

free trade agreement comes into place. Inward FDI could rise or fall depending upon the location effects of the trade agreement. Canada could be a more desirable place for foreign firms to undertake production for both domestic and export purposes as trade barriers are reduced, with the implication that increased trade and inward FDI occur simultaneously, or are complementary to one another. On the other hand, a reduction in trade barriers could lower FDI in some sectors if firms no longer need to locate within the Canadian market in order to serve Canadian demand. In the latter case, FDI and trade would be viewed as substitutes as trade barriers are removed. With NAFTA, firms can produce from a US or Mexican base and then export to Canada. With respect to outward FDI there are similar tradeoffs from the point of view of Canadian multinational firms. Canadian outward FDI may transfer low-wage, low-skill production to other countries, and at the same time increase the production of high value-added goods to be exported, thus causing an increase in high-paying, high-skill jobs in Canada. Thus, it may be that higher outward FDI in one industry causes exports to increase in other industries. Even if one finds the intra-industry relationship between trade and FDI to be one of substitutes, they may be complements when considering inter-industry links. Some outward Canadian FDI may also simply reflect the attempt by Canadian firms to avoid trade harassment in the US market. On theoretical grounds, there are no strong a priori expectations as to the effect of FTA-NAFTA on FDI patterns other than an expectation that two-way flows would rise.

Given that there is potential two way causality running between trade and FDI, one would in principle like to know what aspects of the agreement might have spurred additional FDI in the absence of trade liberalization. The Canada-U.S. FTA included a number of provisions which reduced discrimination against bilateral foreign direct investment, including the extension of rights-of-establishment and national treatment. A range of prominent sectors, such as basic telecommunications, was excluded from coverage under the investment liberalization provisions of the Agreement and Canada's existing foreign investment screening procedures were left in place (Globerman and Walker, 1993). Nevertheless, the thrust of the investment provisions of the FTA was clearly to expand the legal scope for bilateral direct investment. Moreover, the inclusion of a relatively robust dispute resolution procedure arguably reduced the risks of either government acting in a discriminatory manner towards investors from the other country.

Independent of its relationship to trade liberalization, there is quite a large literature which establishes that FDI promotes competitiveness through increased innovation, technology transfer and international knowledge spillovers (Caves, 1974; Globerman, 1979; Blomstrom and Persson, 1983; Blomstrom and Wolff, 1989; Xu, 2000). Some of these studies will be reviewed later in this chapter when the growth and dynamic effects are discussed. The literature on these effects however is largely international in nature; no specific FTA studies deal with the issue directly.

There are also relatively few studies which attempt to isolate the impact of the FTA-NAFTA on FDI patterns or relate them to shifts in trade patterns. But, those that do, generally come to similar conclusions. Schwanen (1997) looks at