Intelligence MEMOS

As NAFTA renegotiations proceed, the C.D. Howe Institute Intelligence Memos will be looking at what to expect and provide analysis on the latest developments. This post is part of that series.

From: Brenda González-Hermosillo

To: NAFTA negotiators

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Re: **Bringing financial services into the NAFTA renegotiation**

Much has been said recently about the objectives and outcomes of the NAFTA renegotiation. Reflecting the US agenda, which called for the "modernization" of NAFTA, most of the discussions appear to have focused largely on tangible merchandise trade. Sometimes the focal points have been specific products that are politically charged to some constituencies (Canadian lumber or Mexican avocados taking over part of the US market). While other times, the focus is on supply chains that produce an actual tangible product built with components from various countries (automobiles). At times, the main objective of the US administration appears to be simply achieving a "target" merchandise trade balance to reflect "fair" trade. All of these stated objectives mostly deal with goods that consumers shop for and bring home physically, or products that are fabricated domestically for export.

However, a basic understanding of the national accounting system that deals with the international balance of payments includes not only the merchandise account, but importantly also includes services and cross-border capital flows. By construction, the merchandise account balance plus the services balance, plus the capital account, add up to approximately zero. Due to difficulties in timing financial flows, which are often used to finance the traded goods, there can be in practice significant "errors and omissions." If all the cross-border capital flows of one nation with the rest of the world could be measured on a timely and accurately basis, then the balance of payments would be "balanced."

Why is this important? Because a current account deficit is necessarily a reflection of a capital account surplus (and vice-versa). But a capital account surplus means that the country in question is receiving net capital inflows (including financial and direct foreign investment.)

Financial services are part of that intangible, but critical, category of international trade flows. It is a critical issue because the purchase of imported goods and services often depends on external financing. The provision of cross-border financial services is also often done through local branches or subsidiaries of foreign banks in the host country. But we don't hear much about financial services in the NAFTA negotiations.

To be fair, there has not been total silence regarding the financial services chapter of NAFTA. There are pressures in the US to expand data access from financial firms in partner countries. It is not clear where those negotiations stand, but it is possible that they may not go very far on the basis of concerns for financial stability.

The first principle of international trade is that countries should export the goods and services in which they have competitive advantage, and import those in which they do not—hence, have surpluses and deficits in different sectors. It turns out that NAFTA already helps the US benefit from its competitive advantage in financial services. The US has a $4.3 billion surplus in financial services trade with Canada and a $1.1 billion surplus with Mexico, according to the Bureau of Economic Analysis.

In 1994, NAFTA was the first international trade agreement in which financial services were included and the first time in which a developing country joined in an international trade agreement with advanced economies. Much has changed since 1994, especially in financial services. Prior to 1994, Mexico would not allow any foreign bank to operate domestically, though Citibank had been grandfathered. Most banks in Mexico are now foreign-owned. The Mexican banking sector is quite vibrant and resilient to market, liquidity and credit risks thanks to high capital buffers, which is in sharp contrast to the period before NAFTA.

The US Administration appears much less interested in renegotiating financial services in NAFTA, than other sectors. Why? Because the US already has greatly benefited from its trade in financial services. So Canada and Mexico should take advantage of that US strength and use it as a bargaining chip when negotiating other sectors. At the very least, NAFTA negotiators should put all the chess pieces on the board. This is precisely what international trade theory would have said about the advantages of free trade: not that nobody would lose, but that if the overall gains were used to compensate the losers, then everybody would still be better off.

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