

Trends in Foreign Investment in Canada's Forest Industry

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Foreign capital, foreign entrepreneurs and foreign markets have been important influences in the development of Canada's natural resource industries. These foreign links, coupled with the importance of the resource sectors, have given natural resources a special role in Canada's economic history. They have led economic historians to explain Canada's growth in terms of the "staple theory", which holds that economic development proceeds through a progression from one natural resource to another — furs, fish, minerals, timber, and petroleum — responding to foreign demand for the products and depending on foreign capital and entrepreneurship to produce them (Innes, 1956).

These foreign influences on the Canadian economy have always been controversial. With respect to foreign investment, particularly, the attitude of Canadians and their provincial and federal governments has been somewhat ambivalent, alternately (and often simultaneously) wooing foreign investors to spur economic growth and shunning them to protect Canadian ownership and control of resources. Thus foreign investment has been a continuing issue in public debates about Canada's economic policy, and it has figured prominently in commissions and inquiries on Canadian economic strategy (Gordon, 1957; Watkins, 1968; MacDonald, 1985; Porter and the Monitor Company, 1991).

In 1962, the Corporations and Labour Union Returns Act (CALURA) was passed specifically "... to evaluate the extent and effect of non-resident ownership and control of corporations." This Act calls for annual reports, which provide Statistics Canada with information on foreign-held assets and equity (which we refer to later in the article). In 1974, in response to public anxiety about growing foreign ownership and control, the Foreign Investment Review Agency (FIRA) was set up to monitor and regulate foreign investment in Canada. The controversial FIRA operated until 1985, when it was replaced by the less restrictive Investment Canada. This marked a significant reversal in policy, reflected in the new agency's lower hurdles to foreign investment. More recently, Canada's free trade agreements with the United States and Mexico opened the door even wider to foreign investors from these countries, though not without a great deal of controversy that continues today.

Public debate focuses on two aspects of this issue. One is the trend in foreign investment, especially whether it is increasing or decreasing, in terms of both its absolute level and its relative share in particular industries. The other is the form of the investment, particularly whether it represents passive portfolio investment or control of Canadian firms and resources. The parties to the debate tend to be polarized and their arguments political and uncompromising. Yet the issues can be evalu-

ated only through careful analysis of the magnitude and form of foreign investment, how it affects the Canadian political economy, and its related consequences for Canadians with reference to the broad objectives of public policy.

This article examines recent trends in foreign investment in the Canadian forest products industry. This industry has historically been the focus of much of the broader debate about foreign investment and control in Canada (Lower, 1938; Gillis and Roach, 1986). Recent developments have drawn renewed attention to this industry and the influence of foreign capital on it (Noble, 1989).

The article consists of four main parts. The first, beginning in the next section, documents trends in foreign investment in Canada's forest industry. The amount and proportion of foreign investment is traced, and a striking shift in the sources of foreign capital is noted. The second part analyses these trends in each of the major sectors of the industry — timber holdings, sawmilling, and pulp and paper manufacturing. More detailed information available for British Columbia is used to examine these developments. The third part offers an explanation of the observed trends in terms of changing international circumstances in forest products production and marketing, and the incentives of foreign investors. The final section discusses the policy implications of the observed trends.

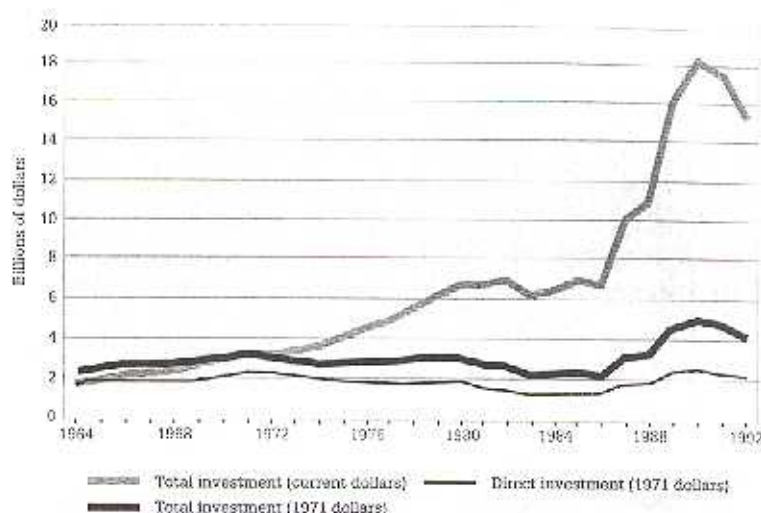
Recent Trends in Foreign Investment

Level and Form of Foreign Investment

Long-term foreign investment in the Canadian forest industry over the last 29 years, measured in current dollars, is shown in Chart 1. The chart indicates that the level of investment rose fairly steadily until 1986, then accelerated. Over the whole period from 1964 to 1992, foreign investment increased from \$1.7 billion to \$15.5 billion.

