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STRATEGIC RESPONSES TO FREE TRADE*

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I. *Introduction: The Free Trade Agreement and Corporate Adjustment*

Once the Canada-U.S. Free Trade Agreement was signed on 2nd January 1988 it became imperative for Canadian corporations to rethink their strategic planning. Although the agreement still faces some potential legislative obstacles before it becomes effective on 1st January 1989 it is apparent that the environment for international business has been changed significantly by this major trade deal.

To the strategic planners in large corporations the issue of adjustment is a familiar one; the whole point of strategic management is to assess external environmental changes and to design internal strategies and structures to accommodate such changes. The greater the degree to which external shocks can be predicted the lower is the risk to the firm, as appropriate policies can be implemented to minimize the costs of adjustment.

Corporate adjustment to the bilateral trade agreement will be eased since the private sector has been consulted about many of the details in the agreement. This was achieved through the participation of many business leaders (over 300 chief executive officers and presidents) in the Sectoral Advisory Groups on International Trade (SAGITS). There were 15 of these SAGITS; they met regularly with trade officials and ministers over the last two years to help formulate the Canadian position in the trade negotiations. In this interactive process many of the potential adjustment problems of Canadian corporations were discussed and often steps were taken to minimize adjustment costs.

For example, corporations which face real adjustment costs can be helped by Government in two major ways. First, they can receive direct financial assistance in the form of low interest loans and other subsidies to help restructuring and plant relocations. Second, they can benefit from long phase-ins before new trade regulations become effective. In general, the Canadian government has worked with the private sector to ensure that the second method of adjustment assistance is in place. One illustration of this is that the free trade agreement cuts all bilateral tariffs to zero by the end of a ten-year period. Yet industries which volunteered were able to secure quicker tariff reductions; the final text of the agreement reflects many examples of such phased tariff reductions.

These two points, the ongoing nature of strategic planning as corporations adjust to

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changes in environmental conditions plus the process of active participation of the private sector in the trade negotiations, leads to an important conclusion. Corporate adjustment to free trade is already underway and few of Canada's large corporations will be affected adversely by the agreement. Indeed, most of Canada's large corporations are hungry for free trade. Now that we have it Canadians can watch their corporate leaders take the opportunity to organize for future prosperity.

This focus on the strategic planning of large corporations is, of course, justified since in Canada the great majority of economic activity is carried out by such firms. Indeed, in terms of U.S.-Canadian trade as much as 70 percent of all international transactions are carried out by multinational enterprises, the majority of this by about 40 companies with sales of a billion dollars or more. These members of the "billion dollar club" consist of a set of Canadian-owned multinationals such as Northern Telecom, Alcan, Noranda and so on plus a set of foreign-owned subsidiaries such as General Motors Canada, Ford Canada, C.G.E., DuPont Canada and so on. These firms are already well positioned in terms of global competitive strategy and the impact of the free trade agreement on them will be neutral at worst and otherwise highly favourable.

These large multinationals are already integrated across the U.S.-Canadian border. Often they made initial plant location decisions based on the need to secure access to either the Canadian or U.S. markets in the face of barriers to exporting. Now, however, virtually all of these multinationals continue to produce and distribute through foreign subsidiaries due to other managerial motives such as the need to service customers, to be close to suppliers, to accommodate local political interests and so on. Stated more formally, most of these multinationals have erected entry barriers which they naturally wish to maintain against potential rivals.

The major impact of the free trade agreement on the billion dollar club is simply to improve the investment climate. This is achieved by having the rules of the game in place, instead of being subject to arbitrary changes through the process of decentralized administered protection, as occurred in the use of U.S. trade remedy law cases in recent years. The binational appeal body for the dispute settlement mechanism should lead to more objective analysis by the trade agencies, the negation of frivolous cases, quicker decisions, and an overall improved trade climate. The elimination of such uncertainty is the essence of good strategic planning, so the larger multinationals will benefit from this and related aspects of the trade agreement which improve market access.

There are two other types of Canadian corporations which need to be considered. First there are small and medium sized businesses producing in Canada and exporting to the United States. Clearly these firms will benefit from secure and relatively open access to the U.S. market. They are immensely better off when compared to the alternative which was one of increasing U.S. protectionism through the use of often capricious trade laws and other regulations affecting imports. For this reason it is small business which should benefit the most from the free trade agreement.

