

market. This could attract economic activity away from those Member States that do not participate in the first wave either because they do not meet the Maastricht convergence criteria or because they decide not to participate in EMU. The authors then suggest that this dynamic might exacerbate any shortfall in meeting the convergence criteria, thereby creating a permanent group of Member States that are "outsiders". In the longer term this scenario seems unlikely to materialise, but it may characterise a short term problem with EMU. The direct implications for Canadian FDI mostly fall on the outgoing FDI side, in that it might create incentives for Canadian FDI to concentrate on the "core" Member States, rather than the traditional recipients (such as the UK). There may also be indirect implications, as third countries (such as the US and Japan) decide to concentrate investment on this "core" single market, rather than in Canada ("FDI diversion" effects analogous to those with trade).

Agglomeration effects, if they occur, might also reduce constraints on FDI inflows into the EU, as competition for this incoming FDI intensifies⁵. The Multilateral Agreement on Investment (MAI) which is currently in negotiation under the auspices of the OECD, may eliminate differences between regulatory environments so that differentiation by appealing to country characteristics (such as economic policies, labour regulations and adoption of a single currency) is the only way in which countries can attract FDI at the margin. For example, the previous UK conservative government, which had refused to sign the social chapter (which sets minimum labour standards, including a maximum number of hours a week that can be legally demanded of employees), allowed a differentiation with continental Europe on the basis of labour regulations, attracting a significant inflow of Japanese FDI in the early 1990s. With a new government in the UK, this differential characteristic is likely to be eliminated, as the new Labour government is committed to signing the social chapter. Even so, the new UK government has also committed itself to a referendum on the single currency, which may result in the UK remaining permanently outside of EMU. This could have two effects - firstly, agglomeration effects could occur in the manufacturing sector in continental Europe, and secondly, the financial services sector may begin to shift some operations from London, and the City may begin to lose its dominant position as Europe's financial centre. Thus there is the possibility of a change in the pattern of FDI between Canada and the EU, notably in the case of the UK, and also perhaps in the level of FDI, although the direction of this change is less certain. As for incoming Canadian FDI, there is unlikely to be any direct effects, but depending on how successfully EMU enhances the EU single market, there is a possibility that there may be a fall in incoming FDI from third party countries.

Another aspect to FDI is its relationship with trade. If FDI is market-oriented, then it will tend to substitute for trade, but if it is input-oriented or cost-oriented then it will tend to be complementary to trade. With Canada-EU FDI, flows in both directions across the Atlantic are most likely to be market-oriented, so this would suggest that increased economic integration would tend to reduce FDI, given no effects on trade patterns. As Caves (1991) points out, this does not seem to be the case, as trade and FDI appear to be complementary with respect to formation of regional trading blocs. But this also suggests that a decrease in incoming FDI to Canada, perhaps due to agglomeration effects in the EU, could also negatively impact trade.

Fisher and Voudén (1996) attempt to capture the relationship between trade and investment in an overlapping generational framework, and find that the interaction of tariffs and FDI can affect growth. For example, in countries that are net sources of foreign investment, a tariff on labour-intensive consumption will increase domestic real wages, and hence encourage savings. These savings will encourage the outflow of FDI to the rest of the world. To apply this idea to the notion of a customs union (like the EU), the key variable is the average rate of protection of the consumption sector - if the average

⁵ The reasons for EMU giving rise to agglomeration effects are rather intangible, but could potentially relate to demonstration of the political commitment to a deeper level of economic integration in the EU and the centralisation of firm functions in a central location as EMU reduces the requirement for individual Member State operations. There are also reasons to believe that FDI is fickle - relatively minor political or economic decisions can act as a catalyst to trigger large amounts of FDI, as in the case of China after Tiananmen square.