To illustrate the inflation-adjusted trend in foreign investment, Chart 1 also shows these annual stocks expressed in constant 1971 dollars. This shows that much of the apparent increase over the 29-year period is attributable

Chart 1 Foreign Investment in the Canadian Forest Industry

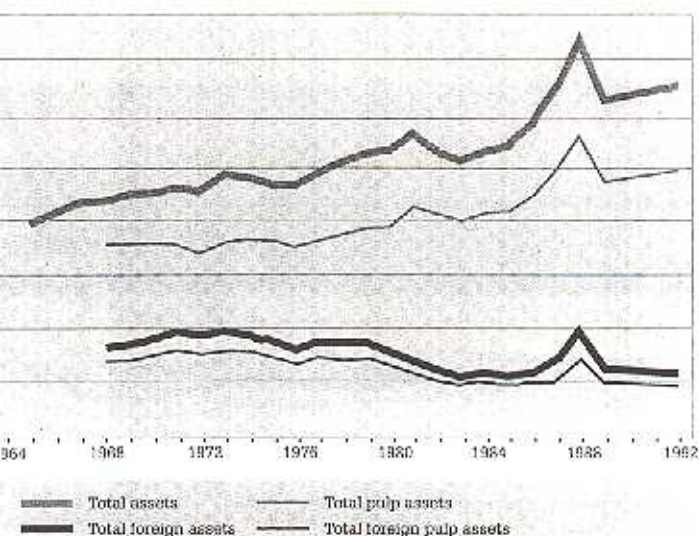


Source: Statistics Canada, Catalogue 67-202, various years and Catalogue 11-210

to inflation, and that the real value of foreign investment actually declined from the 1970s to the mid 1980s. However, this decline was more than made up in the sharp increase following 1986, and record highs were reported in 1990. Over the entire 29-year period, total real foreign investment in the forest industry almost doubled.

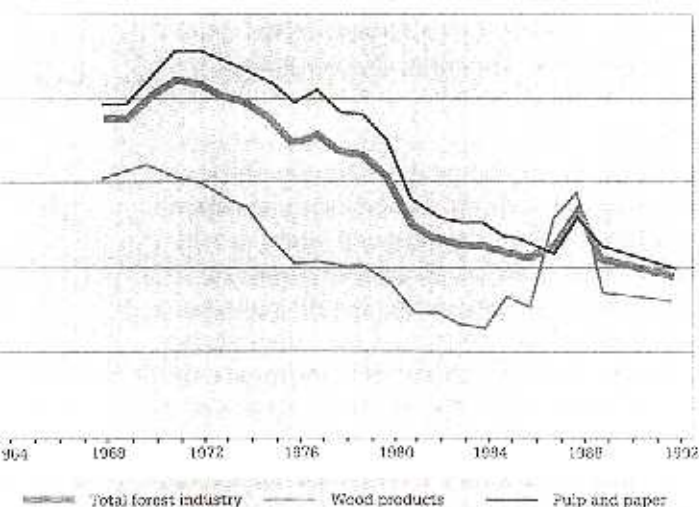
Long-term investment is traditionally classified as either *direct* or *portfolio* investment. Although the line between them is often blurred in practice, Statistics Canada (1995) defines and distinguishes them to provide a measure of foreign control over the industry. Foreign *direct investment* is investment made by foreigners in Canadian enterprises in amounts or in kinds which enable the foreign investor to influence the management of the enterprise. Investment is classified as direct where the investor owns at least 10 per cent of the equity in a firm, but it includes, in addition to the equity owned, any other long-term claims against the enterprise in such forms as bonds, debentures, loans, and advances. *Portfolio investment* consists of financial assets such as stocks and bonds, in amounts considered unlikely to convey a controlling influence in decision-making within the enterprise. It is important to note that, under this classification, both direct investors and portfolio investors may hold both equity and debt issued by an enterprise.

Chart 2 Assets of the Canadian Forest Industry



Source: Statistics Canada, Catalogue 61-210, various years.

Chart 3 Share of Assets in the Canadian Forest Industry Held by Foreigners



Source: Statistics Canada, Catalogue 61-210, various years.

For present purposes, the important difference between direct investment and portfolio investment is in the control over Canadian companies it gives to foreigners. Direct investors, in addition to exercising their voting rights as shareholders and thereby influencing the management of the enterprise, typically contribute management services as well as capital, thus exercising some control over

the way their capital is used. In contrast, portfolio investors are less concerned with influencing policy and the operations of an enterprise; accordingly, they are usually considered by economic nationalists to be less threatening than direct investors.

Foreign direct investment has consistently been the largest of the two categories, but the gap between them has narrowed. From 76 per cent in 1964, direct investment's share of the total declined to 55 per cent in 1992 (Chart 1). Apart from divergent trends between 1975 and 1985, the direct and portfolio components of total foreign investment in the forest industry followed much the same pattern: increasing up to 1971 followed by decline, and trending steeply upward over the last half of the 1980s followed by another decline. With the exception of a slight trough between 1972-1976, and in 1991-1992, foreign portfolio investment increased in real terms throughout the 29 year period. The period of decline in direct investment, which contributes to the decline in total foreign investment, overlapped the life of FIRA, suggesting the restrictive influence of that program.

Share of Foreign Investment

These trends in foreign investment were undoubtedly influenced by a variety of factors in addition to government policies such as FIRA. One is the pattern of overall investment in the industry. This can be traced with the help of the historical statistics on Canadian and foreign-held assets presented in CALURA reports.¹

Foreign-held assets differ from Statistics Canada's definition of long term foreign investment (referred to in the preceding paragraphs) by including short-term investment and undistributed earnings. However, the comparison of foreign-held assets shown in Chart 2 with long term foreign investment shown in Chart 1, both measured in constant 1971 dollars, shows that the difference between the two statistics is small and their trends over time broadly similar. (However, the CALURA statistics are available only over the shorter period indicated in Chart 2.)

