28% of the value of total Canada direct investment in the United States. The sample was considered as quite representative of the population in terms of geographic distribution, but had a slight bias towards larger firms. In addition, although the mining, manufacturing and finance sectors in the sample correctly portrayed the profile of the population, the petroleum industry was underpresented, while the trade, real estate and services sectors were overrepresented. Nevertheless, the Institute considered the reliability of results to be quite good, particularly since adjustments were made to take into account these deviations.

The survey produced to following results of relevance to our purposes:

- The overwhelming majority of respondents, save those in primary industries, rated market potential, market size and proximity to customers as the major factors influencing past, present and future views on investment in the United States. Primary industries considered access to raw materials, market size and corporate taxation as major criteria.

- About one third of firms surveyed considered tariff and non-tariff barriers as very important or important in influencing their decision to invest in the United Stats rather than in Canada.

- There were significant differences in the attitude of manufacturing and that of all other firms towards trade barriers as illustrated below:

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Table 11

Sectoral Difference in Factors Influencing the Location Decision*

	Important	Not important
Tariff barriers		
manufacturing	35%	65%
all other industries	6	94%
Non-tariff barriers		
manufacturing	30	70
all other industries	13	87

* At the time last investment was made

- There were significant increases in the importance of tariff and non-tariff barriers when firms were asked to rate them as at the time of their last investment and five years into the future, as follows:

Table 12

Changes in the Relative Importance of Trade Barriers as Investment Factors

Factor	Importance at the time of the last investment*	Importance five years from now*	Percentage difference
Tariff barriers	19%	38%	19%
Non-tariff barriers	22	40	18

* Percentage of respondents rating the factor as very important or important.

- Seventy percent of the firms surveyed produced the same goods and services as their U.S. subsidiaries thus implying that licensing or exporting might have been possible. Licensing, however, was not even considered by 81% of the respondents.

- As for the choice between exporting or producing, higher Canadian production costs were perceived as a minor element in the decision to produce locally. Rather, overcoming trade barriers and most importantly, being close to the market appeared to be the governing factors for investment on the United States.

- Although, a priori, investment in the United States when exports are an alternative constitutes a loss to the Canadian economy, survey results pointed to a different conclusion. Survey data indicated that most production by Canadian subsidiaries in the United States was either sold locally or to third country markets where there was no competition with exports from the Canadian parent. Consequently, there was minimal displacement of employment or profits in Canada due to direct competition in the Canadian market.

- What about displacement of exports by the parent company to the US? As previously mentioned, 30% of firms surveyed had different product lines between th Canadian parent company and its American subsidiary of the 70% which did have similar products, more than half had never exported to the United States before establishing an affiliate there. In addition, 57% of these investing firms which had exported previously to the United States believed that their exports would have been smaller had they not set up a US operation while only 18% believed the contary.

Hence, evidence indicates the magnitude of export losses due to US investment may be exaggerated.

- Survey results as well as population data indicate that Canadian subsidiaries have a greater propensity to import from Canada than US firms in general and that more than half of their Canadian imports consist of final goods. Thus, although undoubtedly small relative to total subsidiary sales, these derived exports contribute to production of high value added goods in Canada which might not exist without investment.

A more restricted study comprising eighteen Canadian multinationals was undertaken by the International Business Council of Canada (IBCC) in 1985. The group was chosen to represent as wide a range of industries as possible and focused on specific foreign investments or divestments made between 1980 and 1984. The purpose of the study was to better explore the reasons for foreign investment by Canadian firms and the impact this outflow has in our economy.

The IBCC study found that Canadian foreign investment was principally intended:

- in the case of most companies in faster growing industries, to extend their sales into markets which otherwise would be closed to them, or in which they could not otherwise compete effectively. For this group, overcoming trade barriers, and serving the domestic market were the governing reasons for investment abroad.

- in the case of most companies in slower growing industries, to modify their production capacity, their product lines or even their business. For this group, strengthening the existing business of the Canadian parent and diversifying into other business were the governing reasons.

- The study did not reveal any evidence to show that investment abroad has hada major negative impact on the Canadian economy:

  - on investment, the study found that companies surveyed continued to invest in Canada. Indeed, those which were major capital exporters invested heavily in Canada-relative to the proportion of their revenues derived from the domestic market. In addition, and with few exceptions, investments undertaken abroad did not have viable alternatives on Canada.

  - on exports, the study concludes that rather than displacing, foreign investment maintained or increased them. In cases in which investment was taken to gain access to the foreign market, or to diversity operations exports were not possible under present conditions. Therefore foreign investment secured an outlet for at least some level of inter-corporate exports, and supported some jobs at home.

To summarize, then, trade barriers appear to have had a significant role in recent Canadian investment on the United States and its importance seems to be increasing. Although criteria related to market factors or corporate policy continue to play a governing role on these investment decisions, overcoming barriers to entry into the American economy have become an increasingly important reason, particularly, it appears, for Canadian manufacturing firms.

In cases where serving the domestic market, diversifying product lines or operations were the dominant factors, the investment decision appears to have had a neutral to mildly positive impact on the Canadian economy, in terms of net exports gained or jobs created. In cases where ease and security of access were significantly involved, however, there seems to be a net loss to the Canadian economy as the American market could have been served from Canada under conditions of non-restricted trade.

