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The Implications of the FTA and NAFTA for Canada and Mexico

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ABSTRACT

This report highlights the possible implications of the Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA) for Canada and Mexico. While it is still early, the initial evidence indicates that these treaties are contributing to a continental process of industrial restructuring that will contribute to higher living standards over time.

The report focusses on the chapters in the treaties that deal with financial services. The FTA was path-breaking because it was the first international treaty of its kind to deal explicitly with financial services. NAFTA also broke new ground in that it went beyond attempts to resolve identified bilateral problems and established principles to guide future trade relations.

The financial service provisions of NAFTA will have significantly greater practical implications for Mexico than for either Canada or the United States. Since Mexico is embarking upon a relatively greater shift towards openness, the gain in efficiency in the provision of domestic financial services and the international allocation of capital will also be commensurately greater. Nevertheless, the report does note certain important implications for Canada and the United States as well.

The fact that the financial markets of Canada and the United States were highly integrated prior to these treaties implies that they will not have significant effects on the conduct of Canadian monetary policy. In contrast, the liberalization of Mexican financial markets is likely to make the framework of Mexican monetary policy look more like that of Canada.

The report finishes by asking whether freer trade in North America should be accompanied by fixed exchange rates between the economic partners. It concludes, largely on the basis of arguments about optimum currency areas, that both Canada and Mexico will be better served by maintaining a regime of flexible exchange rates with respect to the U.S. dollar.

RÉSUMÉ

Ce rapport met en lumière les possibles répercussions sur le Canada et le Mexique de l'Accord de libre-échange entre le Canada et les États-Unis (ALE) et de l'Accord de libre-échange nord-américain (ALENA). Bien qu'il soit encore trop tôt pour en tirer des conclusions précises, les premières observations empiriques indiquent que ces traités contribuent à l'heure actuelle à un processus de restructuration industrielle à l'échelle du continent qui entraînera au fil du temps une élévation du niveau de vie.

Le rapport s'intéresse particulièrement aux chapitres des traités qui portent sur les services financiers. L'ALE a créé un précédent puisqu'il a été le premier traité international de cette nature à aborder explicitement la question des services financiers. L'ALENA a innové lui aussi puisqu'il ne s'est pas limité à essayer de résoudre certains problèmes bilatéraux, mais a posé les principes devant guider les futures relations commerciales.

Les clauses de l'ALENA qui traitent des services financiers auront dans la pratique des répercussions nettement plus importantes sur le Mexique que sur le Canada et les États-Unis. Puisque le Mexique s'engage dans un processus d'ouverture accrue sur l'extérieur, les gains d'efficacité en matière de prestation de services financiers intérieurs et la répartition des capitaux à l'échelle internationale s'en trouveront améliorés d'autant. Le rapport fait aussi état d'importantes conséquences pour le Canada et les États-Unis.

Le fait que les marchés financiers canadiens et américains aient été étroitement intégrés avant la conclusion de ces traités implique que ceux-ci n'auront pas d'effets significatifs sur la conduite de la politique monétaire au Canada. Par contre, la libéralisation des marchés financiers mexicains devrait faire en sorte que le cadre de mise en oeuvre de la politique monétaire mexicaine ressemble davantage à celui du Canada.

L'auteur se demande en définitive si le renforcement du libre-échange en Amérique du Nord devrait être assorti d'un régime de taux de change fixes applicable aux partenaires économiques concernés. Reprenant généralement à son compte les arguments qui ont été avancés au sujet des zones monétaires optimales, l'auteur conclut que le Canada et le Mexique seront mieux servis par le maintien de taux de change flottants entre leurs monnaies et le dollar É.-U.

1 INTRODUCTION

The Free Trade Agreement (FTA) signed between Canada and the United States in January 1989 will bring “almost” free trade in goods and services between our two countries by the year 2004. The North American Free Trade Agreement (NAFTA) of 1993 not only extends the FTA to include Mexico but also alters and improves the FTA in certain ways.

These treaties are important at both the political and economic levels. Politically, they represent the final, if grudging, acceptance of the argument that Canada and Mexico can retain their distinctive political identities in spite of their close economic ties with a much larger trading partner.[1] At the economic level, not only do these agreements have broad implications for North American economic integration, but they also raise particular issues likely to be of special interest to treasury officials and central bankers. Whether this experience may have useful lessons for smaller countries in eastern Europe and the former Soviet Union remains to be seen.

In Section 2, I consider the broad implications of these treaties for North American trade and investment relationships. In Section 3, I consider narrower issues involving trade in financial services and the conduct of monetary policy. Of particular interest in this section is the relationship between the choice of trade regimes and exchange rate regimes.

1. The gross national products (GNPs) of Canada and Mexico in 1993 were respectively 8.7 per cent (1993) and 5.5 per cent (1992) of U.S. GNP, converted at annual average exchange rates.

2 THE BROAD IMPLICATIONS OF THE FTA AND NAFTA

2.1 The situation prior to the treaties

These treaties must be evaluated in their historical and global context. In large degree, they simply recognize the reality of the growing economic and financial integration of the global and North American economies. Nevertheless, the treaties remain important in their own right in that they ratify and encourage trends that might otherwise have been rolled back by the forces of protectionism.

In the 1980s, the level of global trade increased continuously, in spite of a growing recourse in many countries to non-tariff barriers to trade. This trend was accompanied by an enormous increase in the amount of foreign direct investment (FDI).[2] In part, this latter phenomenon was an attempt to get in behind protective trade barriers, but it was also a response to other factors. Lower communication costs encouraged FDI, particularly in low-cost countries, as did the greater willingness of host countries to accept and even encourage such investments.