As Chart 2 shows, the value of assets in the Canadian forest products industry, measured in constant dollars, grew fairly steadily between 1965 and 1992. Consequently, the de-

cline in foreign investment between 1972 and 1986 caused the foreign share to decline as well. The fraction of the industry's total assets held by foreigners declined gradually from about 40 per cent to 20 per cent by 1992, as shown in Chart 3.

The forest industry's share of foreign investment in the whole of Canada's manufacturing sector declined as well. While the industry accounted for as much as 24 per cent of all foreign investment in Canadian manufacturing in 1971, its share had fallen to 15 per cent by 1985. This decline was especially marked in the category of portfolio investment, but it was significant in direct investment as well. During this period the forest sector's contribution to total manufacturing output in Canada fell only slightly, from 14 per cent in the mid-1960s to 13 per cent in the 1980s. Since the FIRA program applied to all Canadian industries, these observations suggest that other influences, as well, were affecting foreign investment in the forest sector.

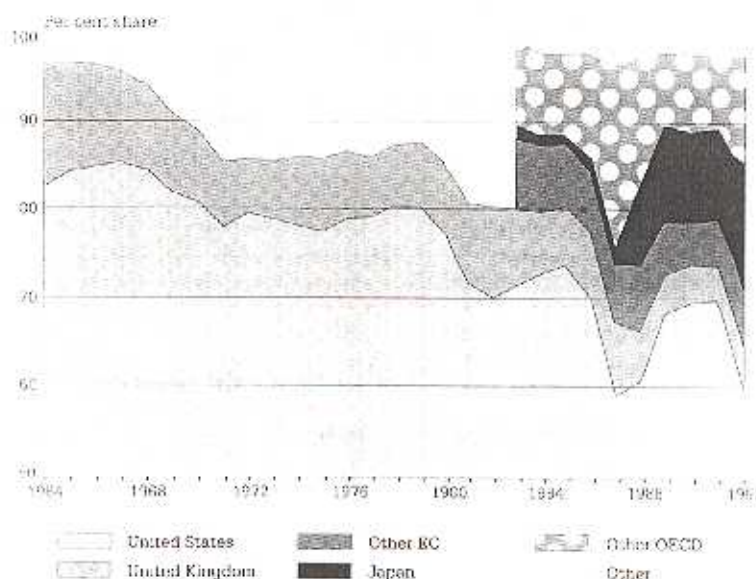
Sources of Foreign Capital

In recent years, and indeed throughout this century, the United States has been overwhelmingly the leading source of foreign investment in Canada's forest industry. However, the U.S. share of total foreign investment has been declining.

As Chart 4 shows, the U.S. share of long term foreign investment declined gradually and irregularly until the late 1970s, when the decline accelerated. Notwithstanding a couple of short recoveries in the 1980s, the decline since 1979 has been substantial. The U.S. share fell from 84 per cent of total foreign direct investment in 1964 to 60 per cent in 1992. The U.S. share of portfolio investment also declined from 84 per cent in 1964 to 63 per cent in 1992.

The second largest source of foreign investment in the forest industry historically has been the United Kingdom, but the relative importance of this source also has declined throughout the period examined here. By 1989, the United Kingdom accounted for less than 5 per cent of total foreign investment in Canada's forest industry, compared to 14 per cent in 1964.

Chart 4 Sources of Foreign Investment in Canada's Forest Industry



Source: Statistics Canada, Catalogue 67-202, various years.

Note: Before 1983, other refers to non-U.S. and non-U.K.

The most dramatic trend has been the increasing share of industrial countries other than the United States and the United Kingdom, for which Statistics Canada provides a partial breakdown only since 1983, as shown in Chart 4. The proportion of total foreign investment originating in countries other than the two traditional leaders increased gradually during the two decades following 1965, prior to which it was negligible. In 1986 and 1987, these other sources increased their share sharply, and, after a decrease between 1988 and 1991, increased again in 1992. By 1992, the share of industrialized countries other than the United States and the United Kingdom had grown to 38 per cent of total foreign investment.

The first wave of investment from sources other than the United States and Britain occurred in the years preceding 1971, when most of the increase in foreign investment (indicated in Chart 1) was attributable to such sources. Much originated in Scandinavia and other European countries. The next wave began in the early 1980s. While total foreign investment did not change greatly during this period, significant disinvestment by U.S. investors was offset by new investment from other sources, especially New Zealand and Scandinavia (which are included in the

Table 1 Numbers of Firms Having Majority Foreign Ownership and their Share of Timber Rights and Manufacturing Capacity in British Columbia¹

	1975	1980	1990
	number		
number of firms:			
0% foreign owned	15	18	7
1-99% foreign owned	6	5	8
1-74% foreign owned	8	5	3
	per cent of total		
share of timber rights ²	34.5	36.5	30.4 ³
share of manufacturing capacity:			
timber	29.1	33.1	26.1
pulp	37.4	37.7	45.2
paper	17.6	28.9	45.3
veneer and plywood	43.2	43.2	36.5

Source: B.C. Ministry of Forests (1991a and 1991b); Forestry Canada (1989); Pearce (1976 and 1980).

¹ Companies having majority foreign ownership are defined as firms in which non-residents own more than 50 percent of the outstanding shares. Excluded are firms which are exactly 50 percent foreign-owned (see Table 2).

² The share of timber rights is calculated as the percentage of the committed allowable annual cut.

³ Excludes timber allocated under the Small Business Enterprise Program, which did not exist in the earlier years of this table (inclusion of this category would reduce the figure to 26.3 percent).

