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The U.S. Financial Crisis and its NAFTA Linkages

by

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1. Introduction

The year 2009 coincides with the fifteenth anniversary of the enactment of the North American Free Trade Agreement (NAFTA) and the twentieth anniversary of the implementation of the Canada-U.S. Free Trade Accord (FTA). With possible exception of Gallagher and Wise (2009), there are, however, very few in the media who have even bothered to take notice. Indeed, there are undoubtedly a lot fewer neoliberal policymakers in any of the three NAFTA countries who are in any mood to celebrate, especially when all eyes have been focused on how to deal with a financial crisis that by Fall of 2008 seemed to be spinning completely out of control. What is perhaps still more astonishing is the fact that there are even fewer who have pointed to a possible link between NAFTA and the financial crisis originating in the U.S. (i.e., the triggering of the subprime mortgage crisis in 2007 and the ensuing slump affecting the world economy). In contrast, we would like to argue that the distinct model of export-led growth (ELG), which first took shape under the FTA and then extended to Mexico under NAFTA, heralds the formal consolidation of a process of "NAFTAization" of the world economy, especially as a growing number of countries, China being most visible, have become ever more tied to exports to the U.S. as their main source of economic growth.

The object of this paper is to identify the NAFTA linkages to this crisis. As the debate over the "Buy America" clause of the U.S. Recovery and Reinvestment Act at the beginning of 2009 highlights, our analysis supports the view that the basis for a long-term solution to the financial ills afflicting both the U.S. and the world economy must include a re-regulation of trade and financial flows that would favor inward-looking domestic demand policies. Hence, an internationally coordinated inward-looking growth policy along Keynesian lines, diametrically opposed to the established wisdom in support of the liberalization *à outrance* of both the goods and financial capital markets, could be an important first step in establishing a more solid foundation for sustained long-term economic growth — a growth process that would not be plagued by recurrent crises as it had been during the "Golden Age" of the early post- W.W.II years.

2. The Financial Crisis and NAFTA

2.1 The NAFTA Model and Its Impact on the Evolution of Trade and Financial Flows

After a long period of policy drift following the breakdown of the Bretton Woods system of the early 1970s, NAFTA emerged as an institutional structure for the promotion of greater economic integration, especially as international markets in both goods and financial capital became ever more liberalized by the late 1980s. The codification (in 1989 and 1994) of this evolving neoliberal policy system into a precise legal framework became an important step in making it a reference model which could then be emulated internationally as, for example, via the vehicle of the World Trade Organization (WTO). Indeed, it is not a coincident that the ending of the Uruguay Round of multilateral trade negotiations and the birth of the WTO, which opened new areas of binding agreement not found in its predecessor (the General Agreement on Tariffs and Trade – the GATT), occurred soon after the passing of NAFTA. The latter's institutional design is so well anchored nowadays that, even during the deepest crisis afflicting the U.S. and the international economy in 70 years, its structure cannot be seriously put to question, as exemplified by the political backtracking on the "Buy America" provision of the Obama administration stimulus package in February 2009. Indeed, in an interview on the Canadian Broadcasting Corporation on the eve of his first trip to Canada, President Obama himself argued that, except for the original Clinton labor and environmental standards side deals that ought to be incorporated in the main agreement so as to make the standards "enforceable", he did not see any need for changes to the accord (Youngman 2009). This is because free trade as an ideology has become deeply rooted in the psyche of policy makers. However, it is also because of the overt threats and legal sanctions — that is to say, any protectionist measure by any one country would be met by beggar-thy-neighbor retaliatory measures by others, thereby collectively crippling world trade.

While both the original FTA and then NAFTA were undeniably trade agreements in the traditional sense of eliminating tariff barriers, these were not the typical examples of, say, the naïve Ricardian two-country model of trade liberalization. Both the asymmetric political power relation among the three NAFTA countries and the fact that Canada and Mexico trade with a country that is the purveyor of the premier international currency, would suggest that NAFTA would be something significantly different from the textbook model. In fact, it was above all an investment deal that, more than ever before, opened borders to capital mobility and entrenched investors' rights so that the free play of the market would at best be restrained by the lowest common denominator of regulatory control. Indeed, when investors' rights provisions were coupled with a massive trade liberalization of financial services, it singled to business firms, especially in the financial sector, that only the sky was the limit.

In a sense, the objective of NAFTA was not so much to enhance trade within North America, since by the 1980s both Canada and Mexico (with the latter joining GATT in 1986) were very eager to graduate and move further in that direction, regardless of the particular institutional arrangement in place. The purpose was to use NAFTA as a trampoline for expanding trade in services and permitting further growth of U.S. financial flows with the rest of the world, especially with Asia, under neoliberal rules that would more closely approximate those under NAFTA. One has only to think of the attempts to negotiate hemispheric free trade (the so-called "Free Trade Area of the Americas") and even bilateral trade agreements such as with South Korea over the last decade. Table 1 substantiates this. For instance, while American imports rose by about 60 percent (as a percentage of GDP) in its overall trade with the rest of the world, the import ratios from the NAFTA countries rose initially, they then peaked at the turn of the millennium, and were only to fall back to the level that they were before NAFTA by 2007. A similar phenomenon can be deciphered in Table 2, when accounting for the bilateral trade relations (Canada-U.S.A. and Mexico-U.S.A.) separately.[1] As can be seen in Table 2, while rising at the outset, U.S. imports from both Canada and Mexico reached a plateau and then declined as a share of total U.S. imports since 2000.

Table 1: Evolution of U.S. Imports of Goods and Services (as Percentage of GDP) and from Canada and Mexico (as Percentage of Total U.S. Imports), 1986 - 2007

	1986	*1993*	*2000*	*2007*
Total U.S. Imports as % of U.S. GDP	10.2	10.8	15.0	17.2
Sum of Imports from Canada and Mexico as % of Total U.S. Imports	21.6	23.7	27.1	24.3

Source: Bureau of Economic Analysis, U.S. Department of Commerce, International Economic Accounts, Tables 1.1.5 and 12, www.bea.gov/international .

Table 2: U.S. Bilateral Goods and Services Trade with Canada and Mexico (as Percentage of Total U.S. Imports), 1986-2007

	1986	*1993*	*2000*	*2007*
Exports to Canada	14.4	16.4	13.8	12.4
Imports from Canada	16.9	17.0	17.1	14.6
Balance with Canada	-2.5	-0.6	-3.3	-2.2
Exports to Mexico	3.7	7.2	8.5	6.7
Imports from Mexico	4.7	6.7	10.0	9.7
Balance with Mexico	-1.0	0.6	-1.5	-2.9

Source: Bureau of Economic Analysis, U.S. Department of Commerce, International Economic Accounts, Tables 1.1.5 and 12, www.bea.gov/international .