Second, there are corporations in import competing sectors which will need to adjust to free trade. However, here the adjustment process will be minimized since most of these sectors are also represented on SAGITs, and at their request, they were exempted. Examples include the cultural industries, beer and much of the agricultural sector where all the marketing boards were maintained and quotas retained to keep out foreign suppliers. Even in textiles and apparel steps were taken to minimize the adjustment problem by phase-ins, special provisions on duty remission for imported fabric from third countries and related measures.

The implication of this analysis of the issue of corporate adjustment is perhaps surprising to readers of the *Toronto Star*, the authors of studies on trade policy for the Ontario Government, disciples of Mel Hurtig, economic romantics such as Abe Rotstein or Jim Laxer, or others unaware of the realities of modern international business. There is no adjustment problem. All sectors of Canadian business can utilize the phase-ins of the trade agreement to restructure and organize themselves for expanded economic activity in a formally-recognized North American market.

II. *Strategic Management and Trade Liberalization*

The process of strategic planning follows patterns in which the competitive strengths of the corporation are constantly reassessed in light of new information about the domestic and international environments within which the firm operates. Such environmental changes include trade liberalization measures, to which the firm must react. This process of competitive strategy has been synthesized most recently in works by Porter (1980, 1985). Applications in an international dimension are considered by Rugman (1985) and Porter (1986). Here this thinking is applied in a new context, to discover the basic principles involved in reacting, at the firm level, to fundamental changes in the U.S.-Canadian trading relationship.

In particular, we analyze the reaction of multinational enterprises to the free trade agreement, recently negotiated by Canada and the United States, see Canada (1987). This comprehensive bilateral trade agreement sets out procedures to eliminate all bilateral tariff and many non-tariff barriers to trade. Multinational enterprises account for about 70 percent of all bilateral trade so the manner in which they will adjust to a comprehensive trade agreement is of paramount importance. Their internal managerial decisions also have profound repercussions on the employment, social and political aspects of a bilateral trade agreement. In this study we shall focus our attention on the behaviour of Canadian and U.S. multinationals operating in Canada.

By definition, strategic management decisions take place under conditions of uncertainty and partial ignorance; consequently they cannot be easily understood nor programmed by the analyst. Investment decisions are especially important to model. Several authors have investigated the international dimension of business strategies based upon the concept of internalization theory. This explanation of the behaviour of multinational enterprises was developed in a Canadian context by Rugman (1980, 1981). Internalization theory is based on the idea that markets and hierarchical structures (firms) are alternatives: a product or service will be provided if it can be produced at a cost less than that involved with an open market transaction.

Internalization allows a multinational enterprise to establish and retain proprietary rights over its firm specific advantages (FSAs) so that they cannot be dissipated to other firms. The FSAs are defined as the competitive strengths of the company, whether these are derived from production (R and D based) or marketing (customization advantages).

Profitability and growth may also result from country specific advantages (CSAs). The CSAs capture the natural factor endowments of a nation, basically the variables in its aggregate production function. CSAs are related to inputs in terms of their quality, quantity and costs relative to other countries. They also include tariffs, non-tariff barriers and other government barriers to trade, including regulations on foreign direct investment.

Internalization theory suggests that for the internationally competitive operations of multinational enterprises, the overall impact of bilateral trade liberalization will be positive. Its main effects will be to reduce transaction costs associated with exports and to create more certainty for investment decisions. In cases where foreign direct investment and exports are complements, bilateral trade liberalization should increase the level of both, see Safarian (1985). A substitution of exports for foreign direct investment can be expected in cases where tariffs and regulations on trade are the main rationale for engaging in foreign direct investment and where exit barriers are low; then adjustment costs of relocating production activities are limited.

An important implication can be drawn from this analysis; a reduction in trade barriers need not necessarily have an important effect on strategic management decisions in multinational enterprises. These represent only some of the environmental variables taken into account by strategic planners; other factors such as the need for property rights over knowledge, marketing information and so on are not affected at all by trade liberalization.