"Other OECD" category in Chart 4) and Japan. The most recent wave has accompanied the dramatic increase in total investment in the latter half of the 1980s. This is due primarily to vigorous expansion by investors from Japan and other OECD countries.

By the mid-1980s, U.S. investment ceased its decline and began to increase, and by the end of the decade U.S. and U.K. investment had regained their 1971 real level. Thus most of the increase in foreign investment since 1971 came from other countries, mainly Scandinavia, New Zealand and Japan. These data also indicate that the new source countries provided new foreign capital and did not simply replace other foreign investors.

Foreign Investment by Industry Sector

CALURA reports also provide data that enable us to trace certain trends in foreign investment within the principal sectors of the forest industry. Foreign-held assets in both the pulp and paper industry and the wood products industries (mainly sawmilling) follow a pattern roughly similar to that of total foreign investment. However, foreign investors appear to have preferred the pulp and paper sector over the wood products. This is reflected in Chart 3, which shows the relative shares of total assets held by foreigners in these two sectors of the industry as well as in the industry as a whole. Nevertheless, the foreign-held share of assets in the pulp and paper sector as well as in the wood products industries has declined over the last 25 years.

In wood products, the decline ended in 1984, and showed a sharp increase in the subsequent four years, then again falling below the percentage of assets held by foreigners in the late 1960s. These trends are the combined effect of growth in total assets in these industries, and reduction in foreign holdings. As these industries have expanded, foreigners have divested holdings to Canadians.

Foreign Ownership in British Columbia's Forest Industry

Additional insight into patterns of foreign ownership and control can be gained from data on the forest industry in British Columbia. This is by far the leading province in Canada's forest industry, accounting for 45 percent of both the timber harvested and the value of forest products produced (Forestry Canada, 1988). However, as we will see, the industry in British Columbia differs from that in other provinces, as do some of the trends in foreign ownership. Statistics Canada does not compile provincial statistics on ownership, such as those above. However, information about individual firms, available in British Columbia, can be aggregated to reveal the extent of foreign ownership in each of the major sectors of the industry in the province, including holdings of resource rights (which is probably the most sensitive issue in public discussion).

Fortunately, some historical compilations of this kind enable an examination of trends.

Table 1 shows the extent of foreign majority ownership within sectors of British Columbia's forest industry, in terms of the number of firms and their share of rights to timber and manufacturing capacity in 1975, 1980 and 1990. These data refer to firms *majority owned* by foreigners; that is, firms whose foreign shareholders hold more than 50 per cent of their total shares outstanding. Table 2 lists the companies that comprise this category. It also shows joint ventures that are equal partnerships between Canadians and foreigners (listed as exactly 50 per cent foreign owned).

The data in Table 1 show a decline, over the last decade at least, in the share of timber rights, and of manufacturing capacity for lumber and plywood, accounted for by firms having majority foreign ownership. More conspicuous, however, is the increase in the share of pulp and paper manufacturing plant owned by such firms. By 1990, firms more than 50 per cent foreign-owned accounted for almost half the total pulp and paper manufacturing capacity in British Columbia, having grown substantially over the preceding decade. This expansion contrasts with the declining share of foreign-held assets in the pulp and paper sector of Canada as a whole, noted earlier.

The data for British Columbia, coupled with our earlier observations about trends in Canada as a whole, indicate that the downward trend in the proportion of assets held by foreigners is paralleled by a decline in the number of firms in the industry having majority foreign ownership, and in their share of the timber supply and of wood products manufacturing capacity. However, their share of manufacturing capacity in the pulp and paper sector has grown significantly.

The lists of foreign-owned firms in Table 2 substantiate some of the broad changes noted earlier in the industry in Canada as a whole. The 1975 list reveals the predominance of U.S. owners. But even then, U.S. disinvestment had begun. Notably absent from the list is Columbia Cellulose, a subsidiary of the Celanese Corporation, having been purchased by the B.C. government in 1973. The government had also purchased the pulp and

paper complex at Ocean Falls from U.S.-owned Crown Zellerbach.

After 1975, more U.S. firms disappeared from the list, having been purchased by Canadians. Canyon Creek and Triangle Pacific were bought by Canadian-owned Slocan Forest Products, and Swanson was acquired by Canfor. Rayonier was purchased by a consortium of Canadian forest companies and banks, and is now owned by locally-based Doman Industries. Others that became majority Canadian owned are Evans Products, the Pas Lumber and MacGillis & Gibbs.

These changes contributed to the increase in domestic ownership and to the decline in the U.S. dominance among foreign sources of investment noted earlier. Disinvestment of British and European interests after 1975 mainly involved Canadian patriation as well. Thus Canadians acquired majority ownership of Netherlands, Tahsis, Intercontinental Pulp and Prince George Pulp and Paper. In addition, Japanese-owned Crestbrook Forest Industries purchased Dutch-owned Crows Nest Industries.

Some U.S. owners were replaced by other foreign investors, notably through the purchase of Crown Zellerbach's B.C. assets by New Zealand's Fletcher Challenge in 1983. American-owned Peace Wood Products was bought by a British firm in the early 1980s, though this firm later sold it to Canadian interests. The opposite occurred when U.S.-owned West Fraser acquired shares in Eurocan from Finnish interests.

There was also some acquisition of Canadian firms by foreigners, the major example being the takeover of British Columbia Forest Products in 1987 by New Zealand-controlled Fletcher Challenge Canada. In addition, a Chinese company entered into a joint venture to purchase Celgar Pulp.