The same general phenomenon can also be seen when one looks at the financial flows between the U.S. and its two NAFTA partners as compared to the overall U.S. financial flows internationally. The growing net positive financial inflows to the U.S. merely mirror the latter's growing trade deficit as shown in the top section of Table 3 for the period between 1986 and 2007. However, while it has continued to maintain an overall trade deficit with its two NAFTA neighbors, broadly speaking, its financial flows show a declining share of both Canadian and Mexican financial movements (with respect to the total, as displayed in parentheses for Canada and Mexico in Table 3). Although financial flows between the U.S. and its NAFTA partners did rise a great deal during the post-NAFTA era, the U.S. flows had generally grown even more so vis-à-vis the rest of the world.

Table 3: U.S. Financial Inflows and Outflows, Total, Canada and Mexico, in Billions of U.S. Dollars, 1986-2007

	1986	***1993***	***2000***	***2007***
Financial Outflow from U.S. (Total) (Change in U.S. Foreign Assets Abroad)	-111.7	-200.6	-560.5	-1,289.9
Financial Inflow to U.S. (Total) (Change in Foreign-Owned Assets in US)	+228.3	+279.8	+1,038.2	+2,057.8
Net Change	+116.6	+79.2	+477.7	+767.9
Financial Outflow from U.S. (Canada) (Change in U.S. Foreign Assets in Canada)	-10.1 (9.1%)	-23.6 (11.8%)	-36.1 (6.4%)	-67.2 (5.2%)
Financial Inflow to U.S. (Canada) (Change in Canadian-Owned Assets in US)	+13.6 (6.0%)	+10.9 (3.9%)	+49.6 (3.9%)	+73.7 (3.6%)
Net Change	+3.5	-12.7	+13.5	+6.5
Financial Outflow from U.S. (Mexico) (Change in U.S. Foreign Assets in Mexico)	+1.4 (1.2%)	-14.5 (7.2%)	-1.5 (0.3%)	-12.8 (1.0%)
Financial Inflow to U.S. (Mexico) (Change in Mexican-Owned Assets in US)	+0.2 (0.1%)	+7.7 (2.7%)	+11.5 (1.1%)	+13.0 (0.6%)
Net Change	+1.6	-6.8	+10.0	+0.1

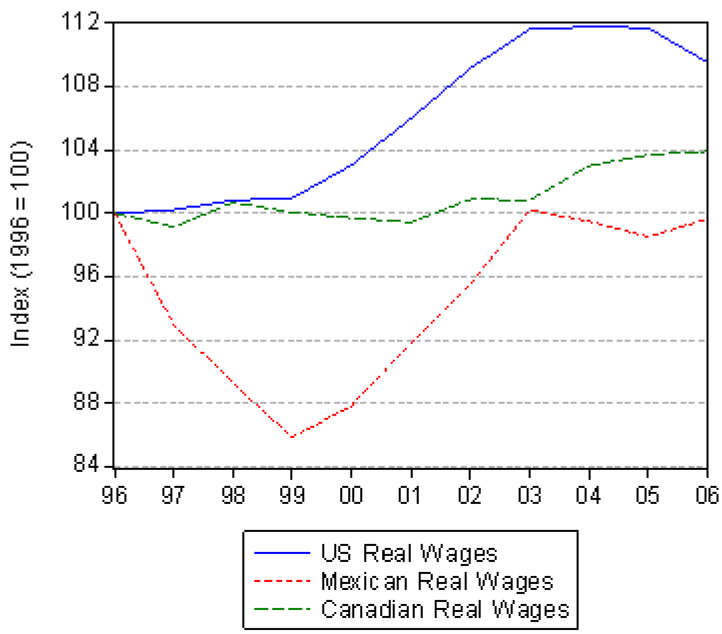
Source: Bureau of Economic Analysis, US Department of Commerce, International Economic Accounts, Tables 1 and 12, www.bea.gov/international .

N.B.: The percentages in parentheses below the various financial flows for Canada and Mexico describe the proportion of the country specific inflows/outflows as a percentage of the respective total US figure in the top tier of Table 3.

2.2 The Underlying Cause of the Subprime Crisis and the NAFTA Linkage

From the initial pressures under NAFTA, and with the implementation of rigorous anti-inflationary monetary and fiscal policies in both Canada and Mexico, this growing trade and financial liberalization imparted a deflationary bias on the evolution of money and real wages as well as prices in the respective countries on the North American continent while widening the share of profit (see Seccareccia 2007, Baragar and Seccareccia 2008). On the other hand, for the NAFTA model actually to succeed, it necessitated high consumption (and therefore high wages), especially in the U.S., to sustain aggregate demand and their ELG strategies, not only for Canada and Mexico but also for the rest of the world economy. This pattern of growth for North America, based on high consumption growth for the U.S. and a low inflation environment (because of austere macroeconomic policy and because of low labor costs in Mexico and low energy and raw materials prices from Canada) did occur, and the ELG model quickly extended its tentacles to outside of North America as growing industrial giants, such as China, began to replace Mexico as source of labor-intensive manufactured products (see Blecker and Seccareccia, 2009). However, the impact that this had on real wage growth on each of the three NAFTA countries is of greatest interest. As evidenced from the series provided by the U.S. Bureau of Labor Statistics, real wages (at least for the manufacturing sector) grew somewhat in the U.S., they grew rather marginally in Canada, and actually declined during the early years of NAFTA in Mexico, only to reach a level in 2006 that was still marginally below its 1996 level! Interestingly, all three countries showed practically no growth and, in one case, there was a significant decline in real wages until the turn of the millennium. While real wages showed some upward trend, primarily in the U.S. and reaching a plateau between 2003 and 2005, even there real wages only grew by an average of about one percent annually for the decade between 1996 and 2006 as a whole, which was well below the trend growth in productivity for that same period. Although one could not argue outright that the growing U.S. trade deficit (which was partly a byproduct of this reconfiguration of both the North American and world economy based on outward looking measures to stimulate growth) was actually a source of impoverishment for the rest of the world (see Scott, 2007), the experience of Mexico in the NAFTA context is one that confirms that real wages collapsed during the early NAFTA era and have not grown during much of the first decade of the 21st Century.

