As a **trading nation in world markets** and a continuing participant in and beneficiary from FDI flows, Canadian policy makers need improved access and information on international investment policies to construct effective policy frameworks which will attract investment, promote efficient production in Canada and assist Canadian investors abroad. To achieve a more open environment for FDI, and to increase the transparency of international FDI policies, it is recommended that Canada support the establishment of an FDI policy review mechanism similar to the GATT Trade Policy Review, while continuing to support and promote multilateral trade liberalization policies.

The paper develops the aforementioned policy considerations by examining key relationships between trade flows, economic growth and FDI flows.

Traditionally, the relationship between trade and economic growth suggests that trade is an important contributor to economic growth by allowing the optimal allocation of resources resulting from the specialized production of goods and services. In addition, countries will trade according to their comparative advantage in the production of goods and services. Export growth permits economies of scale and a degree of specialization that allow higher levels of production and hence, output, than could be sustained by a country's domestic demand. Import growth lessens potential supply shortages of goods and services used in production. International trade generates positive externalities that can raise the efficiency of production and stimulate economic growth.

Studies exploring the relationship between trade and investment have focused, due in most part to data limitations, on the impact of foreign direct investment (FDI) on trade flows. Early work showed that tariff barriers could cause the exporting country to invest (relocate production) in the importing country, completely substituting for commodity trade, while later studies have emphasized the complementary nature of FDI and trade.

The impact of FDI on merchandise trade balance for an economy depends on whether the economy is acting as a host economy attracting FDI or as an outward investing home economy. For host economies, the sourcing of production inputs due to a direct investment, whether local or offshore, will be related to the ability of local sources to meet the needs for capital equipment, intermediate goods, services and raw materials for the investment project and will likely be sector dependent.

For exports, the impacts are dependent on whether the FDI is export-oriented or local market-oriented. If the investment is the result of import substitution policies by the host country, then imports should be reduced. Export-oriented investments, unless heavily subsidised, have to be efficient to compete on the world markets; exports should increase.

Government policies can also have important effects on the balance of payments impact of direct investment projects. Government policies which aim to maximize balance of payments flows may encourage non-competitive production due to price distortions created by government policy. The benefits of a government policy designed to allow for market forces to