As we noted earlier, new foreign investment during this later period came almost entirely from Asia-Pacific countries, and concentrated on the pulp and paper sector. Thus Japanese firms became joint venturers with established Canadian and U.S. firms in enterprises in Table 2 newly listed in 1990, such as Quesnel River Pulp and Paper and Howe Sound Pulp and Paper. These firms contributed to the increase in the majority foreign-owned share of

**Table 2 Forest Products Firms in British Columbia
Having Majority Foreign Ownership**

Percent Foreign Owned	1975		1980		1989	
	Firm	Nationality ¹	Firm	Nationality ¹	Firm	Nationality ¹
00	Bell Pole Co.	U.S.	Bell Pole Co.	U.S.	Bell Pole Co.	U.S.
	Canyon Creek	U.S.	Canyon Creek	U.S.	CIPA Lumber	JPN
	Darkwoods Forestry	DEU	CIPA Lumber	JPN	Crown For. Prod.	N.Z.
	Eurocan	FIN, U.S.	Crows Nest Industries	NLD	Darkwoods Forestry	DEU
	Evans	U.S.	Darkwoods Forestry	DEU	Louisiana Pacific	U.S.
	Merrill & Wagner	U.S.	Eurocan	FIN, U.S.	Pope & Talbot	U.S.
	Netherlands	U.K.	Evans	U.S.	Weyerhaeuser	U.S.
	The Pas Lumber	U.S.	Merrill & Wagner	U.S.		
	Pope & Talbot	U.S.	Netherlands	U.K.		
	Q.C. Timber	JPN	Northwood Properties	U.S.		
	Rayonier	U.S.	Pope & Talbot	U.S.		
	Swanson	U.S.	Q.C. Timber	JPN		
	Tahsis	DNK, U.S.	Rayonier	U.S.		
	Triangle Pacific	U.S.	Salmo Forest Prod.	U.S.		
	Weyerhaeuser	U.S.	Swanson	U.S.		
			Tahsis	DNK, U.S.		
			Triangle Pacific	U.S.		
			Weyerhaeuser	U.S.		
5-99	Crown Zellerbach	U.S.	Crown Zellerbach	U.S.	Babine Forest	FIN, U.S.
	CIPA Lumber	JPN	Lakewood Lumber	U.S.	Cariboo Pulp & Paper	JPN, U.S.
	MacGillis & Gibbs	U.S.	MacGillis & Gibbs	U.S.	Celgar Pulp	CHN, U.S.
	Peace Wood Prod.	U.S.	Mayo	JPN	Eurocan	FIN, U.S.
	Prince Rupert For.	JPN	Peace Wood Prod.	U.S.	Houston Forest Prod.	FIN, U.S.
	Weldwood	U.S.			Onesnel River Pulp	JPN, U.S.
					Weldwood	U.S.
					West Fraser	U.S.

Table 2 (con't)

Per cent foreign owned	1975		1980		1989	
	Firm	Nationality ¹	Firm	Nationality ¹	Firm	Nationality ¹
51-74	Babine Forest	FIN, U.S.	Babine Forest	U.S., FIN	Crestbrook Forest	JPN
	Crestbrook Forest	JPN	Fraser Lake/Ft. Fraser	U.S.	Fletcher Challenge	N.Z.
	Crows Nest Industries	NLD	Scott Paper	U.S.	Scott Paper	U.S.
	Fraser Lake/Ft. Fraser	U.S.	Weldwood	U.S.		
	International Pulp	DEU, U.K.	West Fraser	U.S.		
	Mayo	JPN				
	Scott Paper	U.S.				
	West Fraser	U.S.				
50	Prince George Pulp	U.K.	Crestbrook Forest	JPN	Howe Sound Pulp & Paper	JPN
	Northwood Pulp & Timber	U.S.	Northwood Pulp & Timber	U.S.	Northwood Pulp & Timber	U.S.

Source: Statistics Canada (1991), Pearse (1976 and 1980), Forestry Canada (1989).

DNK = Denmark, CHN = China, FIN = Finland, DEU = German, NLD = Netherlands, JPN = Japan, N.Z. = New Zealand.

the pulp and paper industry in British Columbia in recent years. In contrast, none of the firms in Table 2 newly listed in 1990 is specifically associated with expansion of lumber manufacturing.

Interpretation of Trends

The forces shaping these changes in foreign participation in the forest industry are inevitably varied and complicated. However, it is possible to explain the main trends in terms of the determinants of international capital movements generally, developments in regional patterns of supply and demand for forest products, the structural character of the forest industry, and governmental policies.

Financial Returns

In making investment decisions, investors, foreign or domestic, can be assumed to be guided in the first instance by their expectations about returns and risks on capital in-

vested in alternative ways. Many also seek to diversify the risk in whole portfolios of investments. Foreign investor decisions about investing in Canada's forest products industry are thus guided primarily by the expected financial performance of the industry relative to other possible investments.

In comparing U.S. and Canadian forest products companies, Schwindt (1985:55) found that "... financial performance, both in aggregate, and by product specialization group, is roughly similar across countries." His results suggested that, although Canadian companies lagged slightly in return on equity, they performed slightly better in return on total capital employed. This is consistent with our finding that foreign portfolio investors have found the Canadian forest industry attractive, and increasingly so relative to foreign direct investors.