These trends towards international integration were also being reflected in North American markets. By 1988 three-quarters of Canadian trade was already with the United States and the comparable figure for Mexico was two-thirds. Moreover, in that same year, 67 per cent of all FDI in Canada was from the United States, and almost as large a proportion of the FDI emanating from Canada went to the United States. Also, a large number of multinational enterprises (MNE), mostly American but many Canadian, were operating throughout North America. Even prior to the FTA, many of the large MNEs had begun to restructure themselves along continental lines. Increasingly, plants tended to specialize, either in particular products or in certain stages of the production process.

2. Net outward FDI from member countries of the Organisation for Economic Co-operation and Development (OECD) grew at an annual rate of 13.8 per cent between 1981 and 1990, about double the rate of growth of nominal income and exports from those countries.

Government attitudes to these economic trends were also changing, particularly in Mexico. In Canada, gradual reduction of tariffs over a 50-year period removed almost three-quarters of the U.S.-Canada tariff barriers existing in 1935. As a welcome but long-delayed complement to this trend, the name of the Foreign Investment Review Board was changed in 1985 to Investment Canada, and the agency was finally given a new mandate to encourage FDI. In Mexico there was an even more momentous change in the 1980s as, in the wake of the debt crisis, the country finally rejected its postwar policy of import-substituting industrialization. Moreover, Mexico also began a wholesale process of privatization and invited foreigners to be active participants. With a similar view to opening up the Mexican economy, Mexico joined the General Agreement on Tariffs and Trade (GATT) in 1985 and began unilaterally to lower tariffs at a very rapid rate.

2.2 The principal features of the treaties

Canada approached the United States in 1985 with a view to negotiating a trade-liberalizing, bilateral agreement, and the United States soon agreed to do so. The Canadian approach was premised on the notion that Canada needed free access to a large market if it were to reap economies of both scope and scale.[3] The Canadian objective was not merely to maintain access in the face of growing protectionist pressures in the United States, but to enhance that access. It was also hoped that this large regional base would allow Canada to become more competitive in global markets and more attractive to FDI from whatever source.

The FTA conforms to GATT but extends it in many ways. In particular, it lowers bilateral tariffs significantly over the next 15 years; it extends trade-liberalizing measures to agriculture, services (including financial services), business travel and investment; and it proposes a specific set of

3. Australia, New Zealand and Canada were in 1985 the only developed countries without free access to a market of at least 100 million people. As Canada tried to diversify away from natural resource extraction and foster the provision of more sophisticated goods and services, the question of market access was becoming ever more important (Lipsey and York 1988).

dispute settlement mechanisms. While the FTA is based explicitly on the concept of "national treatment,"[4] some service industries were exempted from NAFTA on the insistence of one or the other participant. In short, the FTA was a major step forward in the integration of the Canadian and U.S. economies, but it could not be judged a final step.

The Mexican government proposed to the United States government in 1990 that it negotiate with Mexico a bilateral agreement similar to the FTA. The U.S. government agreed to this request – it was supportive of the process of economic liberalization in Mexico and hoped that other countries in Latin America might be encouraged to go down the same liberalizing path. Canada then made a proposal that it be a third signatory to a multilateral agreement (NAFTA), on the grounds that separate bilateral agreements with the United States would give the United States an unfair advantage as the only country with enhanced access to all the others.[5]

NAFTA came into effect in January 1994 and generally extends to Mexico most of the provisions of the FTA. In addition, a number of the provisions of the FTA were rewritten with the intention of improving them.[6] Finally, as with the FTA, it was not possible to deal with all of Mexico's concerns in NAFTA, and a number of areas have been effectively exempted from the agreement.

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4. According to the principle of national treatment, foreigners should have the same rights as nationals. This principle differs from that of reciprocal treatment, which means that a foreigner in country A will be given only the rights given to country A nationals in the foreign country.

5. The separate bilateral agreements model is often referred to as the "hub and spokes" model, whereas the multilateral approach is referred to as the "hub and wheel" model (see Wonnacott 1990).

6. In particular, the antidumping and countervailing provisions of Chapter 19 of the FTA, which were only interim measures, are now to be treated as permanent until a better system can be found to replace them. As well, the rules of origin provisions in NAFTA are generally clearer, more liberal and less capable of being abused (Wonnacott 1993). This having been said, Wonnacott notes that in the area of textiles, apparel and automobiles, the rules of origin clauses have the effect of blocking out foreign content in favour of North American content. There were also some significant changes with respect to the provision of banking services, which are treated in more detail below.

2.3 The effects of these agreements to date

It is difficult to assess fully the extent to which these liberalizing agreements have raised or will raise living standards in Canada and Mexico. This was, after all, the principal anticipated benefit. The agreements, especially NAFTA, were signed only recently and, in any event, only reinforce deeper forces (technological change and deregulation more generally), which were already leading to significant structural change. The fact that the U.S. and Canadian economies have also been buffeted over the last few years by the debt-deflation hangover from the inflationary excesses of the 1980s, also complicates analysis.

Nevertheless, certain promising trends are already evident and the principal fears of Canadians opposed to the FTA and NAFTA do not seem to have been realized. Far from proving unable to compete with the United States under the FTA, Canada has made strong export gains in those sectors where advocates of the agreement foresaw gains. While we have also lost out to U.S. imports in areas where losses were foreseen, Schwanen (1992) notes that our *net* performance with respect to the United States has been impressive. Canada's share of total U.S. imports has remained steady under the FTA, in contrast to the declines recorded by all other industrial countries. In sum, the trade evidence is consistent with an ongoing restructuring in Canada and increasing specialization in higher-value-added industries.

The same conclusion arises from a look at investment data. Clearly there was no wholesale flight of Canadian investment capital to the United States – indeed, the share of Canadian outward bound FDI going to the United States actually fell after 1987, and this trend was particularly pronounced for manufacturing. Moreover, the Canadian share of all FDI in North America rose from an average of 1 1/2 per cent in the years 1981–87 to 5 per cent in 1992. This data is consistent with anecdotal evidence which says that the FTA gave added impetus to the process of allocating world (or at least North American) product mandates to branch plants on both sides of the Canada-U.S. border, solely on the basis of business criteria.