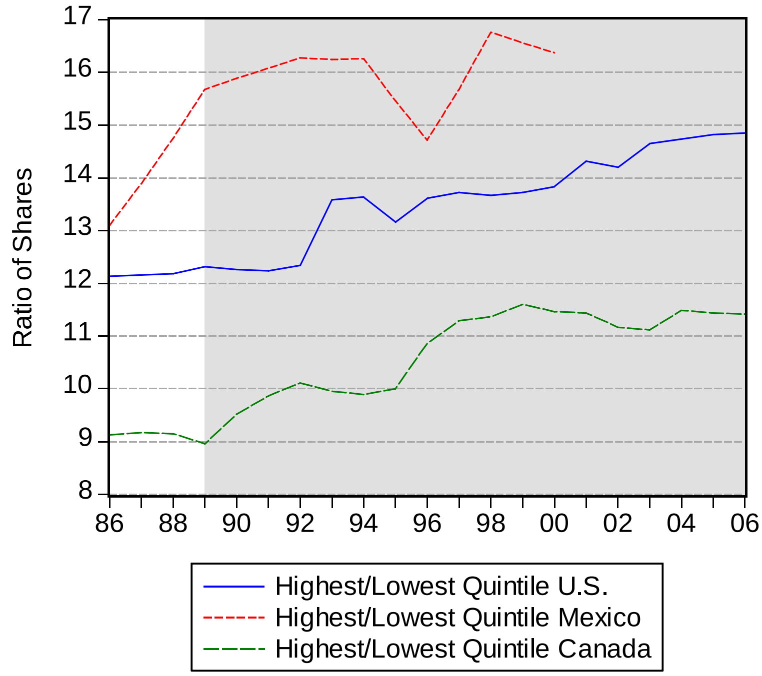
Figure 1: Evolution of Real Wages in the Manufacturing Sector in the NAFTA Countries, 1996-2006 (Wages were calculated in their National Currencies and Deflated by their Respective CPIs)



Source: U.S. Bureau of Labor Statistcs; Statistics Canada; and Banco de Mexico

This labor market state of anemic real wage growth had led to another undesirable consequence when looked at from the angle of income inequality in all of the three NAFTA countries. Evidence for Mexico is mostly anecdotal since solid data is not easily available and could be calculated on the basis of information provided from the OECD only for the period up to 2000. However, even from the limited empirical evidence available, it does corroborate the view that the collapse of real wages throughout the early part of the post-1994 era had disastrous implications for the most vulnerable at the bottom end of the Mexican income ladder. In any case, such negative effect on income distribution is certainly supported as well by the general evidence on the rise of income inequality in the high income economies of Mexico's NAFTA partners to the north. For instance, throughout most of the 1990s, both the U.S. and Canada witnessed a significant growth in income inequality, and therefore, contrary to what had been marketed by the supporters of NAFTA, the rising tide of trade did not lift all boats! A simple measure of income disparity adopted for the purpose was the ratio of the share of the highest income quintile to that of the lowest income quintile for the three NAFTA countries, displayed in Figure 2. Starting with the FTA, from 1989 onwards, income inequality grew a great deal in Canada until this ratio reached a plateau by the turn of the 21st Century. In the case of the U.S., the ratio rose consistently since the early 1990s to 2006. Undoubtedly other factors affecting income distribution were also at work, reflecting such tendencies as the long-term pattern of de-industrialization; but, as the shaded area for the FTA and then NAFTA period suggest, trade liberalization must have contributed by accelerating this trend towards greater income inequality.

Figure 2: Ratios of the Shares of Income Quintiles, Canada, Mexico and the United States, 1986-2006



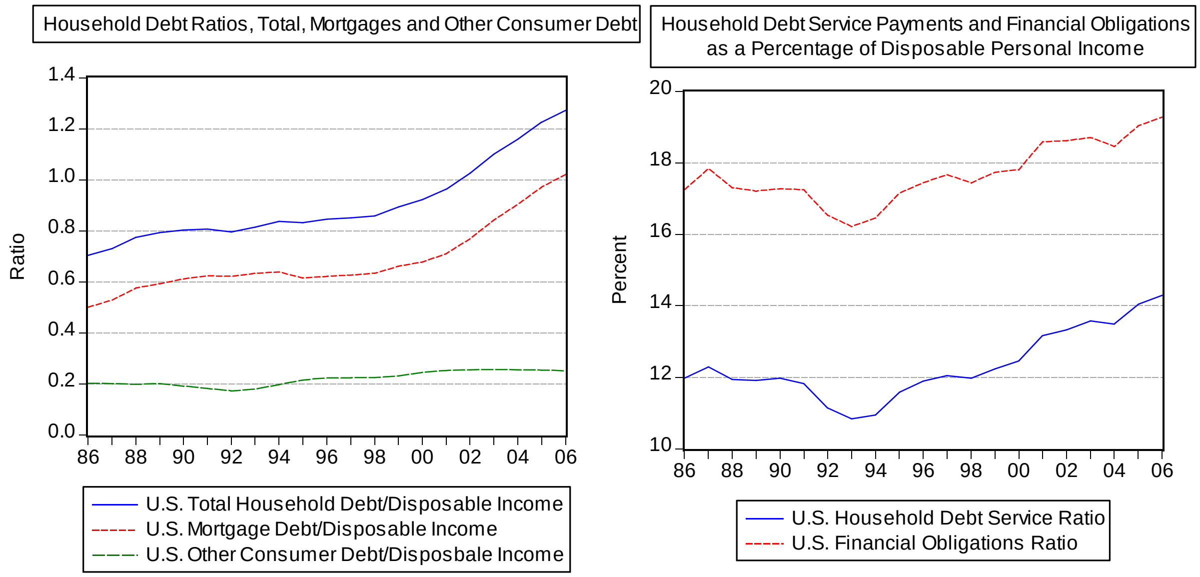
Source: O.E.C.D., OECD Territorial Reviews - Mexico, Paris: OECD Publishing, 2003, Table1.1, p. 33 (with original source INEGI and with some data for the odd years obtained through interpolation); Statistics Canada, CANSIM II, Series V25731827 and V25731831; and U.S. Census Bureau (Income in 2007), Table A-3.

With a relatively flat real wage movement in the U.S. and Canada that was accompanied by growing income disparities, how then could domestic consumption grow quickly enough to absorb the rising quantity of raw materials and manufactured goods being produced in Canada, Mexico and elsewhere to supply what became a growing U.S. consumption binge? The answer of course is that it was the fairly loose monetary policy during the Greenspan era coupled with a plethora of financial innovations made possible in an age of financial deregulation that promoted a significant rise in consumption spending.

The rising inequality accompanied by growing accessibility to credit promoted household indebtedness on a scale not seen hitherto. As shown on the left-hand panel of Figure 3, ratios of household debt to disposable personal income exploded beginning in the mid-1990s and peaked as house prices reached a plateau by 2006-7. The plummeting of house prices brought about by significant monetary tightening (as the effective Federal Funds rate rose from an average of 1.13 to 5.02 percent between 2003 and 2007) was the *coup de grâce* that ended what was otherwise a typical housing bubble and triggered the subprime debacle starting in the summer of 2007. In fact, while all forms of consumer credit expanded during the pre-2007 era, the more interest-sensitive residential mortgages dominated over all other forms of household debt.