III. *Corporate Adjustment and Competitive Strategy*

Porter (1980) has argued that firms can develop three, internally consistent, generic strategies, namely overall cost leadership, differentiation and focus. Multinational enterprises can attempt to turn their CSAs and FSAs into profitability and growth through the use of any of these competitive strategies.

Achieving overall cost leadership requires an organizational emphasis upon the cost control of inputs and a production process that allows firms to obtain economies of scale and experience curve effects. The differentiation strategy, on the contrary, requires the creation of products and services that are perceived as unique by customers. It emphasizes marketing aspects to gain competitive advantages. Focus, the third generic strategy, is aimed at serving a particular segment of the market, such as a narrow geographic area, a well-defined buyer group, or a limited product line. The competitive strengths of a firm engaging in the focus strategy also rest on the ability to achieve low costs or differentiation but only vis-a-vis the chosen market segment. This strategy by definition limits the overall market-share that is achievable but may still generate above average profitability.

Porter's model is strongly related to internalization theory with the latter's focus upon FSAs and CSAs for the multinational enterprise. Each of the three generic strategies can be seen as a set of defensive or offensive actions, aimed at deriving profits and growth from the CSAs and FSAs of the multinational enterprise. Whether the structure of competition in an industry will be strongly affected by a trade agreement between two countries depends on entry and exit barriers, in addition to the CSAs and FSAs of the firms involved.

Entry barriers refer to the difficulties that potential entrants face when trying to enter an industry or a new market. The seven key entry barriers identified by Porter (1980, 1985) are: economies of scale, product differentiation, capital requirements, switching costs, distribution channels, cost disadvantages independent of scale and government policy.

The important issue for managers of multinationals involved in adjustment within the Canadian economy is whether the introduction of a bilateral trade agreement will result in:

1) a status quo, because the decrease in entry barriers (in this case tariff and non-tariff barriers to trade are the equivalent of Porter's government regulation) for a foreign firm is insufficient to allow entry in Canada.

2) New entries of foreign firms because the decrease in entry barriers is so substantial that it provides the economic impetus for entry in Canada.

3) An increase in entry barriers, because existing firms can now expand and profit from new environmental conditions leading to economies of scale and experience curve effects.

Exit barriers are important for multinational enterprises confronted with a weaker competitive position in certain Canadian operations after trade liberalization. The main question then is whether decreased profits will result in divestment. Six exit barriers may prevent a firm from leaving the market: durable and specialized assets, fixed costs of exit, strategic exit barriers, information barriers, managerial or emotional barriers, government and social barriers. If any of these exit barriers is high, a multinational enterprise may decide to maintain operations that would otherwise have been closed down: a change in generic strategy may then be required so as to restore profitability.

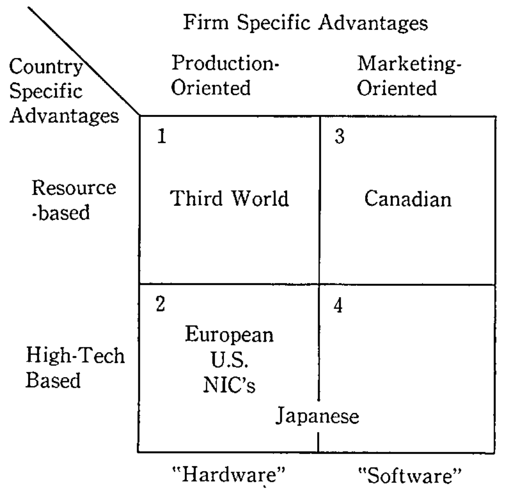
The influence of entry and exit barriers on the strategic adjustment behaviour of multinational enterprises operating in Canada will be discussed in the next sections. Two elements should be emphasized. First, an increase in entry barriers resulting from scale effects has been the main focus of attention by Canadian economists, as summarized in studies for the Macdonald Royal Commission, Canada (1985). These demonstrate that bilateral trade liberalization will allow Canadian firms to increase their production efficiency by serving the much larger U.S. market. Second, Harris (1985) has developed a version of the "asymmetry argument." Canadian firms wishing to develop activities in the United States will face much higher entry barriers than U.S. firms wanting to enter the Canadian market. The Canadian market is viewed by the U.S. firms as an "incremental" market, which can be penetrated at low costs, while Canadian firms are faced with a market which is often ten times larger than their domestic base. For Canadian firms entering the U.S. market will involve substantial investments, especially in marketing.