The Policy Environment

When considering investments in foreign countries, direct investors also look for politi-

cal stability, sound economic and trade policies, favourable tax policies, the availability of a competent labour force, secure supplies of energy and raw materials, and suitable infrastructure. In these respects, broadly referred to as the "investment climate," Canada is generally considered to offer an attractive environment for foreign investors.

However, a governmental policy such as FIRA can be expected to contribute to a decline in direct investment, as we observed during the life of this program, through both its direct restrictive impact on investments and its effect on foreign investors' perceptions of opportunities in Canada. This is consistent, also, with the observed decline during this period of direct foreign investment relative to portfolio foreign investment, since the latter was largely unaffected by FIRA.

Regional Supply and Demand

The disparity, among world regions, between their demand for forest products and their resource supply is significant and increasing. While demand has continued to grow in the traditional consuming areas of Europe and the United States, consumption has expanded vigorously in the Asia Pacific region in recent years. On the supply side, scope for expanded production of timber, particularly softwoods, is limited mainly to certain regions of Canada and Europe, possibly Russia, and countries with expanding plantation forestry such as New Zealand and Chile. The imbalance between regional supplies and demands has been aggravated by the elimination of some traditional sources of supply for industrialized countries of the Asia-Pacific region. Prohibitions on either logging or log exports have been adopted in countries such as Indonesia, Malaysia and Thailand (Marchak, 1991).

As a source of supply of raw material for the forest products industry, Canada historically offered relatively abundant natural resources at attractive prices. Canada contains 7.5 per cent of the world's stock of merchantable timber and 15.6 per cent of the softwood (Forestry Canada, 1988). British Columbia alone claims a volume almost equal to that of the People's Republic of China, home to one-fifth of the world's population. Moreover, Canada's share of world timber production has

been increasing — from 5.1 per cent in 1970 to 5.7 per cent in 1987 — and there appears to be scope for further increase in some provinces (Food and Agriculture Organization, various years; Reed, 1986). Even more important to prospective foreign investors, the cost of timber in Canada is considerably lower than in other supply regions such as Scandinavia and the United States (Haley, 1980; Singh, 1988). These advantages have been gradually disappearing, however. British Columbia, Quebec and Ontario are now not expected to be able to maintain current harvest rates of softwood much longer, and the costs of timber in Canada were higher than in the United States by the later 1980s (NHK Consultants Inc., 1992).

Not surprisingly, therefore, companies involved in forest products manufacturing and marketing in countries that are net importers of these products are attracted to Canada as a source of raw material for expansion. A ready means of securing access to these resources is through investment in established enterprises that hold rights to timber in Canada. Thus established forest products companies in resource-poor countries are lured into joint ventures or takeovers in British Columbia and elsewhere in Canada. Such integration "backward" into resources and basic manufacturing is evident in the trends observed above — the expansion into the Canadian industry of forest products firms based in Japan, the industrialized countries of the European Union and even developing countries such as China and South Korea. Increasingly, the outputs from joint ventures held by foreigners go to these countries. For example, Celgar pulp sells about half of its output to China.²

Firms in foreign countries that are net exporters of forest products are motivated by opportunities to expand in world markets, and thus look for new opportunities to apply their special technical, managerial, or marketing skills to increase their market shares. They integrate "horizontally" into parallel lines of production in other countries such as Canada. This type of behaviour can be seen in the early investment in Canada from Scandinavia and Germany, and more recently from New Zealand's Fletcher Challenge. Recent investments by U.S. companies, such as Stone Corporation's takeover of Consolidated Bathurst,

also reflect efforts to secure market share in an increasingly globalized industry.

Security for Investments

As suggested above, foreign firms already established in the forest products industry are attracted by the opportunity they find in Canada to protect their existing investments in manufacturing and related facilities by securing access to raw materials. Canadian forest products companies, also, are concerned about the security of their investments; their concern, however, is typically less about raw materials than it is for assured markets for their products. One solution is an association or merger with a partner having an established position in foreign markets. The strongest candidates for foreign partnerships are firms in countries with large markets but limited natural resources. Thus the search for secure markets on the part of Canadian firms complements the search for secure raw materials on the part of foreign firms, which finds expression in the joint ventures and partnerships observed in British Columbia in recent years, exemplified by Celgar, Quesnel River Pulp, Cariboo Pulp and Paper, and Howe Sound Pulp and Paper.

Capital Intensity and Market Structure

Our analysis of trends reveals that foreign investment in the pulp and paper sector has greatly exceeded that in the wood products industries. This reflects, in part, the fact that Canada's pulp and paper sector as a whole accounts for many more assets than the wood product sector, the former being both larger and more capital intensive. But we also noted that, over most of the last three decades, the foreign *share* of total assets was higher in the pulp and paper sector.

A conspicuous characteristic of the pulp and paper industry is its economies of scale. The combination of scale economies and capital intensity means that pulp and paper ventures involve huge amounts of capital, much more than solid wood processing ventures. This in turn gives investors stronger incentives to secure access to raw materials and markets through acquisitions, mergers and new investments.

The economies of scale and capital intensiveness of the pulp and paper sector also serve as barriers to new entrants in the industry, and contribute to its characteristic oligopolistic industrial structure (Booth, 1990). These conditions lead to industrial growth mainly through expansion of existing firms, and to competition among them largely in the form of competition for market shares. Foreign firms seeking to expand therefore find it advantageous to do so through investments in established firms rather than by means of new ventures (Caves, 1974). Acquisitions and mergers provide them a direct means of expanding their market shares.

