For release on delivery
10:00 a.m. E.S.T.
March 19, 1994

NAFTA: The Benefits and Challenges of Financial Integration

Remarks by

Edward W. Kelley, Jr.

Member, Board of Governors of the Federal Reserve System

at

Federal Reserve Bank of Dallas Conference

on

"The Role of Saving in Economic Growth"

Houston, Texas

March 19, 1994

I appreciate the opportunity to talk with you today about financial integration in North America. In recent months, substantial attention has been devoted to examining NAFTA's potential role in strengthening the links between financial markets in the United States, Canada, and Mexico. Based on the postwar record, as well as recent experience with financial flows, I am convinced that the process of financial integration can provide important benefits to each participating economy, in terms of efficient resource allocation as well as enhanced market discipline. At the same time, greater financial integration will pose substantial challenges for policymakers in each of the three NAFTA countries. It will be important to meet these challenges by avoiding potential sources of macroeconomic instability and by alleviating distortions in financial markets. The process of facing these challenges will be strengthened by the pursuit of sound fiscal and monetary policies in all three countries.

Before expanding further on these points, it may be useful to clarify the characteristics of financial integration and to highlight its significance for the determination of national savings and investment. Financial integration among a group of countries may be defined in terms of three general principles: capital mobility, unrestricted market entry, and effective but non-discriminatory regulation. Thus, the <u>process</u> of financial integration refers to the set of changes in financial regulation and market structure that are required for implementing these three principles.

First, the principle of <u>capital mobility</u> implies that

individuals and firms may freely move financial assets across borders within the group of financially integrated countries. These movements of capital may include commercial bank lending, portfolio investment in stocks and bonds, and direct foreign investment in productive assets. Through each of these channels, savings in one country may be used to finance investment in a neighboring country.

The second general principle of financial integration is that financial institutions such as commercial banks and securities firms may freely operate across national boundaries, subject, of course, to appropriate safety and soundness considerations. Under this principle of unrestricted market entry, each financial institution has the ability to engage in a full range of operations, through affiliation or purchase of existing firms, or through establishment of its own operations, all under the conditions of a third principle.

This final principle of financial integration is that all financial transactions within a given country are subject to essentially equivalent government regulations, regardless of the nationality of the parties involved. This principle of non-discriminatory regulation ensures that domestically owned financial institutions do not receive any special treatment relative to foreign-owned institutions, so that market competition takes place on a level playing field.

It should be emphasized that the principle of non-discriminatory regulation does not imply that financial

regulations should be identical across countries. Financially integrated economies may differ greatly with respect to the structure of their financial systems. Thus, it may be perfectly appropriate for each country to maintain different financial regulations, as long as these regulations do not discriminate on the basis of national affiliation. Of course, in the very long run, financially integrated economies may tend to converge, thereby diminishing the need for differences in financial regulations.

The postwar historical record reveals a substantial degree of capital mobility in North America, but also suggests a key role for NAFTA in the ongoing process of financial integration.[1] Through the elimination of tariffs and non-tariff trade barriers among the three countries, NAFTA may have a significant impact on the size of future capital flows in the region, especially in the form of trade financing. At the same time, through specific provisions on investment and financial services, NAFTA embodies many aspects of the basic principles of financial integration.

NAFTA enhances cross-border capital mobility as well as non-discriminatory regulation by guaranteeing that investors from any NAFTA country will receive national treatment, or indeed most-favored-nation treatment if any foreign firms are treated more favorably than national firms. Canada and Mexico will retain the right to review acquisitions of very large domestic

---

[1]An appendix to this paper provides a brief review of the postwar data on capital flows in North America.

firms, and Mexico retains the right to maintain limits on investment in a few specific industries such as petroleum extraction. In almost all other cases, direct foreign investment and equity investment are subject to the same regulations as investment by domestic residents. Investors have the right to repatriate profits and other capital revenue, although controls on capital mobility are permitted in certain exceptional circumstances. The agreement also provides settlement mechanisms to resolve disputes involving cross-border investments.