This implies growing mutual gains from the exploitation of comparative advantage.

The principal fear raised by some Americans and Canadians, with respect to NAFTA, has been that cheap Mexican labour will cost jobs as FDI is attracted to Mexico and exports to Canada and the United States increase. This argument ignores the fact that productivity levels are, on average, commensurately lower in Mexico and that unit labour costs are significantly less advantageous. It also ignores the crucial role of exchange rate adjustment, should freer trade lead to persistent trade imbalances.

Nevertheless, there is one sense in which these concerns are well founded. That is, Mexico does seem to have a comparative advantage in low-skill and low-value-added manufacturing (Investment Canada 1994, 8). Accordingly, low-skill Canadian and American workers will have to retrain, and over the long term be reabsorbed into expanding industries based on higher skill levels. For individual workers, this may not be an easy transition. Moreover, it bears repeating that the general restructuring associated with the FTA and NAFTA may also have short-term consequences for unemployment during the period of transition.

This last observation leads to the question of the broad political implications of these trade agreements. Perhaps the most important implication is that industry- or company-specific subsidies by governments will now be much more difficult to justify. Indeed, many of the supporters of the FTA and NAFTA justified their support partly because of this.[7] There may also be some pressure for harmonization of regulation in certain areas.

However, the treaties do not demand any harmonization of economy-wide subsidies or indeed any harmonization of social programs. If one of the participating countries chooses to be a high-benefit–high-cost jurisdiction, that is its own affair. Moreover, there is always the possibility of exchange rate changes to offset any resulting balance of payments

7. In Canada, for example, there are still many interprovincial barriers to trade. It was hoped that the FTA would contribute to their removal.

problems. This issue of exchange rate regimes and trade arrangements is discussed in more detail further on.

3 THE FINANCIAL AND MONETARY IMPLICATIONS OF THE FTA AND NAFTA

We hear more and more these days about the globalization of financial markets and the implications of these international trends for national authorities. Even more than in the case of trade, technological change has been of crucial importance. It has opened up new possibilities for international financial transactions and at the same time reduced the costs of both new and traditional transactions. In such an environment, capital controls and national regulations have become progressively less binding. This has led, as a result, to a progressive deregulation of financial markets in most advanced countries and a growing reliance on market forces. This has certainly been the case in the United States, Canada and Mexico.

This point provides some context for the discussion below of the financial and monetary implications of the FTA and NAFTA. These agreements, and particularly their provisions with respect to trade in financial services, are steps forward. Nevertheless, they remain only steps along the way to the fully integrated financial markets that seem likely to emerge in North America.

3.1 The situation prior to NAFTA

By any standard, Canadian financial markets were highly integrated with U.S. financial markets well before the passage of NAFTA and even before the coming into force of the FTA. Tests by Murray and Khemani (1989) and Caramazza et al. (1986) failed to reject the hypothesis of perfect capital mobility and perfect asset substitutability using short-term financial instruments. Trying to measure the extent to which markets for longer term financial assets are integrated is a still more difficult task, but I know of no evidence that convincingly rejects the hypothesis of a very high degree of integration.

A prima facie case for a long-standing and high degree of integration can also be made on the basis of a review of existing Canadian legislation and regulations. There have been essentially no capital or foreign exchange controls since the 1950s.[8] Moreover, there have been no domestic restrictions with respect to either interest rate levels or the provision of credit since the late 1960s.

In recent papers, both Governor Kelly of the Board of Governors of the Federal Reserve System (1994), and González-Hermosillo (1994a) have asserted that perfect financial integration also demands unrestricted market entry and non-discriminatory regulations with respect to foreign financial institutions. The Canadian financial system has met this test in large measure for many years, even though some restrictions were in place until quite recently.

While foreign insurance companies have always been allowed to play a big role in Canadian markets, foreign banks were prohibited by law through to the end of the 1970s. However, faced with growing evidence that foreign banks nevertheless had a significant presence in Canada (so-called suitcase banking), the 1980 Bank Act finally allowed foreign banks to establish wholly owned banking subsidiaries in Canada. While this establishment was subject to certain restrictions, in general these restrictions were never binding.[9] By the time of the FTA, there were already 57 foreign banks operating in Canada, and it is worth noting that there was a similar if less dramatic opening up with respect to securities dealers.

The FTA was a path-breaking agreement in that it explicitly treated the issue of trade in financial services and accepted the principle of national treatment rather than reciprocity (see footnote 4). In that sense, it provided encouragement for those who subsequently wished to treat global financial services under the General Agreement on Trade in Services (GATS). Viewed rather more narrowly, the FTA did not much alter the domestic financial landscape in either Canada or the United States. Canadian subsidiaries of American banks were no longer subject to the

8. At times, however, FDI into Canada was subject to critical evaluation, and domestic content requirements for pension fund portfolios continue to apply.

9. There was an initial cap of 8 per cent on the assets of foreign bank subsidiaries relative to domestic financial institutions. Moreover, foreign bank subsidiaries needed the approval of the Minister of Finance to open more than one branch in Canada.

constraints imposed in the 1980 Bank Act, but as noted above, these had never been binding. The United States, for its part, agreed to some minor exemptions for Canadian banks from the provisions of the Glass-Steagall Act and the McFadden Act.

Foreign banks in Canada, far from overrunning the system after 1980, have on balance failed to achieve rates of return on equity as high even as those on Canadian treasury bills. While they have had some significant areas of success, their most important contribution has been to stimulate the domestic banks to stronger efforts to maintain their dominant position in Canadian wholesale and, especially, retail banking (White 1991).

Since the passage of the FTA, the share of U.S. banks and insurance companies has actually declined somewhat (González-Hermosillo 1994b). In the same vein, all three U.S. brokerage firms with a retail presence in Canada in 1987 have now withdrawn. This latter development may reflect in part the enhanced competitiveness of domestic brokers after federal legislation in 1987 allowed federally chartered financial institutions to purchase securities dealers as subsidiaries. Most of the major Canadian dealers are now owned by banks.