In the more highly competitive international lumber industry, for example, foreign distributors do not find it necessary to secure control of production in Canada or other supply areas in order to expand their product supply, nor do Canadian producers need to merge to secure markets. These differences undoubtedly help to explain the much greater activity of foreign investors in the Canadian pulp and paper industry than in the wood products industry. It is worth noting that Canadians, too, have found the pulp and paper sector more attractive; the share of total Canadian assets in the forest industry accounted for by this sector increased during the 1970s and 1980s.

Another factor contributing to the preference for the pulp and paper industry may be the expectation of faster growth in this sector. Pulp and paper consumption is considerably more responsive to rising incomes than is the demand for solid wood products (Buongiorno, 1978 and 1979). Thus the Food and Agriculture Organization (1991) predicts relatively strong growth in pulp and paper demand in the near future.

A final comment is warranted on the apparent divergence of trends between British Columbia and Canada as a whole in the degree of foreign participation in the pulp and paper industry. Although the two sets of data differ somewhat, the B.C. statistics, in contrast to those for Canada, suggest sharp growth in the proportion of the industry under foreign ownership and control.

Two possible explanations can be offered. One is the favourable geographic location of

British Columbia on the Pacific rim, which provides favoured access to some of the world's fastest-growing markets and hence also foreign investors. The other is that much of Canada's growth in timber production in recent years has occurred in British Columbia. Foreign investors searching to secure supplies of raw materials in the highly-capitalized pulp and paper sector can be expected to be attracted to areas having the greatest scope for expansion. (Another of the few regions offering such scope is Alberta, which has also attracted new foreign investment in recent years.) It is relevant to note, also, that the growth in the foreign-controlled share of the industry in British Columbia reflects large investments by a few companies, rather than a general trend across the forest industry.

Policy Implications

Measured in constant dollars, foreign investment in Canada's forest industry has almost doubled in the past 29 years. However, investment by Canadians was even greater, with the result that the share of assets held by foreigners in both the pulp and paper and wood industries has declined significantly. Most of the increased foreign investment has occurred since 1986.

The sources of foreign investment have changed considerably over the past three decades. Traditional flows of investment from the United States and the United Kingdom have yielded, first to investors from Scandinavia and other European countries, and more recently and more dramatically to investors from the Asia-Pacific region. These investors have been attracted to the pulp and paper sector much more than the wood products sector.

Foreign participation in pulp and paper manufacturing has grown much faster in British Columbia than in Canada as a whole, and in this province the share of the industry under foreign ownership and control has increased considerably during the last decade. These trends are not evident, however, in holdings by majority foreign-owned companies of timber rights and wood products manufacturing capacity.

Policy Effectiveness

These trends have important implications for several issues of public policy. Most apparent are the impacts of the federal government's changes in foreign investment policy. During the period from 1974 to 1985, while the federal government's FIRA was in effect, foreign investment actually declined. The impact of FIRA restrictions is evidenced in the marked decline in the category of direct investment, while portfolio investment continued to increase. However, the decline in foreign investment was deeper than that for all manufacturing sectors taken together, suggesting that influences specific to this industry were at work as well.

Equally conspicuous was the effect of the shift in policy in 1985, when the newly-elected Conservative government abolished FIRA and replaced it with Investment Canada "to encourage investment in Canada by Canadians and non-Canadians."³ Foreign direct investment inflows jumped from a fairly steady \$4 billion annually during the preceding five years to an average of \$10 billion in the following five (Duncan, 1992). Foreign direct investment in the forest industry followed this pattern of decline during the FIRA period and a steep upward climb thereafter.

It should be noted that foreign investment burgeoned worldwide in the second half of the 1980s, especially in Britain, the United States and Canada, but in Canada the new federal policy undoubtedly provided an accommodating atmosphere. In its first five years of existence, Investment Canada reviewed only 25 per cent of foreign investment proposals, all of which were approved (Investment Canada, 1990).

Promotion of Canadian Competitiveness

The new, more receptive policy on foreign investment can be viewed as one element in a broader economic policy aimed at promoting Canadian competitiveness in the emerging globalized economic order. This objective has dominated the federal government's economic agenda in recent years, evidenced by its attention to free trade, tax reform and the "prosperity initiative." It has been given urgency by the recent decline in productivity

growth, especially in manufacturing, relative to other industrial countries (Economic Council of Canada, 1992).

In this context, new capital is seen as a key to improve competitiveness of Canadian industry through its effect in enhancing the productivity of labour and other inputs in production. For the longer term, new capital investment — domestic and foreign — is regarded as a means of introducing the advanced equipment, new production technologies and research and development needed to build a stronger and more diversified economy (Government of Canada, 1992). To attract this investment capital, Canada needs a favourable investment climate. Among other conditions that contribute to the perception that Canada is a good place to invest (such as political and economic stability, skilled labour, good infrastructure, and social security) is an hospitable policy toward foreign investment.

These issues were analysed in a recent study of Canadian economic policy in the increasingly global world economy by Michael Porter and his colleagues (Porter and the Monitor Company, 1991). In Porter's model, Canada's advantage in resource industries stems from its natural resource base, but continuing growth depends on the strength of the interconnected elements in his "diamond," which includes factor endowments, domestic demand, support industries and competition, as well as government policy. A rich natural resource base is not sufficient to sustain international competitive advantage; that can flow only from continuing improvement and innovation, which depends on dynamic interaction among the other elements of the diamond. Moreover, resource abundance tends to weaken incentives to innovate, leaving economies like Canada's vulnerable to adverse shifts in technology, markets and international competition. Thus "The key test we must apply in appraising Canada's resource-based industries is their record in upgrading competitive advantage" (Porter and the Monitor Company, 1991: 29).