IV. *The Global Matrix and Strategies of Multinationals*

To understand the manner in which multinational enterprises can respond to trade liberalization we need a conceptual framework which ties together national and enterprise influences on global strategic management. This can be achieved by combining in a new matrix the national CSAs with the enterprise-level FSAs. This is demonstrated in Figure 1 where the horizontal axis measures FSAs and the vertical axis captures the CSAs.

The CSA axis is divided into resource-based and high-technology based advantages. Towards the top of the vertical CSA axis a nation's competitive advantage in resources is paramount, with relative factor endowments being the source of a nation's comparative

FIGURE 1. THE GLOBAL MATRIX



advantage. Towards the bottom of the axis the role of high-technology increases, such that a nation's competitive advantage is based on high-tech products. This distinction is potentially important as changes in trade policy can influence the high-tech CSAs. Yet, when resource-based CSAs dominate, a change in trade policy may not exert any major negative influence on the competitive strengths of the multinational enterprises involved.

The FSA axis is functionally determined by the broad characteristics of enterprise structure. It moves horizontally from a production-based FSA to the left, towards a marketing-based service FSA on the right. Production FSAs basically reflect efficient cost minimizing economic decisions. Enterprise strategies will be low cost and price based. Some firms achieve production FSAs through vertical integration, the use of process technology, and economies of scale. At the other extreme on this axis, marketing FSAs reflect micro management skills in the organization of human resources, customization, co-operative relationships with suppliers and customers, marketing networks and control over the channels of distribution. Enterprise strategies to the right of the FSA axis involve overall differentiation or focus differentiation, based upon the gathering of customized intelligence.

Using this matrix, any multinational enterprise can be positioned in its current strategic spaces. Recent research by Rugman and McIlveen (1985) demonstrates that most Canadian multinational enterprises are now operating in quadrant 3 rather than in 1. The Canadian resource-based multinational enterprises have developed a value-added chain in the harvesting, processing and marketing or resource and mature product lines. As Canadian multinational enterprises have expanded mainly as a result of natural CSAs, trade liberalization between Canada and the United States will allow them to exploit these natural CSAs further, without substantial influence being exerted on their production operations.

Figure 1 also allows us to observe that most Canadian multinational enterprises pursue a differentiation strategy. It should be considered as a focus differentiation strategy rather than an overall differentiation strategy, however, since the segment scope (the number of market segments served in an industry) of most firms is rather limited. The fact that most Canadian multinational enterprises pursue focus differentiation strategies is extremely important. The elimination of unnatural market imperfections will not substantially decrease the main entry barriers that foreign competitors face, namely product differentiation, buyer switching costs and access to distribution channels, a result which is somewhat in contradiction with the 'asymmetry' argument of Harris (1985).

In order to predict in detail the influence of trade liberalization on competitive strategie of business firms, the analysis made above must be extended for two reasons. First, it only reflects the operations of multinational enterprises with strong firm specific advantages and not other types of operations. Second, it does not describe the effect of a change in tariff barriers and regulations on artificial CSAs and thus on the strategies of business firms that derived their competitive strengths from protection. In the next section, a new framework is developed to perform such an analysis.

V. *Trade Liberalization and Competitive Strategy*

In the context of bilateral trade policy it is necessary to know how the introduction of trade liberalization will influence the investment behaviour of different categories of firms. Conceptually, for any business of a firm we can analyse whether Canada possesses strong or weak CSAs and whether the different firms engaged in this business in Canada have strong or weak FSAs. A "strong" CSA or FSA is defined here as an advantage sufficient to ensure competitiveness as compared with foreign rivals. A "weak" CSA or FSA is an advantage which, in itself, is insufficient to allow competitiveness and profitability in the international market place. Any business can then be placed in one of the quadrants of Figure 2.