Mexican financial markets were highly regulated prior to NAFTA and, for all practical purposes, foreign financial institutions were not allowed to enter. Interest rate controls were pervasive, and credit was directed in support of the government's strategy of import-substituting industrialization. Nevertheless, it would be inappropriate to characterize Mexican markets as wholly isolated from international developments. Large companies had access to international financial markets, and Mexican citizens commonly invested assets north of the Mexican border.

For most of the postwar period, the banks were the dominant financial institutions in Mexico. However, strict interest rate controls, allied with high cash and liquidity requirements designed to finance high government deficits, led to a rapid erosion of their competitive position. Nor did the nationalization of the banking system at the time of the Mexican debt crisis

(1982) help in this regard. Between 1982 and 1988, the assets of non-bank financial institutions rose from 9 per cent of total financial assets to 32 per cent. Private borrowers, unable to obtain loans from banks in the amounts required, also turned increasingly to the black market for credit (Welch and Gruben 1993) and direct financing through less regulated financial markets.

Faced with the erosion of its traditional source of finance, forced funding through the banks, the Mexican government introduced Treasury bonds (cetes) in 1978. However, as the macroeconomic situation deteriorated through the late 1970s and early 1980s, the government was eventually forced to deal with the financing problem at its source. Between 1987 and 1992 public sector borrowing requirements dropped from 15 per cent of gross domestic product (GDP) to a surplus of 1 per cent by 1992. It was only in this context of reduced financing requirements that the Mexican authorities were able, between 1987 and 1991, to increase the competitiveness of banks by removing virtually all forced funding requirements and by selling the banks back to the private sector. The improved state of government finances also played a major role in the decision to abolish exchange controls in 1991.

These welcome developments left Mexico much better placed to deal with the challenges likely to arise out of NAFTA. Nevertheless, given how recently these changes have occurred, there is no question that the monetary and financial implications of these international trade accords will be greater for Mexico than for either Canada or the United States.

3.2 The financial services provisions of NAFTA

If the FTA was path-breaking in that it explicitly included financial services, it was less ambitious in other respects. The provisions of the FTA addressed specific concerns that had been raised previously by the United States and Canada respectively. The only guiding principle incorporated in the agreement was to preserve “the access that our respective financial institutions have to each other’s market” (Dept. Ext. Affairs 1987, 249).

In sharp contrast, NAFTA is based on a list of forward-looking principles designed more to enhance than simply to preserve market access. The desire to formulate clear principles was in part due to the desire to extend NAFTA to other countries over time. Accession would be much easier in such a context. Closely related to this desire was the hope that successful application of the financial services provisions of NAFTA might establish a global model for further discussions pertaining to the GATS. This would be a further step along the road of fruitful interaction between North American and global discussions on trade in financial services.[10]

Canada's practical experience with the FTA gave us a further reason for supporting a principles-based approach. We had observed that regulatory changes in the United States could have wide-ranging implications, and we felt that a principles-based approach would help ensure that such changes were not made to the detriment of Canadian financial institutions. As for the U.S. negotiators, they hoped that this kind of approach would help shape the future behaviour of both the Mexican government, where there was a long tradition of discretionary rulings, and the United States Congress. Sauvé and González-Hermosillo (1993, 5) note the particular desire of the U.S. Treasury

> to use the NAFTA (and the GATS) as a means of anchoring trade-liberalizing principles in a legally binding treaty to which future domestic legislation would need to conform.

The broadest principle of all recognizes that firms providing financial services should have equal access to customers in member countries, either through rights of establishment or through cross border trading, and all must be subject to non-discriminatory regulation.

10. The successful FTA discussions on trade in financial services encouraged subsequent discussions in the GATT, OECD, Bank for International Settlements and the European Community about the prospects for a global agreement of a similar kind. In light of slow progress in the GATS discussions, the NAFTA negotiators realized that it was all the more important to make progress on a principles-based approach in a regional context. If Mexico, and potentially other Latin American partners, could be convinced of the merits of such an agreement, perhaps other developing countries might eventually view a global agreement more positively.

In support of these broad themes, NAFTA contains provisions to ensure the transparency of all government decisions in this area, plus provisions for de facto rather than de jure national treatment.[11] While a financial services committee has been established to oversee the implementation of the agreement and to minimize conflict, the agreement also contains dispute settlement procedures modelled after those set up by the FTA.

Attention has also been paid to the fact that supervision of financial institutions in North America will continue to be essentially a host-based affair, and that for the foreseeable future, the universal, multibranching banking models of Canada and Mexico will continue to contrast sharply with that of the United States.[12] In this context, NAFTA allows regulators to negotiate bilateral agreements providing for regulatory or supervisory harmonization. Moreover, it has been agreed that the treaty cannot override the obligation of host supervisors and regulators to take any “reasonable measures for prudential reasons” they may deem appropriate (NAFTA 1992, art. 1410, 14-7). While what is “reasonable” may be decided within the disputes settlement mechanism, regulations deemed discriminatory will be subject to compensation rather than removal.

Two further principles may be of particular interest to Europeans. First, “most-favoured nation” treatment will apply to all NAFTA participants if any one participant offers special treatment to a non-NAFTA

11. This approach was borrowed from the GATS discussions and recognizes that an absolutely identical application of regulations may disadvantage foreign firms. For example, some contend that the section 20 limited exemption from Glass-Steagall restrictions hurts U.S.-based subsidiaries of Canadian banks, because it links the right to underwrite to the size of total revenues arising from dealings in U.S. and Canadian government securities. In the case of foreign banks (and also in the case of U.S. regional banks) these revenue benchmarks tend to be rather small. In the same vein, some contend that the Canadian requirement that all foreign banks enter Canada as separate subsidiaries, rather than as branches, limits the competitiveness of U.S. banks. With a limited pool of domestic capital and provisions as to the percentage of capital that can be committed to a single customer, U.S. banks find it difficult to compete for large Canadian corporate accounts while ensuring sufficiently intensive use of their capital.