We can make a couple of observations about the contribution of foreign investment to the competitiveness of Canada's forest industry. On the one hand, there are good examples where foreign investment has led to a sub-

stantial upgrading of plant (such as Howe Sound Pulp and Paper and Celgar Pulp, both in British Columbia). Nevertheless, the industry as a whole has been losing its competitiveness over the last 20 years (Woodbridge, 1992:15). In the forest industry, most foreign investment is driven by foreign firms seeking access to timber supplies. Little has resulted from foreign firms establishing their home base of international operations in Canada — the kind of foreign investment which Porter views as evidence that the host country possesses true international competitive advantage in the industry. Perhaps because of this, the forest industries remain producers of only crudely manufactured commodity products — mainly pulp, newsprint and construction lumber. They show conspicuously low levels of research and development expenditure.

The motivation and form of foreign investment in Canada's forest products industry may also prevent it from strengthening other elements in Porter's diamond of international competitiveness. Where domestic producers are instruments for securing access to raw material supplies for foreign firms, they cannot be expected to exhibit aggressive rivalry in domestic markets. The same is true of the cluster of local support industries; most machinery and equipment is purchased not from local suppliers but is either imported or produced in Canada by foreign firms using technology developed elsewhere. Nor can foreign investment do much to expand the industry's volume of production, because the raw material supply is largely owned and regulated by provincial governments. Thus, by the criteria of Porter's model at least, the foreign investment observed in Canada's forest industry is not the kind most likely to improve the industry's international competitiveness.

In any case, the recent spurt of foreign investment began only in 1986, and more time is probably needed to observe its effects. The implications of foreign investment in the forest industry thus seem to warrant careful assessment in light of the special attributes of this sector that make it an important vehicle for strategic economic policy. These include its prominence in Canada's employment, industrial production and balance of payments; its critical role in rural communities and regional economies; its impact on the natural

environment; and public ownership of its resource base.

Foreign Investment and Economic Development

Porter's model is not the only one that offers insights into the implications of foreign investment. The trends we observe in the forest industry can be viewed as modern evidence of the staple theory, in which foreigners provide the capital, entrepreneurship and markets for resource development. A significant similarity of Porter's model to the staple theory is the dependence of economic progress on the development of linkages from the resource sectors forward and backward to other industries to generate a process of continuing economic growth and diversification.

However, the changing context of international capital flows must be recognized. Since World War II, international linkages have passed through distinct phases. The first was driven by *trade* following the dismantling of protectionist barriers in the 1950s and 1960s; the next in the form of *financial* integration fueled by the oil shocks, the recycling of the OPEC surplus, the deregulation revolution and the emergence of the Japanese current account surplus; and the present globalization of *entrepreneurship* characterized by a surge in international capital flows, especially foreign direct investment (Ostry, 1990).

The main agent in the current globalizing activity is the multinational enterprise, pursuing international mergers, acquisitions and other forms of international networking. A characteristic of this process is the linkage between investment and trade: a growing proportion of trade is intra-enterprise, resulting from foreign investments. Our observations about foreign investment in Canada's forest industry are consistent with this interpretation of global trends. The internationalization of modern corporations, including forest products producers, can be expected to alter the nature and effects of their foreign investments.

Other Implications

Finally, because foreign investment is often alleged to have a variety of implications other than purely economic ones, it is important to point out some effects which are unlikely or

for which we have no evidence. We have already commented on research and development expenditure and the development of value-added production; while both are widely accepted as important to long-run industrial vigour, and both are notably truncated in the forest industry, foreign investment of the kind we observe in the forest industry is not likely to strengthen them.

Considerable concern has centred on the growing concentration of the forest industry and whether foreign investment tends to aggravate this trend. Foreign ownership is more prevalent among large firms than small. And foreign investors may be attracted by industries which have high barriers to entry. But neither of these observations necessarily means that foreign investment contributes to the process of concentration; that is a question that awaits further research.

In any event, the concern about concentration and the erosion of competition arises not so much with respect to the industry's product markets as its markets for timber. Mergers and acquisitions have substantially reduced or eliminated competition for public timber in many timber producing regions of Canada, a development which many regard as contrary to the public interest. However, this is likely to be driven much less by foreign investment than by provincial forest licensing policies (Pearse, 1976 and 1993).

Several issues centre on possible implications of foreign investment for environmental protection, resource sustainability and the stability of resource-based communities (Government of Canada, 1990). The suggestion is that foreign owners will be less sensitive to these concerns, but there is no evidence of which we are aware to suggest that the source of capital makes any consistent difference. Provincial governments take primary responsibility for regulating harvest rates to sustainable levels, for determining expenditures on silviculture and enhancement of forest yields, and for the preservation of wilderness and other forest values, and in doing so they do not discriminate between domestic and foreign controlled firms (Canadian Council of Forest Ministers, 1992). However, our research was not aimed at revealing differences in behaviour toward the environment or local dependent communities.

Notes

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1. CALURA data are published in Statistics Canada, *Corporations and Labour Returns Act Report, Part I*, Catalogue 61-210.

2. Liping Li, personal communication, 1994.

3. Canada Investment Act 1985, Ch. 28, S2.

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