NAFTA reduces market entry restrictions by providing that financial institutions may freely sell almost all financial services across borders and may establish subsidiary operations in any NAFTA country. The U.S.-Canada Free Trade Agreement eliminated previous restrictions on the market share of the Canadian banking industry that could be held by U.S. commercial bank subsidiaries. Over the next few years, NAFTA will gradually phase out similar restrictions on the market share of specific Mexican financial industries, including banking, held by U.S. and Canadian financial institutions. These are positive steps toward more equitable treatment for U.S. banks in our two neighboring countries. I hope that restrictions on interstate branching in the United States will be removed in the near future, and indeed that financial institutions will eventually have the ability to establish branch operations throughout North America.

Some clues about NAFTA's influence on future capital flows are evident from the financial developments of the past four

years. The U.S.-Canada Free Trade Agreement was implemented in early 1989. In 1990, the United States became a net exporter of capital to Canada for the first time in nearly a decade. By 1992, the U.S. net capital flow to Canada reached about 2 percent of Canadian GDP. Bilateral trade in financial services has also grown rapidly over the past four years, and it seems reasonable to expect that capital flows and trade in financial services will continue to grow in future years.

The Mexican government liberalized its foreign investment regulations in May 1989. These changes, combined with broad structural reforms in many other areas, initiated a "new dynamic" in Mexico's economy that successfully halted the previous outflow of financial capital. More recently, as a result of these reforms and in anticipation of the implementation of NAFTA, capital inflows reached extraordinary levels of about 7.5 percent of GDP in 1991 and 1992. In contrast to the large capital inflows of 1979-81, official loans and bank debt comprised a small fraction of recent inflows, while portfolio investment in corporate stocks and bonds accounted for about half of these movements. Now that NAFTA has been approved, we may expect that substantial capital flows will continue and that trade in financial services will grow during the next few years.

As NAFTA augments the process of financial integration in North America, each country will receive substantial benefits in terms of efficient resource allocation. In an environment of high capital mobility, savers can shift their assets across

national borders to find investments with the highest risk-adjusted rates of return. As non-discriminatory regulations are implemented and market entry restrictions are alleviated, financial institutions may be expected to become more efficient in allocating these funds. Therefore, countries with net domestic savings can receive higher rates of return on more diversified portfolios, while countries with lower levels of domestic savings benefit from the ability to finance a larger number of productive investments.

For example, suppose that a particular country implements structural reforms that create opportunities for new investment projects with relatively high rates of return. In a closed economy, domestic residents might have to sacrifice a substantial amount of current consumption to generate sufficient savings to finance these investment projects. In contrast, in a financially integrated group of economies, the savings of other countries can also be used to finance the investments. In this case, the recipient country is able to sustain higher consumption as well as higher investment. Over a period of time, these investments raise productivity in the recipient economy, and generate sufficient profits to pay an attractive rate of return to the savers in other countries. Thus, in a financially integrated region, structural reforms in one country can produce benefits for every country in the region.

Some aspects of financial integration provide both benefits and challenges. For example, financial integration strengthens

the incentives for each government to maintain sound economic policies. A country with inappropriate or unstable policies, such as persistent fiscal deficits and low domestic savings, may have difficulty in attracting foreign investment, especially if investors perceive a significant risk of repayment problems. Such an economy may also experience capital flight, as savers move assets to countries with more attractive investments in terms of risk and return.

Financial integration places a special constraint on monetary and exchange rate policies. If the authorities seek to maintain a fixed exchange rate with a neighboring country, then monetary policy must be used to ensure that domestic inflation does not diverge substantially from the inflation rate of the neighboring country. Otherwise, growing expectations of currency devaluation can generate large capital flows out of the high-inflation country. Even with floating exchange rates, fluctuations in capital flows and in currency values can provide information and warning signals about potential imbalances that should receive attention from government authorities.