12. In this paper the term “universal banking” means that banks can offer a full range of financial services. This definition is narrower than the traditional, continental European definition which implies that banks can also own and control non-financial companies.

country (NAFTA 1992, art. 1406, 14-5). Second, with respect to rules of origin, the United States and Mexico have both agreed that any financial institution incorporated within their jurisdiction will be treated as a national, regardless of who has ultimate ownership. This should facilitate the entry of European and other foreign banks into Mexico in particular, through the vehicle of a Canadian or U.S. subsidiary.[13] In contrast, Canada reserved the right to treat U.S. and Mexican banks that were ultimately owned by non–North Americans as failing to qualify for NAFTA benefits. Banks from non-NAFTA countries do, of course, have the right to direct establishment of subsidiaries in Canada.

In addition to the statement of principles, NAFTA also makes some specific provisions. With respect to banking services in Mexico, any NAFTA country can establish wholly owned subsidiaries after the year 2000, though no single foreign bank can account for more than 4 per cent of the capital in the Mexican system unless the extra capital has been raised in the form of retained earnings. This last provision is designed to stop the takeover by foreigners of any of the large Mexican banks. Prior to 2000, the proportion of total capital allowed to be held by foreign banks can rise gradually to a maximum of 15 per cent before the aggregate constraint disappears. While similar sorts of restrictive provisions apply to foreign securities firms in Mexico, other kinds of financial sector services are generally treated more liberally.

As for the provision of financial services in Canada and the United States, the bilateral relations between these two countries were left essentially unchanged from the FTA. Mexico was also granted the same rights in Canada as the United States had, and a grandfather clause extended to Mexican financial firms a limited number of rights previously granted to them by the United States.

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13. During a transition period (discussed later) which ends in the year 2000, there will be limits on the aggregate share of all foreign bank assets in Mexico. During this period, there could still be discrimination against banks ultimately owned outside North America.

3.3 The financial sector implications of the FTA and NAFTA

3.3.1 Implications for financial efficiency and capital flows

All three North American countries will be affected by the provisions of the FTA and NAFTA, which generally encourage the further integration of the financial sectors of these economies with each other. The principal gains from financial integration of this sort have largely to do with the more efficient allocation of capital across international boundaries and the more efficient provision of domestic financial services to consumers.

More highly integrated capital markets do seem likely to improve the efficient allocation of capital across borders. For various reasons, the rate of return on investment in a single country may deviate from the domestic rate of time preference, implying that investment carried out using foreign savings may be beneficial to all. Canada, for example, has annually imported foreign savings equal to about 1 1/2 per cent of GDP (the average current account deficit) since the time of Confederation in 1867. The United States has also benefited from both the import and the export of capital at various times in its history.

In contrast, Mexico has been essentially a closed economy until quite recently, and will likely gain the most from the liberalization of international capital flows. Albeit in the context of lower U.S. interest rates, Mexican policies designed to ensure macroeconomic stabilization, together with the anticipation of the passage of NAFTA, led to capital inflows into Mexico averaging 7 1/2 per cent of GDP in both 1991 and 1992. Moreover, a good part of this inflow has been in the form of equities and FDI. This latter development would seem particularly welcome in light of the insights provided by recent literature on the theory of endogenous growth (Macklem 1993).

With respect to the efficient provision of financial services, White (1991) notes the important contributions made by foreign banks in Canada after changes to the Bank Act in 1980 allowed them full access to Canadian markets. LaWare implicitly made the same point with respect to the United States when he stated his opposition to proposed legislation that would restrict the U.S. operations of banks from countries that did not offer national treatment to U.S. banks. LaWare felt that such restrictions would imply foregoing “the considerable benefits of foreign banks’ participation in our market” (LaWare 1994, 2). From this historical perspective, the implications of NAFTA and the GATT are again likely to be greater for the relatively closed Mexican financial system than for the financial systems of either the United States or Canada.

There is little doubt that Mexico’s financial system is relatively underdeveloped. Whereas there is approximately one bank branch per 2 000 people in Canada and the United States, the comparable figure in Mexico is 19 000. Access to insurance coverage and mortgages is also relatively restricted in Mexico. It is also noteworthy that, in spite of relatively high operating costs, the rate of return on equity was 27 per cent for Mexican banks in 1992 versus 13 per cent in the United States and 10 per cent in Canada, and the disparities were even greater for securities dealers.

Competition from foreign banks should be able to help address these problems. Moreover, Canadian banks should be well-placed, relative to U.S. banks, to exploit these opportunities, given that both Canada and Mexico allow multibranching and universal banking. In contrast, U.S. banks have the advantage of closer geographical proximity and a greater knowledge of local customs and the language.

All of this having been said, the Mexican banks have been given some time to adapt to foreign competition and to refurbish their banking skills.[14] They also retain a formidable advantage with respect to local know-how and customer relations. The very significant startup costs in Mexico, allied with memories of the losses incurred on Mexican investments over the last two decades, may also act to blunt the initial impact of direct competition from foreign financial institutions in Mexico. Finally, there are also opportunities for fruitful co-operation between Mexican and

14. As noted above, for many years the Mexican banks were not allowed to make commercial loans on the basis of normal banking criteria. Learning how to evaluate commercial credits will take some time.

foreign banks, with the latter providing service-for-fee management skills to help improve the level of service in the Mexican banks themselves.

