bilateral Canadian-US trade by sector and thus have no non-NAFTA countries for purposes of comparison. They estimate a time series model of Canadian export growth to the US from 1980 to 1998, finding that growth in Canadian exports to the US is largely explained by US income and the depreciation of the Canadian dollar. Their estimates suggest that of the total increase in exports, only 8 percent is due to the FTA. A close examination of their parameter estimates reports a US income elasticity for Canadian exports of 2.7—a highly implausible number. The results largely follow from the limited manner in which the impact of FTA-NAFTA are imputed.

Some of these studies focused on the issue of trade diverting effects of NAFTA from a US perspective including Canadian trade. Both Krueger (2000) and Soloaga and Winters (2001) are largely concerned with this issue and both focus on the US-Mexico aspect of NAFTA. Krueger claims to find no evidence of trade diversion and Soloaga and Winters find some mild evidence of trade diversion within NAFTA—largely these effects hinge on a shift towards Mexican produced goods at the expense of goods from East Asia.

A recent variant on the trade diversion argument has found its way into the Canadian policy debate following the release of John McCallum's (1995) study on international versus interprovincial trade using pre FTA data. It is well known that, subsequent to the FTA, there was a substantial increase in international trade, while there was a mild decline in interprovincial trade. From 1988 to 2000 interprovincial trade declined as a percentage of GDP from 27 percent to around 20 percent. Is it the case that "trade diversion" has occurred within Canada so that north-south Canada-US trade is replacing east-west interprovincial trade as a consequence of FTA? There are two points to make about this type of trade share shift analysis. First, and most important, the fall in the share of interprovincial trade cannot be trade diversion in the traditional sense. Trade diversion, which is income reducing, only occurs if a low cost source of imports is replaced with a high cost source of imports. In the absence of internal tariffs on trade between provinces, if a province shifts its source of imports from another province to a source outside of Canada, it cannot result in trade diversion There remains, however, the possibility that trade patterns shift and that clearly seems to have occurred in the data. Not surprisingly, the removal of barriers on international trade, with no barriers to interprovincial trade, led to an increase in international relative to interprovincial trade. Helliwell, Lee and Messinger (1999) use a gravity model to infer the extent of the shift in trade. Their estimates suggest that in 1996 interprovincial trade would have been 13 percent higher if the pre-FTA trade structure had remained in place *and* Canadian and US GDP by state and province were the same as actually existed in 1996. In the case of Canada, the latter assumption is highly implausible given the income creating effect of trade with the US that occurred over that period.

Foreign Direct Investment

The impact of trade agreements on FDI flows and stocks remains in general a contentious area. Unlike trade, the impact of increased outward and inward FDI is theoretically ambiguous with respect to its ultimate effects on economic performance. There are a variety of potential channels at work when a