Clearly, then, the process of financial integration in North America poses substantial challenges for government policy of each partner in NAFTA. The post-war record demonstrates that even with imperfect capital mobility, the consequences of inappropriate policies have occasionally been very painful. As the degree of capital mobility continues to increase, policymakers in all three countries face an ongoing challenge

to maintain sound fiscal and monetary policies.

As the largest economy in North America, the United States must pursue sound policies, not only in its own interests but also because U.S. policy actions can have serious repercussions for its regional partners. At the same time, as smaller economies, Canada and Mexico can face large fluctuations in external capital flows. Given their relative size as a share of GDP, such capital flows can have substantial macroeconomic consequences. For this reason, the authorities face a challenging task in monitoring capital movements and formulating appropriate policy responses.

Stable capital flows based on long-term investment opportunities have substantial benefits, particularly when unrestricted market entry and non-discriminatory regulation ensure that resources are allocated according to market criteria. However, even in such an environment, temporary surges in financial flows can distort the allocation of resources and generate a boom/bust economic cycle. Since temporary capital surges are sometimes difficult to control and have potentially serious consequences, all three NAFTA partners have reason to redouble their efforts to maintain sound monetary and fiscal policies.

As budget deficits are reduced and fiscal stability is achieved, this will eliminate a substantial source of speculative financial flows. As each economy moves toward a sustainable growth rate without strong inflationary pressures, the monetary

authorities can avoid large fluctuations in interest rates and associated capital flows. By pursuing sound monetary and fiscal policies, each country can reduce its vulnerability to the adverse effects of temporary surges in capital flows.

In terms of creating a stable macroeconomic environment, one must be impressed with the recent fiscal achievements of the Mexican authorities. In 1987, the public sector deficit totalled about 16 percent of GDP for the second year in a row. Since then, the Mexican authorities gradually eliminated the deficit, and achieved a small public sector surplus by 1992. Of course, the U.S. government also has made several attempts over the past few years to reduce our budget deficit. Some progress has been made over the past year, but continuing efforts will be necessary to ensure that the deficit does not start expanding once again. The Chrétien administration also faces a challenge in reducing the Canadian budget deficit, which has hovered around 5 percent of GDP in recent years. If the United States and Canada can achieve more balanced fiscal accounts, public borrowing requirements will cease to dominate the pattern of financial flows in North America, thereby freeing up more funds for private sector development.

As NAFTA stimulates capital mobility and trade in financial services, policymakers will also face challenges in financial market supervision and regulation. As levels of direct foreign investment and cross-border portfolio investment continue to grow, I would hope to see an ongoing process of harmonizing

national accounting practices and securities trading regulations.

As commercial banks enter new markets, financial integration will generate healthy competition in the North American banking industry that will prove beneficial to all parties. However, prudential supervision and regulation must ensure that these competitive pressures do not lead to unsound lending practices, and that problems with any particular financial institution are resolved in a timely manner at minimum cost.

Differences in the financial systems of the three NAFTA countries present significant challenges for the implementation of a consistent set of prudential standards, while maintaining the principle of non-discrimination. Prudential standards continue to evolve in each country in the face of innovations in technology, financial instruments, and risk management procedures. In that context, NAFTA can provide a useful framework for consultation and cooperation in banking supervision and regulation. As the process of financial integration continues under NAFTA, appropriate supervision and regulation of financial markets will minimize prudential problems and allow capital flows to be directed toward efficient and productive investments.

This conference exemplifies the spirit of cooperation that lies at the heart of NAFTA. I am confident that this spirit of cooperation will enable us to face the challenges and experience the benefits of financial integration in North America.

Appendix: Postwar Financial Flows in North America

This appendix provides a brief review of financial flows in North America over the period 1950-1985. From the capital accounts for the United States and Canada, three phases of financial flows may be identified. First, during the 1950s and 1960s, relatively high levels of gross domestic investment in Canada stimulated persistent capital inflows from the United States. Over this period, the U.S. economy generated significant net domestic savings, about one-third of which was directed toward Canada. Net capital inflows from the United States averaged more than 2 percent of Canadian GDP per year for almost two decades.