Despite the rising problem of effective demand engendered by flat real wages and increasing income inequality, this growing household indebtedness and plummeting saving rate had initially spurred growth forward (either domestically or via exports) in the three NAFTA economies. But, as had been predicted by such distinguished scholars as Wynne Godley since the late 1990s, it was only a matter of time that the U.S., together with its trading partners, would be facing a severe collapse when looked at from the angle of the net financial imbalances across the wide sectors of the U.S. economy (see Godley 1999; and Godley and Izurieta, 2001). Securitization made it easier for the financial sector to spread, as well as to hide, the high risk associated with ballooning household debt. Eventually, as evidenced by the subprime crisis, growing securitization merely ensured that the speed and breadth of the propagation of the financial collapse across the financial sector would be all the more severe as these subprime mortgages were repackaged into various kinds of financial derivatives — the so-called "collateralized debt obligations" (CDOs) — held by investment banks and other financial institutions both in the U.S. and internationally. However, the seed of the financial collapse was the underlying imbalance between debt and income. The high consumer spending which was pushing forward household debt ratios throughout the NAFTA era (see Figure 3 below) simply could not be sustained without a significant rise in real incomes for those low-income households accumulating ever more debt during the pre-2007 period.

Figure 3: Debt and Debt Servicing Ratios, United States, 1986-2006



Source: U.S. Federal Reserve Board and U.S. Bureau of Economic Analysis.

3. Canada and the Financial Crisis

3.1 The Emergence and Transmission of the Financial Crisis under NAFTA

In early 2009, many international observers praised Canadian policy makers for their “genius” in weathering the financial storm (see, for instance, Zakaria, 2009). Canada has been viewed by some as an island of stability in the midst of extreme financial turbulence. We are told that, if it were not for the instability caused by the behavior of some unscrupulous American mortgage vendors and hedge fund managers, together with the intervention of U.S. policy makers to push the hand of the market (via cheap money policy to support homeownership for low-income American households), the crisis would never have occurred (Hlinka 2008). Though seemingly less turbulent, when set against the experience of other industrialized countries, the Canadian economy has in fact been deeply battered by the financial fallout.

It can be said that Canada’s financial affliction has been caused both by forces that had been nurtured under NAFTA as well as factors that are endogenous to the evolution of the domestic economy. Hence, many of the trends that we see in the U.S. have often occurred, usually with a lag, in Canada. For instance, forces pushing for a more unequal distribution of income reflect a general pattern of growth in most industrialized countries, as these economies slowed down since the 1970s with the abandonment of Keynesian policies and, as these economies became more service oriented, with a general decline of trade union density rates.[2] We would argue that, though many of the underlying forces were already at work, NAFTA certainly compounded this trend towards greater income inequality in Canada, as real wages grew more slowly, especially of unskilled workers.

In addition to its strong net exports to the U.S. throughout much of the pre-2007 era, a principal source of Canadian economic growth came from strong consumer spending. This is well substantiated in Table 3 below, which traces the overall downward trend in the personal saving rate.[3] What is most revealing from this table is the way in which average propensities to save differ among income groups. The disaggregated data by quintiles reveals the general decline of the saving rate for most income groups, with the exception of the highest income quintiles. Indeed, the sharpest fall in the saving rate was for households in the lowest income quintiles who, on average, had the lowest positive/highest negative saving rates. These increasingly negative saving rates would not be possible for any protracted period without support from the banks, presumably by some loosening of their creditworthiness criteria over time. Hence, low interest rate policy coupled with some relaxing of the creditworthiness requirements were not only characteristics of the U.S. economy but the phenomenon also manifested itself in Canada, with growing substrata of Canadian households falling deeper into debt.

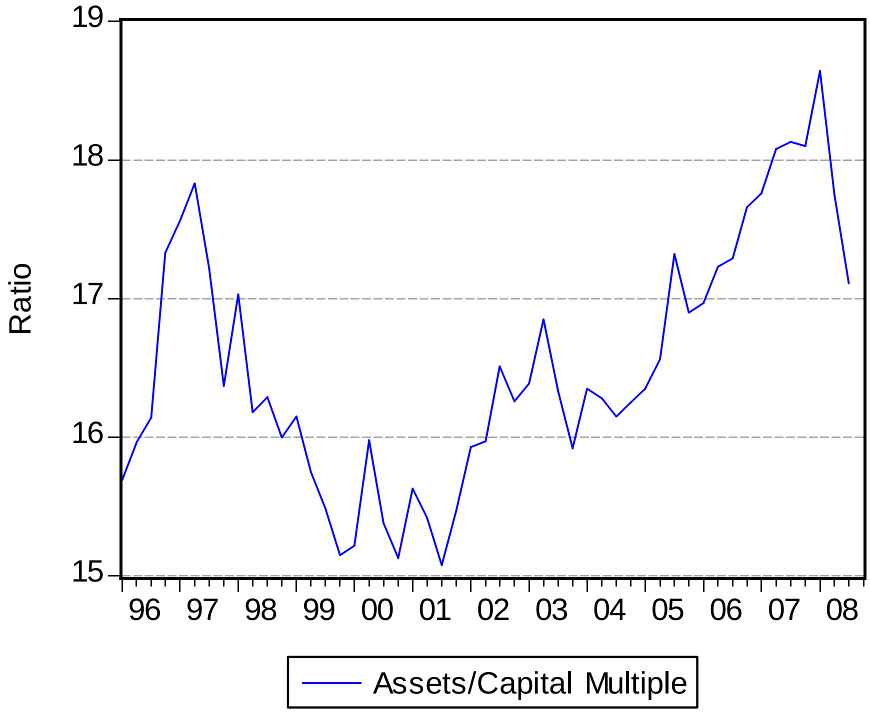
Table 3: Evolution of the Saving Rate in Canada, Total and by Income Quintile, 1986-2006						
Year	**Total Personal Saving Rate** (National Accounting Basis)	**Lowest Quintile**	**Second Quintile**	**Third Quintile**	**Fourth Quintile**	**Highest Quintile**
1986	13.4	-12.1	-1.6	5.4	11.2	22.0
1996	7.0	-17.1	0.9	11.1	17.0	28.3
2006	2.3	-37.5	-6.4	4.9	14.4	29.7

Source: Statistics Canada, *National Income and Expenditures Accounts*, and Statistics Canada, *Family Expenditure in Canada*; and Statistics Canada, *Survey of Household Spending* (calculated from micro data made available from the Income Statistics Division of Statistics Canada).