This diagram presents a classification of the businesses in which a firm competes in terms of the strengths of CSAs and FSAs. International competitiveness is assured whenever

FIGURE 2. THE COMPETITIVE ADVANTAGE MATRIX

Country Specific Advantages \ Firm Specific Advantages	Strong	Weak
Strong	1	3
Weak	2	4

FSAs and CSAs are strong simultaneously (quadrant 1). If CSAs are weak, however, FSAs will have to be very substantial, in order to compete with global rivals (quadrant 2). A similar observation holds in case a firm does not possess strong FSAs; then only through CSAs can a strong competitive position be assured (quadrant 3). For businesses where both CSAs and FSAs are lacking or restricted, competing internationally with efficient foreign rivals is made very difficult (quadrant 4).

A bilateral trade agreement will have different effects on different categories of businesses in Figure 2 in terms of investment behaviour. Recent empirical research reported by Rugman (1988) has classified the different Canadian operations of Canadian and U.S. multinationals into the four quadrants of Figure 2, and also evaluated their probable responses to a bilateral trade liberalization. The largest Canadian multinationals and largest subsidiaries of U.S. multinationals were included in this research, i.e., that is the "billion dollar club." The main results will now be discussed by making a distinction between six different cases. Four cases describe the situation whereby firms classified in a particular quadrant before trade liberalization remain in that same quadrant after the bilateral trade agreement. Two additional cases must be distinguished however as the CSAs of certain businesses will be lost after trade liberalization. This is the situation where firms used strong artificial CSAs as a competitive strength but now incur adjustment costs because they shift to a quadrant with weak CSAs.

The first case consists of the businesses located in quadrant 1 for which a bilateral trade agreement has little effect, or where it constitutes primarily a decrease in trade barriers and hence a stronger competitive position in the bilateral trade area. In this case, the potential effects will be an increase in domestic investment and some substitution of exports for foreign direct investment. Such a situation can be expected for most Canadian resource-based multinationals, especially in global industries, that possess strong FSAs and CSAs independent of protection. Examples include firms in the pulp and paper industry (Abitibi-Price, Consolidated-Bathurst, Domtar, MacMillan Bloedel), and in the mining and metals industry (Noranda, Alcan and Cominco). Several of these mature, resource-based firms may actually be in quadrant 3 but the trade agreement offers them the chance to move to 1.

The same observation holds for subsidiaries of foreign multinational enterprises with world product mandates (WPMs) or globally rationalized businesses. Both categories of subsidiaries possess strong FSAs of their parents that allow them to compete efficiently on an international scale. A WPM can be defined as the full development, production and marketing of a new product line in a subsidiary of a multinational enterprise (Rugman 1983). At present WPMs are restricted to mainly vertically integrated multinational enterprises which operate in Canada to take advantage of its natural resources. WPMs based on the processing and marketing of Canadian resources in the areas of minerals, forestry, agriculture, food processing and other related areas are common examples. Globally rationalized businesses typically produce only a limited fraction of the total product line of a multinational enterprise for the world market. Unlike subsidiaries with WPMs they are essentially production driven and concentrate on low costs.

Finally, there are the branch plants of foreign multinational enterprises. If they are efficient firms now operating to service the Canadian market for customization, machinery or low cost reasons then they will retain their competitive advantages after trade liberalization. It appears that most of the larger subsidiaries of U.S. multinational enterprises in

Canada are such branch plants (automobile sector, oil sector, distribution, etc.). These subsidiaries are internationally competitive firms that derive their competitive strengths from the FSA of their U.S. parent.

The second case consists of the businesses which were located in quadrant 1 of Figure 2, but which will shift to quadrant 2, because of trade liberalization: these operations derived part of their competitive strengths from strong artificial CSAs (shelter from international competition by tariffs), which would be eliminated with the introduction of a bilateral trade agreement.

There are three likely responses: a) a status quo because strong FSAs combined with high exit barriers compensate for the decline in CSAs; b) restructuring, a major change in generic strategy; c) relocation of activities (exit, depending upon exit barriers). The latter two situations will be primarily applicable to a limited set of subsidiaries of U.S. multinational enterprises; those that were set up to serve the Canadian market because of the high costs associated with exports, but are of inefficient scale to compete successfully in a free trade area. Only if exit barriers are low will a relocation of activities be carried out. In the case of high exit barriers, a change in generic strategy may be necessary to maintain profitability. Strategies of overall cost leadership or differentiation that could be successfully pursued in the Canadian context, before the introduction of trade liberalization, cannot be sustained in a more global environment. Then a focus strategy becomes necessary. This may take the form of global rationalization whereby the product scope of the subsidiary is restricted. FSAs of the parent company then make international competitiveness possible.