Likely impact of trade liberalization on investment

Based on an analysis of four major surveys on investment intentions, we conclude that trade barriers appear to have decreasing significance as a criterion for investment in Canada by US firms, but increasing significance for investment in the United States by Canadian firms. Consequently, removal of barriers under a comprehensive trade agreement will likely have a neutral effect on U.S. investment in Canada and a mildly negative impact on Canadian investment in the United States. Bilateral investment flows under liberalized trade arrangements may be expected, in the short to medium term, to shift more in Canada's favour due to a reduction in Canadian investment to the United States. The overall impact will be slight, however, since the factors found to be most important in investment decisions (market growth, market size, proximity to customers) are highly insensitive to the elimination of trade barriers.

As far as the fate of American subsidiaries in Canada is concerned, removal of trade barriers is likely to result in no change or further rationalization in the large majority of cases. Gradual removal of barriers and appropriate government policies should be implemented to ensure that the process of rationalization maximizes the number of establishments and jobs left in Canada. It must be remembered, however, that a great deal of rationalization in the Canadian operations of foreign subsidiaries has already taken place as a result of trade liberalization under the Kennedy and Tokyo Rounds.

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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 developed within Canada's manufacturing sector during the 1970's, according to studies conducted by the Economic Council of Canada:

- Both exports and imports increased as Canadian firms reduced the number of their product lines and became internationally competitive on a much smaller range of products.

- Virtually all manufacturing industries experienced increases in their exports and imports. In about half the cases the rate of growth of exports exceeded that of imports; the reverse was true for the remainder. In no instance, however, did a whole industry tend to disappear or experience substantial contraction due to imports.

- In both expanding and declining industries the adjustment mechanism was mainly through variations in the rate of entry of new firms, rather than the rate of market exit by either scrapping or sale. This strongly suggests that the adjustment process is less traumatic than assumed by opponents of trade liberalization particularly in terms of direct impact on employment.

- Foreign owned firms, on average, reacted neutrally to changes on trade flows during the 1970s when measured by their rates of entry to or exit from an industry, thus suggesting MNEs are more likely to react to trade liberalization through product rationalization rather than divestiture of their operations.

- Canadian owned firms, on the other hand, bore the brunt of increased import competition during the same period while, at the same time, took greater advantage of export opportunities. This observation suggests that the rationalization process which seems to accompany trade liberalization may benefit the competitive position of the domestic sector at the expense of the foreign sector.

- The adjustment process at the firm level was characterized by astonishingly high rates of market entry and exit, thus implying greater flexibility and continuous adaptability to exogenous changes by the manufacturing sector than traditionally thought.

- The relatively slight effects on unemployment suggested by the nature of the adjustment process were given some support by government surveys of laid off workers on three major import sensitive industries (clothing, textiles and electrical products) between 1974 and 1977. Results indicated that two-thirds found new employment and half of these (the median) within six to eight weeks; one third were still unemployed, with the median having been out of work between 13 and 16 weeks; and one third had left the labour force. Average periods of unemployment for members of the labour force who eventually had and had not found employment were much higher than their respective medians thus indicating the existence of "hard-core" unemployed who recorded unemployment spells of two years or more. The surveys also found that more than two thirds of the workers who found new jobs, did so in other industries or economic sectors, thus indicating a fairly high degree of labour mobility.

In sum, a major empirical analysis of Canadian industry reaction to the most recent tariff cuts shows none of the effects predicted by the "deindustrialization" agrument. Although Canadian imports increased, so did exports. No industry experienced major declines. Observed firm behaviour suggests the bulk of the adjustment process was undertaken by Canadian firms and that the main instrument of change was the rate in which new firms entered a particular industry rather than the rate of firm exit by disinvestment or scrapping. The implication of relatively mild employment dislocation suggested by the adjustment process was validated to a large extent by the result of surveys measuring the length of unemployment for displaced workers in three import sensitive manufacturing industries.

These conclusions have been supported by a growing body of academic studies dealing with the nature of the adjustment process. They show that trade liberalization, through the operations of scale economies and product differentiation, results in increased production, productivity and competitiveness in the manufacturing sector. Import competition provides the catalyst for firms to adjust their production techniques and activities; free access to the larger US market allows them to exploit scale economies, hence improving productivity and cost competitiveness. Although some industries will contract (but by no means disappear) when exposed to US competition, and there will be short term dislocation, there are no grounds to predict a massive collapse of Canadian manufacturing once trade barriers are removed.

The implications of this scenario for investment flows into the manufacturing sector are quite evident; adjustments arising from trade liberalization will result in somewhat increased capital expenditures in industries having comparative advantage over its U.S. counterparts and in somewhat reduced expenditures or disinvestment on those having comparative disadvantages as rationalization occurs. There will be no massive changes in either the magnitude or the destination of new investment, but rather a gradual shift of resources among firms within a industry and among industries as they react to changes in the competitive environment.

<u>Resource extraction and processing industries</u> - There are relatively few bilateral barriers to trade in this sector, most of them concentrated in higher value-added products. Adjustments on this sector willprobably involve an expansion of processing facilities in Canada, since Canadian producers have a competitive advantage in natural resources with respect to their American counterparts, and are already world competitors. In addition, removal of US trade barriers on Canadian exports would provide natural resource producers and processors with a competitive advantage on the US market in relation to offshore producers and procesors. It must be pointed out, however, that depressed commodity markets

and increased competition from low-cost producers in the developing world may deter any major expansion plans in Canada in the near future.

<u>Services</u> - The existence of multifarious non-tariff barriers in this sector implies increased investment in Canada under trade liberalization, particularly since delivery of many services requires a local establishment and proximity to customers. Unfortunately, no research has been undertaken yet on the nature of the adjustment process for service firms. Hence, it is impossible to predict confidently the net impact on combined US-Canadian investment on services; intuitively, however, trade liberalization in services would appear to benefit mostly the United States.