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 Vousden (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 rate increases with the formation of a union, then FDI should increase and hence world growth will increase. To carry the model one step further to look at a monetary union, the key effect would be whether the use of a single currency increases the average rate of protection or not. Clearly, in the long run, the adoption of a single currency will reduce the "domestic" costs of trading in the EU, thus effectively increasing the average level of protection, thereby reducing trade and increasing the level of outward FDI. This implies that EMU would increase FDI outflows from the EU to Canada over the longer term. It is therefore encouraging to find, from the perspective of FDI, that nearly all the EU Member States that are likely to participate in the first wave of EMU already have total net outflows of FDI (see OECD (1994)). This inflow of FDI to Canada would likely be market-oriented FDI, and would likely take advantage of Canada's strategic position in NAFTA as a specialised supplier of specific merchandise goods and services to other NAFTA members. This effect is called "dynamic" trade creation in the academic literature.

6.2 Completing the Single Market in Financial Services

There is a growing body of academic literature that addresses the question of EMU and its interaction with the deregulation of the financial services sector in the EU (see Majnoni, Rebecchini and Santini (1992) and Frankel (1996), for example).

The general consensus in the literature and the media is that the adoption of a single currency will lead to significant structural changes in European financial markets, forcing a greater degree of competition, and thus reducing transaction costs. A reduction in transaction costs, in turn, would tend to suggest that FDI might be encouraged, as the fixed costs of equity acquisition would fall. Further, adoption of the single currency could also lead to increased liquidity in European financial markets, hence making borrowing less expensive, once a subsidiary is established, or once a company is acquired. In short, all these effects would tend to encourage inward FDI.

Of course, the one caveat that needs to be placed on these assertions is that any structural changes in European financial markets would lead to industry economies of scale, and this implies a concentration of financial markets in regional centres, or at least the establishment of a single European bourse. This would certainly be hampered by resistance from national interests, or an unwillingness to allow financial centres that are already established, whether in a Member State that is proceeding to the third stage of EMU or not, to expand and accumulate activity previously located elsewhere. A particular concern here, naturally, is the position of the UK government towards EMU.

Leaving the above caveat aside, it is likely that adoption of the single currency would lead to an improvement in the environment for FDI in Europe, and thus increased inflows can be anticipated. The effect of greater financial market integration in Europe would not necessarily impact EU FDI flows to Canada, as most of the inward flows relate to market oriented FDI.