Although I have emphasized the likely impact on the Mexican financial sector, it is also the case that NAFTA may yet have significant effects on the future shape of the financial systems in Canada and the United States. This is because of certain dynamic elements in NAFTA having to do with the principles governing establishment. These principles – which in no way require changes in existing legislation – effectively sanction universal banking, multistate branching and international branch banking. In effect, they establish, as an ideal, a world in which the United States repeals both Glass-Steagall and the McFadden Act and Canada allows direct branching by U.S. and Mexican banks. Indeed, the treaty is even more specific: any significant liberalization of U.S. legislation is to cause other parties to review their domestic legislation with a view to implementing the establishment principles just described (NAFTA, art. 1403, 14-2).

Should such a world unfold in light of NAFTA, Canadian banks would likely have more to gain than U.S. banks. With their long history of interstate branching and their growing experience with universal banking, Canadian banks should have initial advantages under the new order. The fact that interstate banking might also have to be achieved through mergers with local firms would also tend to reduce any inherent advantage that larger U.S. banks might have in the United States. As for new opportunities for U.S. banks in Canada under a branching regime, Chant (1994) believes they would be somewhat, but not greatly, improved – in effect, he believes the subsidiary constraint has not been very important. In any event, large U.S. banks would seem less likely to target the highly competitive Canadian banking system if more profitable opportunities were seen to be opening up in Mexico and elsewhere.

3.3.2 Implications for regulation and supervision

There has been a longstanding debate as to whether regional trade arrangements impede or support multilateral trade liberalization. There is some parallel to this debate with respect to the possible implications of the financial services provisions of NAFTA for global regulation and supervision.

On the one hand, the dynamic provisions of the establishment principles under NAFTA are working in the direction of universal banking in North America, and therefore towards a growing similarity with the financial system in Europe. This may enhance the possibility of an eventual set of common rules for financial institutions in all jurisdictions. Of course, whether this is desirable or not will depend crucially on whether the rules eventually converge on what might be described as “best practice.”

On the other hand, there are forces working in the opposite direction (Woolcock 1993). In particular, it must be recognized that NAFTA is explicitly based on “host country” regulation, whereas the European Union and agreements of the European Economic Area are based on “home country” regulation. Moreover, these different approaches are not haphazard and easily changeable but, rather, entirely consistent with the fundamentally different trade principles on which NAFTA and the European Union are based. The former is a free trade area, whereas the latter is an economic union. This having been said, if a trend to regulatory harmonization in North America were to emerge over time, an eventual shift from “host” to “home” regulation would still be possible.

3.4 The monetary and exchange regime implications

3.4.1 Monetary policy and exchange rate movements

The fact that Canadian short-term financial markets have been fully integrated with U.S. markets for many years implies that the FTA and NAFTA will have limited implications for the conduct of monetary policy in Canada. The same is not true for Mexico. Since Canada already “is” where Mexico is “only going,” some lessons might be learned from Canada's experience as a small open economy (SOE).

There is no reason why a very high degree of international financial integration should change the basic objective of monetary policy. It should continue to be directed to the pursuit of domestic price stability (Selody

1990). Indeed, under a floating exchange rate regime like Canada's, the pursuit of a domestic nominal anchor would seem even more desirable given the absence of the discipline that commitment to a fixed exchange rate imposes.

Highly integrated capital markets, however, change considerably the transmission mechanism of monetary policy. In Canada, in judging whether monetary policy has tightened or eased, we accordingly focus on an index of monetary conditions, which is a weighted average of short-term interest rates and the effective exchange rate.[15] This approach reflects the view that the transmission mechanism in an SOE has at least two channels.[16] Between 1987 and 1990, when inflationary pressures were intensive, Canadian monetary policy was designed to raise this index; generally (although not always) interest rates were rising and the exchange rate was appreciating in both nominal and real terms. From 1990 to the present time, with disinflationary pressures predominating, the opposite has been the case.

Canadian experience also provides some evidence of the problems that can emerge in conducting monetary policy in an SOE. Many years ago, Dornbusch (1976) demonstrated how a monetary shock could lead to exchange rate overshooting, even when expectations of future exchange rate movements were firmly anchored in purchasing power parity. Canadian experience, most recently in the summers of 1992 and 1993, shows that both fundamental and faddish shocks can also lead to extrapolative exchange rate movements and expectations, which can feed back in turn on interest rate levels. While the resulting (say) lower exchange rate

15. See Freedman (1994) for the usefulness and limitations of such a concept. The weights used in the index reflect the relative elasticities of spending with respect to interest rates and the exchange rate. These elasticities are based on the use of different empirical methodologies, small structural models, large structural models, reduced forms, VAR analysis and so on.

16. Our empirical work also indicates that monetary policy in an SOE continues to affect both the exposed and the sheltered sectors, and that there is no clear evidence that the transmission mechanism has changed greatly in recent years (White 1992). This latter finding is consistent with the belief that Canadian and U.S. financial markets have been closely linked for many years.

allied with higher interest rates might be thought to leave monetary conditions unchanged, the magnitude of the offsetting effects on spending do not guarantee this outcome. In sum, exchange rate pressures can significantly complicate the conduct of domestic monetary policy.

The Mexican authorities have in recent years put strong emphasis on structural reform, fiscal restraint and the reduction of inflation through restrictive monetary policies. Indeed, inflation fell dramatically from 180 per cent in 1988 to 7.2 per cent in February 1994. The peso has been managed as a form of crawling peg, depreciating more or less in accordance with the "allowable" schedule between 1988 and 1990.[17]

Subsequently, large scale capital inflows, linked in part to financial liberalization and the NAFTA discussions, led to a virtual stabilization of the dollar-peso exchange rate. Given that the inflation rate in Mexico still exceeds that of the United States, this nominal stability implied a real exchange rate appreciation of about 25 per cent between 1990 and the spring of 1994, an appreciation broadly similar to that seen in Canada between 1987 and 1990.[18] At least partly in consequence, Mexico's current account deficit rose to 6.8 per cent of GDP in 1992 and was still 5.7 per cent in 1993, in spite of slowing domestic demand.