However, while moving in the same direction that ultimately led to the 2007 subprime crisis in the U.S., the Canadian financial system revealed some important features which prevented it from sinking into the same quagmire. Firstly, despite the pressure to liberalize under NAFTA, the Canadian banking system has remained relatively protected from foreign competition. In fact, even under the current looser regulatory system since 2001, it makes the foreign acquisition of the major Canadian banks (the so-called Schedule I banks) very difficult since an investor cannot hold more than 20 percent of voting shares and not more than 30 percent of non-voting shares of the larger banks, with direct approval from the federal Minister of Finance. The fact that U.S. banks have not been able to penetrate the Canadian banking sector very much has meant that the latter has not been unduly affected by decisions taken by the head offices in the U.S. as it has been the case in, say, the Canadian automobile sector.

Moreover, in terms of Basel II capital adequacy requirements, Canadian banks tend to be much better capitalized than their American and European counterparts and also tend to be less leveraged than other banking institutions internationally (See Bank of Canada 2008: 24). As a result, Canadian banks have faced significantly less losses and writedowns than banks in the U.S., the UK and continental Europe. For instance, by the fourth quarter of 2008, Canadian banks had reported losses of about $12 billion from the financial fallout, while the figure for the U.S. and Europe combined was over $700 billion in U.S. funds (Cf. Bank of Canada 2008: 9). Figure 4 below traces the evolution of this ratio as measured by the federal Office of the Superintendent of Financial Institutions (OSFI) in Canada for the post-1996 period. The ratio does not follow any discernable business cycle pattern, since it *declined* during the relatively high growth era of the late 1990s, but it *rose* during the post-2001 growth period and fluctuated around a stationary trend during the 2000-2001 slowdown. It peaked late 2007 at 18.6 — a level that was still below the OSFI upper limit of 20 for the asset/capital multiple — and declined sharply during 2008 as banks froze up somewhat their new lending.

Figure 4: Total Canadian Bank Assets to Adjusted Measure of Tier 1 and 2 Capital Multiple, 1996-2008 (Quarterly Observations of the Consolidated Banking Sector)

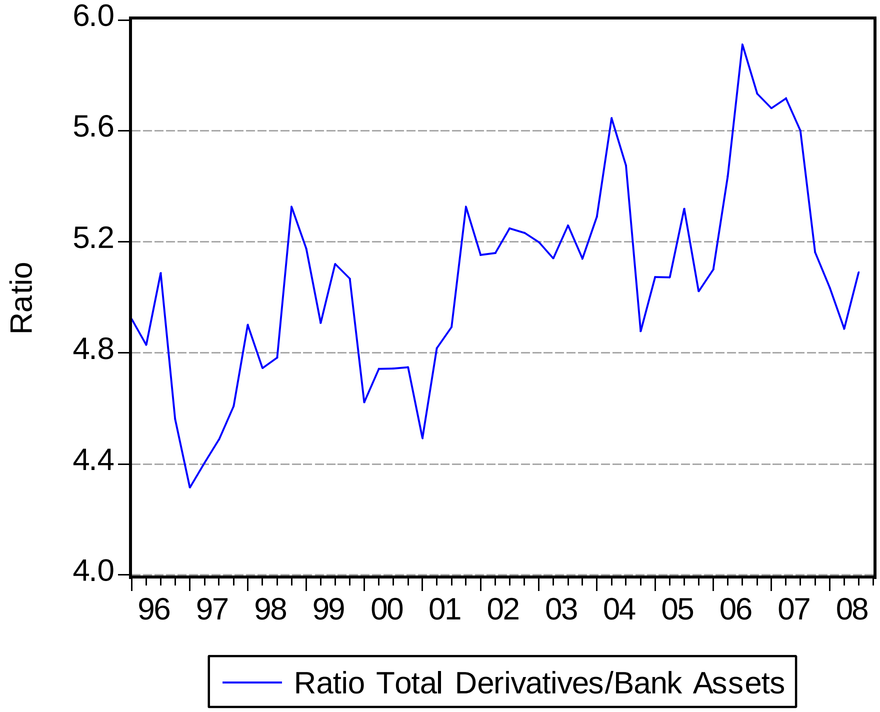


Source: Office of the Superintendent of Financial Institutions Canada

This less-leveraged feature of Canadian banks is not the result of a more conservative culture of business in Canada (as some have suggested, see Zakaria, 2009). It relates to the fact that the country has a deeply rooted and highly concentrated national multi-purpose system of branch-banking with a captive deposit base and less leakage to other financial institutions that could siphon off deposits from the chartered banks. Because of the national scope of both their loan-making and deposit-taking activities, Canadian chartered banks can count on a much higher proportion of the monetary reflux to themselves from their credit creation than do U.S. commercial banks. Indeed, since U.S. commercial banks have historically been more restricted geographically in accordance with state laws, these banks must instead rely more heavily on the role of investment banks in the overall financial circuit. As pointed out by Booth (2008: 43-44), with less exposure to risk because of the less fragmented and more monopolistic nature of the Canadian banking system — with a wide base in regionally diversified markets — Canadian banks have been under less competitive pressure to securitize their loans and have tended to retain proportionally more of their assets in the hands of the originator of the bank loan. For much the same reason and, perhaps, as a barrier to entry, Canadian banks are more capitalized because of this highly oligopolistic banking structure, with Canada's six largest banks accounting for over 90 percent of total bank assets domestically.

This is not to suggest that there was no pressure in Canada to engage in securitization via the creation of off-balance sheet items within the financial system. All sorts of financial derivatives surfaced in Canada during this era: whether it was over-the-counter (OTC) contracts or exchange-traded contracts. Indeed, the value of total contracts of off-balance sheet items grew more than threefold between 1996 and 2008 within the Canadian banking system and as a proportion of total bank assets shown in Figure 5, it went from a ratio of about 4.5 in 1996, reaching a peak at a ratio of nearly six at the end of 2006 and early 2007, and then falling precipitously since 2007. Not only was it profitable for banks and security dealers in general but, most importantly, under NAFTA this activity flourished like never before.

