Executive Summary

One of the primary characteristics that have contributed to the globalization of the world economy has been the growth in the volume of world merchandise exports which has consistently outpaced the growth in world output. As well, the growth in trade in services has also outpaced world output growth. However, since 1985 foreign direct investment (FDI) outflows have significantly outpaced both exports and output. The purpose of this paper is to examine the relationship and linkages between trade and investment flows and provide policy considerations based on Canada's roles as a country attracting FDI, as an outward investing country, and as a trading nation in world markets.

As a **host economy attracting FDI**, a number of factors are important when discussing potential trade and investment policy options. First, the impact of FDI on the host economy cannot be predetermined, because FDI interacts intimately with the host economy environment. For example, stimulating investment in sectors protected by import restrictions can lead to a misallocation of resources toward uncompetitive industries and a suboptimal level of welfare. Second, the trade policy environment of the host economy can influence the export performance of multinationals investing and operating in the host economy. Third, government domestic policies have an important role in attracting FDI. The domestic policy environment should be one of neutrality or non-discrimination between trade and investment policies. Fourth, the domestic policies of the host government can complement the promotion of an open, competitive, trading environment through the provision of public goods such as infrastructure, information and education. Fifth, the transfer of intangible assets is viewed in some analyses as providing more positive impacts on a host's economy than capital transfers. An investment policy environment emphasizing the transfer of technology and other intangibles should be promoted, but not at the expense of distorting the neutrality condition for trade and investment policies.

For Canada as a host economy attracting FDI, the government should continue to promote trade liberalizing policies, evaluate trade and investment policies on a neutrality or non-discrimination basis, and maintain a high priority for infrastructure development and maintenance, the efficient exchange of information, and an emphasis on education and training.

Canada is also a **source for outward FDI**. As outward FDI is often the result of changing locational comparative advantage patterns, the investing economy may develop problems related to structural adjustments. An important policy response for the investing economy would be to adopt policies which facilitate smooth adjustment, especially in the labour market. Moreover, although the rationale that leads a firm to invest abroad is complex, there are several net benefits to the source country, including some evidence that exports from the home country are stimulated by investment abroad.