Most of these capital inflows were invested in Canadian bonds and bank deposits, but direct foreign investment also played an important role, especially in the energy and mining sectors. U.S. direct foreign investment accounted for about 5 percent of annual gross domestic investment in Canada during the 1950s, and about 3 percent of gross domestic investment during the 1960s. However, as the profitability of investments in Canada and the United States gradually converged, bilateral capital flows diminished to relatively low levels by the early 1970s.

OPEC price hikes initiated a second phase of financial flows over the period 1974-1981. As the oil boom re-ignited the rate of gross domestic investment in Canada, net capital inflows from the United States reached a postwar high of 4.2 percent of

Canadian GDP in 1975, and averaged 1.5 percent of GDP per year over the rest of the decade.

In contrast to the previous two decades, however, these capital flows were comprised almost exclusively of portfolio investment. Growing public concern about foreign control of Canadian industries led to the establishment of the Foreign Investment Review Agency in 1974, for the purpose of screening new foreign investments and acquisitions. During the remainder of the decade, direct foreign investment comprised less than 1 percent of gross domestic investment.

In 1982, falling oil prices and high world interest rates generated a severe recession in Canada, with sharply lower rates of domestic investment. The Canadian economy experienced net capital outflows until 1985, and then recorded net capital inflows during the remainder of the decade. In the United States, meanwhile, higher government deficits contributed to a fall in the domestic savings rate, while domestic investment remained essentially unchanged. As a result of these factors, Canada became a net capital exporter to the United States, with bilateral capital flows averaging about 2 percent of Canadian GDP per year from 1982 to 1985.

This period marked the emergence of substantial Canadian direct foreign investment in the U.S. economy, averaging about 0.3 percent of U.S. gross domestic investment, and comprising about a third of all foreign direct investment in the United States. Starting in 1985, the Canadian government also began to

relax its restrictions on U.S. investment in Canada. Many of these changes were later incorporated into the U.S.-Canada Free Trade Agreement, and ultimately became provisions of NAFTA.

Turning now to the historical pattern of capital flows between the United States and Mexico, we can see some striking parallels with the U.S.-Canadian experience. From the 1950s until the early 1970s, Mexico experienced relatively steady net capital inflows averaging about 2 percent of its GDP per year. Official loans and private bank debt comprised the major part of these capital inflows, while portfolio investment was limited by the small size of Mexican securities markets.

Direct foreign investment comprised more than a third of total capital flows to Mexico, and accounted for about 4 percent of gross domestic investment. As in Canada, political pressure led to a gradual tightening of restrictions on foreign investment during the 1960s and early 1970s. This trend culminated in the 1973 Foreign Investment Law, which limited non-residents to minority ownership of Mexican firms.

After the OPEC oil price hike of 1973, Mexico's investment rate increased significantly and reached 27 percent of GDP in 1980 and 1981. Since domestic savings were insufficient to meet the increased level of investment, capital inflows accelerated to an average of 4 percent of GDP per year during the late 1970s, and reached a peak of 7 percent of GDP in 1981. Legal restrictions limited the growth of direct foreign investment, while official loans and short-term private bank debt comprised

an increasing share of these capital inflows. Of course, this composition of capital inflows increased the sensitivity of the Mexican economy to fluctuations in external interest rates.

Eventually, high world interest rates, deep recession in the industrial countries, and a steep drop in oil prices in 1982 generated a financial crisis and severe recession in Mexico. The investment rate dropped sharply and reached a trough of 18 percent in 1986. Although the Mexican government recorded large budget deficits during this period, private savings increased rapidly. From 1983 to 1985, Mexico became a net capital exporter on a global basis, with net capital outflows averaging about 1.5 percent of GDP per year. As in Canada, the Mexican government began to relax its restrictions on direct foreign investment over this period, and initiated steps toward greater financial integration with the United States and Canada.