Figure 5: Value of Total Derivative Contracts as Proportion of Total Bank Assets, 1996-2008 (Quarterly Observations of the Consolidated Banking Sector)



Source: Office of the Superintendent of Financial Institutions Canada

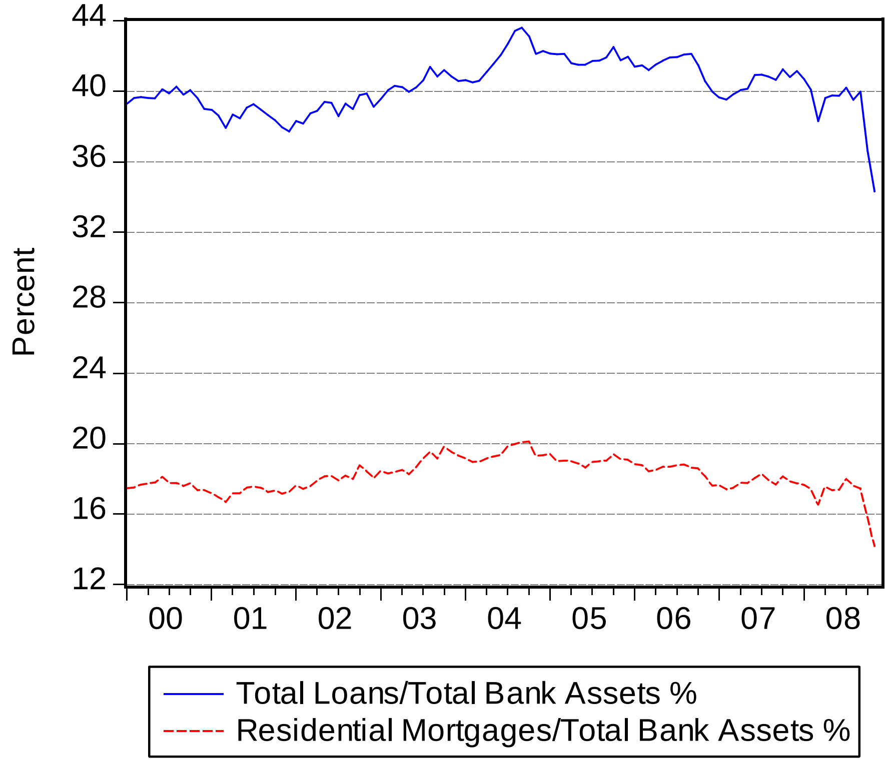
Neither can it be said that there was no pressure to engage in high stakes mortgaging of the type that resulted in the subprime crisis in the U.S. In 2006, sub-prime mortgages accounted for less than 5 percent of mortgages, while in the U.S. this figure was 22 percent (Bergevin 2008). However, in the wake of the oil and commodity price boom and the ensuing hot real estate market, there was growing demand for looser mortgage lending. Indeed, under pressures to deregulate further the financial markets (in the name of providing competitive financial services under NAFTA), the door was opened for the subprime market to move north in May 2006 in the first Conservative budget of the newly-elected Harper minority government. Owing mostly to the lobbying effort of American International Group (AIG) which recruited the support of some former officials of the federally-owned Canada Mortgage and Housing Corporation (CMHC), they finally succeeded in persuading the Harper Conservatives to open Canada's mortgage insurance sector to greater foreign competition (McNish and McArthur, 2008). Hence, in 2007 and early 2008, even as signs were emerging of the gravity of the problem south of the border, subprime mortgages were actually proliferating in Canada. This was so even with the formal opposition of the former Governor of the Bank of Canada, who feared the inflationary consequences of this type of credit expansion not only in the hot Canadian housing market at the time but also on a broader scale, thereby possibly frustrating the Bank of Canada's own low inflation targeting policy. In fact, if it was not for the severity of the U.S. financial crisis in 2008 which, in a sense, nipped the problem in the bud, one would have probably seen the development of a serious subprime crisis in Canada as well.

3.2 The Financial Crisis and Policy Response in Canada

It was therefore the strength of a national banking system, a somewhat stronger regulatory structure, as well as a more favorable conjuncture of factors, including timing of policy changes, which would explain why the Canadian banking system weathered the storm a bit better than a number of other countries internationally. Admittedly, more effective regulations on capital adequacy together with protection of the national banking system from foreign takeover kept the Canadian banking system somewhat more resilient in the face of crisis and thus did not require any official bailout package or the same general level of government support as was provided in the U.S., the U.K. and continental Europe. Despite all of this, the Canadian system did seize up, much as elsewhere during the global financial pandemic of 2008.

As the crisis deepened during the Fall of 2008 and financial institutions lost confidence because of fears of offloading of toxic assets by financial institutions, the Minister of Finance intervened in order to prevent the credit market from seizing. This entailed foremost the guaranteeing of interbank lending as well as broadening the list of assets eligible as collateral for central bank advances, and then by offering to engage in direct purchases in the order of $75 billion of mortgages held through Canada Mortgage and Housing Corporation (Bank of Canada, 2008: 13). However, this had some mitigating effect, but it did not prevent the collapse of the credit market as the financial crisis accelerated during the third quarter of 2008. This is shown in Figures 6 which displays the ratio of total bank loans, as well as residential mortgages, as a percentage of total bank assets in the Canadian banking system from 2000 to 2008. Even when the market conditions did not warrant it as was the case, for instance, with the automobile sector where, unlike the U.S., the Canadian market sustained growth until the beginning of 2009, credit for industry dried up and, much as in the U.S., Canadian automobile producers sought government handouts to keep some of them afloat. Consequently, one witnesses a dramatic across-the-board cut in loans to total bank assets by the third quarter of 2008.

Figure 6: General Loans and Residential Mortgages as a Percentage of Total Chartered Bank Assets, Canada 2000-2008 (Monthly Observations)



Source: Statistics Canada, CANSIM II, Series V36883, V36918, and V36923.

While there were more factors than simply those relating to NAFTA in transmitting the crisis to Canada, because of the continental financial capital market this guaranteed that any disturbance in the U.S. would be quickly impacting Canada. For this reason, it may be said that NAFTA reinforced patterns of growth that made the Canadian economy progressively more vulnerable to U.S. shocks. Moreover, because of NAFTA, the speculative surge that fueled the commodity and energy boom would provide some of the destabilizing tendencies that perhaps had not been as strong in the pre-NAFTA era. Hence, despite attempts by the Canadian government in taking initiatives to stabilize the financial system and to join an international effort in 2009 to provide fiscal stimulus to a battered world economy, the policies of fiscal austerity and monetary looseness that were designed to make the economy succeed in the competitiveness game under NAFTA (see Seccareccia 2007) actually created the fertile conditions for the crisis in North America. However, this will be even more problematic when seen from the Mexican angle to be discussed below.

4. Financial Liberalization in Mexico and NAFTA

4.1 Pre-NAFTA Financial Liberalization

Since the 1970s, the rapid changes in financial markets and the expansion of private credit that accompanied the breakdown of the Bretton Woods monetary system prompted significant transformations in Mexico's financial system and international credit flows. Beginning during that decade, a system of specialized banks turned into one dominated by universal banks and the formation of financial holding companies; financial instruments to fund government spending were created in the bond markets; limits to some interest rates were removed; and the negotiation of new financial instruments and operations in foreign currency were authorized. The government and large state-owned enterprises (electricity, oil) were the largest borrowers, enjoying low or no credit risks in the credit system. In these same years, these entities became the largest domestic borrowers of international private credit. In order to confront new conditions of competition in the domestic market, the largest local banks expanded into the international market through the opening of foreign offices, the purchase of U.S. banks (converting them into subsidiaries), and associating with foreign banks through participation in syndicated loans to governments of developing countries, including Mexico.

