which a true recovery was not witnessed until 1996; The second was the U.S. economic boom that lasted for most of the 1990s.

At about the same time that the FTA was to enter into force, the Bank of Canada announced a significant change in policy direction towards achieving "price stability" (Crow 1998). At about the same time, faced with large deficits and a growing debt, fiscal policy in Canada was also tightening. The result was to cause real interest rates in Canada to exceed those in the U.S. by, on average, more than three percentage points between 1988 and 1996 leading to the 'made-in-Canada' recession of the early 1990s. While the U.S. also suffered a mild slow-down in 1991, the recovery south of the border was much more rapid and was followed by many years of rapid economic growth and productivity improvements. Not unrelated to these events was the depreciation of the Canadian dollar from 89 cents US in 1991 to 62 cents in 2003. It is within this context that the Canada-U.S. FTA entered force on January 1st, 1989.

The main studies used herein are concerned with the impact on Canada, Canada-U.S. or all three NAFTA countries. There are a very large number of NAFTA studies which focus just on the US economy that are not reported unless they bear directly on an issue being discussed. The studies are divided into those focused on: a) trade creation and trade diversion effects, b) foreign direct investment, c) productivity, d) scale and specialization e) jobs and wages, f) product variety and other consumer effects, and g) dynamic effects on innovation, R&D and international technology diffusion. Ideally one would like to explicitly identify the impacts of the trade agreements on the welfare of Canada, Mexico, the United States and other countries. This is often done through the use of applied general equilibrium models which are widely used to evaluate the ex ante effects of trade agreements. However, thus far they have not been used for ex post evaluations of NAFTA. Existing ex post studies focus on specific channels of influence without taking an overall view on the net welfare impact.

Trade Creation and Trade Diversion

As noted in the introduction, the growth in trade volumes between Canada and the United States in the 1990s had been quite strong—extraordinary relative to the past history of Canada-US trade. But, for increased trade volumes to have a welfare enhancing impact, it is important to distinguish between trade creation and trade diversion. The preferential reduction in tariffs within a regional integration agreement (RIA) will induce buyers from one country who are members of the RIA to switch their demand towards supply from partner countries, at the expense of both domestic production and imports from non-members. The former is trade creation and occurs when a high cost domestic source of supply is replaced with a lower cost international source. In some cases trade diversion occurs. This is when a low cost foreign source of supply is replaced with a higher cost source from some country that is a member of the RIA. Trade creation is beneficial, but trade diversion may be costly.

The net impact of trade creation benefits less trade diversion costs on national income may be positive or negative, depending on the costs of alternative sources of supply and on trade policy towards non-member countries. Simply looking at shifts in trade volumes, the best of all possible worlds is when trade