The Mexican authorities have been reducing interest rates in the face of declining inflation and slowing economic growth. Nevertheless, it remains to be seen how much the nominal value of the peso will fall. On the one hand, if the capital inflows to date have reflected improved policy "fundamentals," which have increased the equilibrium real exchange rate, such capital flows are less likely to be reversed. The recent establishment of an autonomous Bank of Mexico with a mandate to pursue price stability will also help in this regard. In the same positive vein, it could be noted

17. The average annual rate of depreciation of the peso over those years was 4.7 per cent.

18. Capital inflows act in the first instance to increase the monetary base and lower interest rates. The reaction of the Bank of Mexico over the years has been to offset these influences through "partial sterilization." That is, they have chosen to accept part of the inevitable real exchange rate appreciation through higher domestic inflation and part through a stronger nominal exchange rate.

that much of the current account deficit has been related to imports of machinery and equipment, based on the assumed passage of NAFTA, which should further enhance Mexico's improving export performance.

On the other hand, Canadian experience indicates that international capital flows can be quite sensitive to a cyclical easing of monetary policy, and that overshooting and some degree of market disorder cannot be ruled out. This is particularly the case if political uncertainties must also be taken into account, as is the case in both Mexico and Canada. A combination of economic and political concerns in fact led to an 8 per cent depreciation of the peso between 1 March and 4 April 1994, though the peso has subsequently stabilized to some degree.[19]

In recognition of problems of this sort, and the growing need for ongoing economic co-operation on many fronts, the authorities of the United States, Canada and Mexico signed the North American Framework Agreement on 26 April 1994. This agreement provides for trilateral swap facilities among the participants when market pressures would seem to warrant it, along with regular discussions on matters of mutual economic interest.

3.4.2 Implications for the choice of exchange rate regime

It is sometimes argued that free trade agreements like NAFTA should, ideally, be reflected in more fixed exchange rate arrangements between the participating countries, or even in currency union.[20] Such arguments might seem familiar and, indeed, even compelling to those who have followed the debate on European monetary union. Yet it bears noting that the circumstances in North America and Europe are quite different. The free trade envisaged for North America falls well short of the economic union desired in Europe. Nor is it the case that NAFTA has been designed to

19. The "allowable" depreciation of the peso puts a lower band on the value of the peso over time. Should this band be broached, and it has not been to date, the Mexican authorities are committed to reopening the current wage pact with the unionized sector.

20. Grady (1993).

support the eventual political union of its members. Both of these facts are pertinent to the choice of an exchange rate regime.

There is no right answer with respect to the choice of an exchange rate regime, even abstracting from the political dimensions. It depends on an evaluation and weighting of a large number of criteria. After briefly discussing these criteria, an attempt is made below to apply them to the issue of the bilateral exchange regimes between the United States and Canada and the United States and Mexico.

Microeconomic arguments for fixed exchange rates would include the reduction of transaction costs and the reduction of uncertainty with respect to nominal foreign exchange values. This latter consideration has two dimensions. First, it could be argued that short-run exchange rate volatility reduces trade and, in turn, economic welfare. Second, it could also be argued, for any individual country, that long-run uncertainty about the value of the exchange rate will lead to an exodus of fixed capital towards countries that provide the ultimate markets for the product.[21] Over time, such trends will also reduce the benefits from trade.

The principal macroeconomic arguments for fixed versus flexible exchange rates are drawn from the literature on optimum currency areas (Purvis 1993, and Fenton and Murray 1993). In sum, a single currency is optimal to the degree that different monetary authorities share the same objectives and that different economies are subject to the same shocks. In the event that this latter condition is not met and real exchange rate changes are required, a single currency will be facilitated to the degree that domestic labour markets are flexible in the face of such shocks and that fiscal transfer mechanisms exist to help the disadvantaged to adjust.[22]

21. By having all costs and revenues denominated in the same currency, there is a natural hedge against the effects of currency fluctuations on profits.

22. Purvis once noted that flexible exchange rates are only required in the case of semi-fixed real wages. If domestic wages are completely flexible in the face of shocks, nominal exchange rate movements are not required. And if domestic real wages are completely inflexible, nominal exchange rate changes will not do any good.

In spite of the high and growing degree of trade integration noted in Section 3, considerable doubts remain that there would be significant micro gains from establishing a fixed exchange rate between Canada and the United States. Unlike the case of a single currency, a fixed exchange rate arrangement would still involve the exchange of currencies. While transaction costs might be lowered somewhat if bid-offer spreads narrowed, even this limited benefit would be available only in the case of a truly credible peg.

The notion that uncertainty about exchange rates might lead to a lower-than-optimal level of international trade has received a great deal of attention in the literature. However, a recent survey of this literature, much of it based on data pertaining to Canada-U.S. trade, fails to find compelling evidence that exchange rate volatility does indeed reduce trade levels (Côté 1994).

Another strand of the recent literature deals with the possibility that appreciation of the Canadian dollar against the U.S. dollar between 1987 and 1990 temporarily altered relative cost levels and obscured the *permanent* signals arising from comparative advantage. This led in turn to an increase in direct investment in the United States rather than in Canada, which would not be easily reversed. If so, it could be alleged that Canada failed to reap all the benefits of the restructuring that should have been caused by the FTA. In response, one notes the points made above in subsection 2.3 with respect to FDI since 1987. As well, Amano et al. (1993) have contended that there is no empirical support for this hypothesis of trade hysteresis. Finally, it is worth noting that fixing the exchange rate will encourage specialization along lines of comparative advantage only if the peg is fully credible. This issue is considered further below.

The microeconomic arguments for a fixed exchange rate for the Canadian dollar are therefore not compelling. In contrast, the macroeconomic arguments supporting a more flexible exchange rate regime seem more substantial. While both the Federal Reserve and the Bank of Canada are dedicated to a regime of low inflation in their respective countries, the

Bank of Canada has made more progress to date in this regard. In the measure that the Bank of Canada wishes to continue to exercise an independent monetary policy, a flexible exchange rate regime is required.