While the new Mexican bank holding companies became increasingly international, the domestic financial market became increasingly dollarized, with the availability of credit and domestic interest rates in pesos tied to the conditions of external markets. As such, a strong argument can be made that the financial opening of Mexico began with a strong push beginning in the 1970s (Stallings 2006, Correa 1992).

The debt crisis of 1982 dramatically changed these trends. Banks were left with an enormous currency mismatch due to the dollarization of the financial system, while at the same time they were lenders to the Mexican government and its state-owned enterprises whose debt was in default. The debts of their other large clients, the Mexican corporations with foreign debt, were also in default. The nationalization of the country's banks as well as capital controls offered the only possibility for an orderly restructuring of foreign liabilities, both of the government and of the public and private enterprises, as well as those of the domestic financial sector. Yet in fact, a payment priority was imposed by Mexico's lenders, with U.S. banks leading the list, particularly Citibank, which headed the Lenders' Committee in the renegotiation of the external debt.

Therefore, the financial opening of the Mexican economy in reality precedes the opening to trade and capital movement, both foreign direct investment (FDI) and portfolio investment. Yet these were abruptly suspended as a result of the debt crisis. It is only starting with the successive restructuring of the public and private external debt that policies of financial and trade opening to increase the exporting capacities of the country were enacted. The ELG strategy began at the end of the 1970s with the colonial model of oil exploitation (exporting crude, importing refined products). This ELG strategy deepened in the 1980s and, toward the end of the 1990s, began to show its limits with growing commercial imbalances which were the outcome of the increasing imported composition of total exports (Cypher, 2001).

The pre-NAFTA period (from 1989 to 1992-1994) represents another moment of accelerated changes in the financial market, clearly driven by two forces: the conditions of new financial competition that NAFTA would bring, and the deregulation and financial innovations characteristic of the U.S. financial market. Eighteen banks were re-privatized, once more creating financial holding companies; capital controls were removed; and, the capital markets were reformed in order to allow foreign investment. All of which opened opportunities for the expansion and profit of the external portfolio investments of the U.S. institutional investors.

As will be discussed further, in the case of Mexico, NAFTA content was an instrument that assured the permanence and continuity of the financial transformations already undertaken.

4. 2. Financial Liberalization and Integration

NAFTA was conceived as an economic and financial vision that did not contemplate the existence of financial crises, which in any case would be considered to be caused by errors of economic policy that would be self correcting. The recurring tendency for Mexico to run a current account deficit was taken into consideration, and the establishment of a credit line of $6 billion from the U.S. Fed and the Bank of Canada was envisioned. When NAFTA began in 1994, this amount was the equivalent of only three months of external debt payment, and was used for the first time in April of 1994. Months later, this amount proved to be absurdly small in the face of the large financial commitments which were put in evidence by the rescue package offered by the Fed, BIS, IMF, Citibank and JP Morgan in January of 1995 for $50 billion, which covered the amortization of part of the public and private short-term external debt for several months. This package of loans was fundamental in avoiding a default, which among other things would have jeopardized the financial investments of Goldman Sachs, Merrill Lynch and other investment funds such as Fidelity, Scudder, Oppenheimer, and Putman (Girón, et al. 1995). This is the size of the hole in the NAFTA financial chapter that nobody wants to face, until the financial crisis explodes. Just this last February, the Fed extended $30 billion on its line of credit to the Mexican central bank.

While debates and analyses over the financial aspects of NAFTA during the last fifteen years have been abundant and diverse, this article will only consider three of its fundamental components.

First, NAFTA requires and forces the maintenance of the free movement of capital. No restriction can be imposed unless it is general and temporary, and is accompanied by an immediate negotiation with the IMF to return to this original state. This obligation is naturally of greatest interest not for the expansion of direct and portfolio investment, but rather for the free return of this type of capital, and for the outflow of earnings, dividends, and profits of all types. Such a guarantee at the level of an international commercial treaty is difficult to justify under any circumstances, but in the case of Mexico, it also subordinates monetary and fiscal policy to the maintenance of macroeconomic stability (balanced budgets or surpluses), growing external indebtedness (private and public) and the permanent attraction of external capital (foreign direct and portfolio investments).

The second is that NAFTA committed Mexico to the opening of the domestic financial market, or rather to the participation of foreign bank subsidiaries through the association with local banks or via the acquisition of established banks. Original provisions created a transitional period to protect the national ownership of banks. However, the reality of the banking crisis of 1995 modified the time frames and accelerated the entrance of foreign banks. At the same time, the government's bailout of banks through capitalization and the purchase of assets increased foreign banks' interest in a greater positioning in the domestic banking sector, whose balances had just been restored to health via public funds. The first to arrive were the Spanish banks, which sought wider dimensions in the face of the new competition envisioned with the creation of the European Economic and Monetary Union. Later, the large global players such as Citibank and HSBC came into the domestic market, by buying large local banks with local systemic position(s), along with the Canadian bank Scotiabank. This change of ownership among the largest Mexican banks increased foreign ownership of the local financial system to around 80 percent over the course of some six years, bypassing the clauses for the protection of the payments system in the original NAFTA (Correa, 2004).

Third, NAFTA consolidated the existence of a dual monetary system, in which the dollar constitutes the dominant currency, imposing the perspectives and dynamics of business profit generated in the local currency. This dual currency system also provides an important control over the volume of wages and the level of earnings of medium to low income sectors in local currency. This type of control cannot be achieved under the modalities of dollarization as it existed in Argentina or currently exists in Ecuador.

Therefore, NAFTA was an instrument of financial integration between Mexico and the U.S., with very specific characteristics that were necessarily not planned or agreed upon. But due to this process of integration, it is now certain that the financial system in Mexico is part of the geo-economic territory of the current financial crisis and not simply a victim of current circumstances, a relevant issue that will be further considered.

4.3 Income Distribution and the Financial System

The unequal income distribution in Mexico before and after NAFTA is the main factor underlying the weak local financial system. Historically, the Mexican economy has had an elevated level of income concentration among families and in the ownership of businesses in the most modern and dynamic activities (Vidal, 2002). This concentration was deepened with the spread of privatization, the financial and trade opening, and the internationalization of many of the largest domestic corporations.

This concentration is also reflected in the financial system. The four largest financial groups (all subsidiaries of foreign banks) represent 74 percent of total bank assets; the five largest investment banks control 60 percent of the market; the five largest insurance firms control 51 percent; and 60 percent of the automobile insurance market belongs to five companies; while 60 percent of workers' pension funds are concentrated in the hands of the five largest operators (Banco de México, 2008).