It is apparent, however, that none of the largest Canadian subsidiaries of U.S. multinational enterprises, analyzed in the empirical work of Rugman (1988), fall into these categories of subsidiaries. This is consistent with the observation that the successive reductions in protective tariffs as a result of the different GATT negotiations after the Second World War have not generated any substantial withdrawals of U.S. subsidiaries from Canada, see the Macdonald Royal Commission report (1985) and Safarian (1985). Changes in strategy may be necessary, however, for certain operations of Canadian multinational enterprises where protected domestic markets were an important factor for success. Some firms in the beverage industry, such as Labatt and Molson, fit into this category.

In the third case, we find the businesses located in quadrant 3 of Figure 2 for which trade liberalization constitutes primarily a decrease in trade barriers, but which will not expand because of weak FSAs. In this case no effects on investment behaviour can be expected. This case is primarily applicable not to multinational enterprises but to businesses of local Canadian firms that do not face global competitive pressures from foreign firms, because of the multidomestic character of the industry or because a nationally responsive strategy as described by Porter (1986) constitutes a viable focus strategy. Examples occur in the resource-based sectors where production is mainly for domestic consumption, such as in fish, forestry, some agriculture and related areas which do not depend on marketing boards for protection. This quadrant may, however, also describe a limited set of operations of Canadian multinational enterprises, especially in mature industries, where FSAs have been eroded over time by competitive strategies of efficient foreign rivals, so that a free trade area is not considered as an important market opportunity.

The fourth case is that of the businesses which were located in quadrant 3 but shift to quadrant 4 because the bilateral trade agreement constitutes primarily a decrease in protective

CSAs. These firms will be either forced to divest or to restructure their businesses in Canada (a change in generic strategy). This is again a case of the inefficient local Canadian producers that were sheltered from foreign competition through trade barriers, but which may now be forced to exit, depending upon exit barriers, unless they are able to adopt a focus strategy that can be sustained against competition. Examples occur in the feather, egg, dairy and related industries protected by marketing boards. In all these cases, both exit barriers for local firms and entry barriers for efficient foreign competitors are low. Only if protective mechanisms such as marketing boards are kept, and they werc excluded from the free trade agreement, will such businesses survive. It also applies to certain operations of Canadian multinational enterprises that were only economically viable because of a protected Canadian market, as in the food and beverage industry.

The fifth case is that of the businesses already in quadrant 2. The bilateral trade agreement may have the effect of accelerating relocation to countries with high CSAs. This case is similar to case 2 above. It can be expected however that multinational enterprises in this quadrant already have diversified their geographic scope and/or will not be affected at all by a free trade area: Seagram in the beverage industry and Moore in the technologically intensive information systems industry are examples.

Finally, the sixth case consists of those businesses already in quadrant 4 for which the introduction of trade liberalization could speed up the divestment process. This quadrant basically describes inefficient operations of any type of firm: multinational enterprises or local firms. Exit will again depend upon exit barriers. Certain operations of such a firm as Varity (Massey Ferguson), may fall into this quadrant.

VI. *Conclusion*

In this article, a new framework was developed to gain conceptual insights into the effect of trade liberalization between Canada and the United States on the strategies of multinational enterprises. A matrix (Figure 1) makes it possible to classify the efficient operations of multinational enterprises, according to the nature of their firm specific advantages and country specific advantages. This framework was then extended (in figure 2) to analyze the effect of a change in one particular aspect of country specific advantages, namely trade policy, on efficient and inefficient operations of multinational enterprises.

It was found that most Canadian operations of Canadian and U.S. multinationals will maintain their competitive strengths after the introduction of a bilateral trade agreement. However, some operations of multinational enterprises (especially those with weak firm specific advantages) will have to engage in strategic changes to minimize adjustment costs. In general, theoretical concepts of strategic management work well to explain and predict the strategic responses of multinational enterprises to change in bilateral trade policy.

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