It is also the case that the structure of the Canadian economy differs from that of the United States, and the two economies are likely therefore to be subject to different shocks. In particular, Canada relies more on the production of primary products and is unique in the G-10 in having movements in its external terms of trade that are negatively correlated with those of its main trading partner (Roger 1991). A flexible exchange rate can help facilitate sectoral adjustment in the face of such shocks and help minimize the dangers of associated unemployment and inflation. In recent papers, DeSerres and Lalonde (1993) and Bayoumi and Eichengreen (1993) provide empirical support for the proposition that asymmetric shocks would make the costs of monetary union (or firmly fixed exchange rates) between Canada and the United States very substantial.

Canadian labour markets may be more flexible than those of Europe (Englander and Egebo 1993) but it would be unwise to suppose that domestic wage costs in Canada would adjust rapidly to a Canada-specific shock requiring a change in the *real* exchange rate. In this respect, the capacity of the *nominal* exchange rate to adjust could still be useful. As for the possibility that emigration might help this process of adjustment and reduce the effects on unemployment given a negative real shock in Canada alone, it must be recalled again that the FTA and NAFTA are only trade agreements. They do not provide for the international mobility of labour. And finally, there are no provisions in these trade agreements for fiscal transfers across international borders of the sort that help cushion provincial-specific shocks within the Canadian monetary union.

Joint evaluation of all the above criteria would not seem to support the idea of a fixed peg between the Canadian and U.S. dollars. Moreover, a complementary argument would also recognize the difficulty of actually choosing the level at which a peg might be put in. Such a choice would seem particularly hazardous at the present time, given the enormous forces currently causing changes in world trade patterns. Finally, and closely related to the issue of the chosen level of the fixed exchange rate, is the question of credibility. Barring an immediate transition to a currency union, any fixed rate must be credible to the markets. Without such credibility, speculation on foreign exchange markets will continue and, in the limit, there will be exchange rate changes of the sort seen in the European exchange rate mechanism (ERM) over the last two years. That is, it is perhaps even the case that, over time, fixed exchange rate regimes will demonstrate as much volatility as floating ones.

A very similar kind of analysis could be carried out with respect to the merits of having a fixed exchange rate between the U.S. dollar and the Mexican peso. As in the Canadian case, the micro arguments supporting a fixed rate regime are important but not compelling, while the macro arguments would once again seem to support more exchange rate flexibility rather than less. Nevertheless, while the balance of arguments in favour of a flexible exchange rate regime is strong for Mexico, the case is not quite as overwhelming as was the case for Canada.

With respect to the macro criteria for a regime choice, it is noteworthy that Mexico has traditionally had a much higher inflation rate than the United States. It could then be argued that Mexico could borrow credibility from the Federal Reserve by pegging to the dollar. Note, however, that the Mexican track record in reducing inflation over the last few years has been exemplary, and that the Bank of Mexico has recently been given autonomy from the government with a mandate to pursue price stability. The benefits of imported credibility may then be modest.

Lalonde and St. Amant (1993) have also found that the shocks affecting Mexico over the period 1973–91 have been distinct from those affecting the U.S. economy. As in the Canadian case, this likely arises from a greater reliance on the exploitation of natural resources (especially oil), and a greater exposure to terms of trade fluctuations. This argument for more flexible rates may, however, be offset in part by the fact that labour markets in Mexico seem quite flexible.

The choice of the level of the fixed exchange rate would seem harder for Mexico than Canada, since the implications of NAFTA (and the associated structural reforms) are likely to be very much greater. Will these changes push the equilibrium level of the exchange rate up or down, and in what measure? How much consideration should be given to the fact that Mexican inflation is still above that of the United States? The failure to peg at a credible level could also incite currency speculation, given newly liberalized capital markets, leading potentially to the kinds of events that characterized the ERM in 1992 and 1993.

4 CONCLUSIONS

The FTA and NAFTA will have important implications for Mexico, but also for Canada and the United States. While it could be argued that these treaties only recognize profound, underlying forces leading to global financial and economic integration, the fact is that these treaties attempt to adapt to these forces rather than oppose them. While the full economic effect of these treaties can only be judged with the hindsight of decades, the initial evidence is that a process of continental, industrial restructuring has begun. In the short run, there may be difficulties of adaptation at the level of both individuals and companies, but over time the beneficial effects on output and living standards will become apparent.

While both the FTA and NAFTA were pioneering in the area of trade in financial services, neither is likely to have a large and immediate impact on either Canada or the United States in this sphere. Both countries, prior to the treaties, had relatively open, efficient and highly integrated financial sectors. Nevertheless, over time, these treaties may contribute to the further erosion of current legislative restrictions on the provision of financial services in both countries. In contrast, given its initially more closed and less efficient financial sector, Mexico seems likely to reap important gains relating to both the more efficient provision of financial services and the more efficient allocation of international capital.

Similar conclusions can be drawn concerning the implications for the conduct of monetary policy. While Canada has for decades been subject to the reality of highly mobile international capital flows and has adapted the conduct of its monetary policy to this reality, Mexico will be increasingly subject to the same forces and will also have to adapt. There, the occasional tendency of financial markets to misread fundamentals should be reduced by the recent establishment of an autonomous Bank of Mexico with a clear mandate to pursue price stability.

The growing economic integration of Canada, Mexico and the United States might seem to argue for the establishment of a common currency. Such a conclusion might seem obvious to many Europeans. Yet it is important to note that a free trade area falls well short of economic union, and that the FTA and NAFTA have never been considered as precursors of political union. These are important differences from the European model. A full consideration of all the relevant microeconomic and macroeconomic criteria, the latter drawn principally from the literature on optimum currency areas, leads to a similar conclusion. Canada and Mexico will both continue to be better served by maintaining a flexible, nominal exchange rate with the U.S. dollar.

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