This financial concentration is also expressed in the figures regarding deposits and loans. In terms of banks' traditional deposits, 0.3 percent of accounts represent 58 percent of all deposits, while 80 percent of accounts represent only 1.6 percent of the total. The source does not issue information regarding the investment banks where client concentration is far greater (Banco de Mexico, 2009). In terms of financing, the 300 largest clients receive over 80 percent of total loans issued by the largest banks (CNVB, 2008). Alternatively, the Mexican central bank reports that 30 percent of bank credit is destined to small and medium enterprises (Banco de Mexico, 2008).

However, the high levels of concentration in income and ownership are also expressed in the relatively low level of financial service penetration. A general measure of this low level of penetration is the relation of total assets of financial groups to GDP, which reached 26 percent in 2008. However, this level is far lower than that reached before the crisis in 1994-1995, when the banks were owned by local groups, and obviously far inferior to international standards.

At the same time, this same concentration has been a permanent restraint to traditional bank activity. Loans to the business sector and to the household sector have only reached 27 percent and 14 percent respectively of bank lending. This low level of penetration of financial services in the domestic market became even more notable with the domination of the local market by global banks, an aspect that will be further analyzed below.

The financing of private non-financial enterprises represents approximately 16 percent of GDP; and 9.3 percent of this sum is internal, with 6.2 percent corresponding to bank credit, while 6.7 percent is external. The financing of households represents 13 percent of GDP. Of this total, 5 percent is destined to consumer credit and 8 percent to mortgage lending, of which 3 percent is issued by banks. Household debt service represents 6 percent of household income (Banco de México, 2009).

Although the penetration of some financial services has increased in recent years, for example there are now 25 million active credit cards; it is estimated that only one quarter of Mexican families possess this type of instrument. Only 25 percent of the labor force has life insurance, while 50 percent of cars in circulation have automobile insurance. One of the strategies to increase financial penetration has been the greater use of debit cards (that is, employers deposit workers' salaries in a bank account accessible through automated teller machines). This new measure has been highly favorable for banks, as it permits a constant flow of funds, the payment of deregulated commissions, and a relatively captive population for the marketing of new financial services. One of the largest global banks controls more than 50 percent of this lucrative segment of the market.

However, the most expansive area of business for global bank subsidiaries operating in Mexico has been the derivatives market (OTC), which in nominal value represents more than 100 percent of Mexico's GDP. The greatest portion of these instruments corresponds to interest rate swaps, and 65% of their counterparts are overseas (Banco de México 2008, 2009). The subsidiaries of foreign banks have been able to achieve high levels of profitability, even by international standards, in spite of the fact that they have not significantly increased the volume of credit. In September of 2008, net profits represented more than 10 percent of the net margin (adjusted for risk), and more than 25 percent of banks' net worth.

As such, the unequal distribution of income limits the expansion of traditional banking activity on one hand, even while banks maintain elevated interest rates on loans and charge inflated commissions. This situation encourages local corporations to seek external financing, which entails greater foreign exchange risk, but lower interest rates. The local subsidiaries of global banks are actually at a disadvantage compared with their headquarters in terms of financing the largest Mexican corporations. On the other hand, local small and medium enterprises, with no access to the external market, are far from attaining sufficient financing at a sustainable cost from domestic banks and capital markets. This aspect further strengthens the tendency of local corporations' growing capital exports and, along with them, the permanent dollarization of profits.

4.4 Global Financial Crisis in México

NAFTA was not conceived with the possibility of a financial crisis in the U.S. Nor did anyone imagine that the headquarters of international banks with subsidiaries in Mexico could face bankruptcy or nationalization. In reality, this *sui generis* process of financial integration between Mexico and the U.S. has left the country with a neocolonial financial system, controlled by absentee owners, which is based on rent seeking activities, particularly those related to international arbitrage. Financial authorities have been complacent, lacking independence and juridical instruments to act upon.

In the course of the financial crisis period of 2007-2008, the local subsidiaries of global banks have been rapidly reducing their credit portfolios, although their capture of deposits continues to increase unabated. They are quickly increasing their cash holdings in foreign accounts and their profits repatriated to headquarters during successive quarters (CNVB, 2008).

Economic activity fell abruptly in the last months of 2008, along with the export sector and related economic actors. Particularly hard hit have been the automobile and auto part industries.

The financial conditions of the country continue to deteriorate day by day, as its economic model has been sustained by a constant inflow of dollars (as has happened in other instances of dollarization in Latin America). All of the principal sources of dollars are abruptly contracting, including the export of crude oil, worker remittances, FDI and portfolio investment. Meanwhile, all of the obligations that imply capital outflows have continued or sharpened, including the import of food and energy, the payment of dividends and earnings of subsidiaries of global corporations (including banks), the outflow of portfolio investment, and the interest on external debt, both public and private. The domestic currency has devalued almost 50 percent in the course of only several months, and the central bank has spent more than $18 billion, equivalent to 21 percent of international reserves, to prop up the exchange rate. To understand the magnitude of the problem, one only has to consider that the size of short-term private debt surpasses $20 billion, and interest payments on external debt are estimated at $14 billion in 2009. Portfolio investment in government bonds of foreign residents is estimated at $27 billion in the third quarter of 2008. None of this takes into consideration the large dollar requirements that an abrupt seizure of positions in the derivatives market would demand.

The global crisis of (the) originate-distribute financial model also represents an endogenous financial crisis in Mexico, of a still undetermined size. As often happens with banking crises, the amount of losses only becomes known once they are all brought to light. However, the consequences can be clearly seen on the horizon: contraction in employment, salaries and well-being; lower levels of economic activity; a growing deterioration in the fundamental functions of the government, including assuring security and territorial integrity, among other factors. These considerations are highlighted by the growing fears that Mexico could become a failed state or at least a failed government (Forbes 2008, Enfoque 2009, Kurtzman 2009).

The financial and trade opening, the commitments derived from NAFTA, and the balanced budget law, severely limit the possibilities of the financial authorities to address the economic crisis with a well-directed and sufficiently large countercyclical program. However, the same authorities broadly endorse the policies of the International Monetary Fund, and as such they have no intention of committing themselves to even minimal countercyclical measures. At least for the moment, even the large domestic corporations are being left with no support. Such is the case of the Vitro group, one of the ten largest groups in the country with over 100 years in operation, which recently declared a moratorium on several bonds, and is selling assets at fire sale prices and could declare bankruptcy in the coming months.

NAFTA could be interpreted as an innocent part of the global financial crisis, but it is not so. NAFTA created an unequal financial integration between Mexico and the U.S., and that must be changed in order to build more equal economic relations within the North American economic region.

5. Concluding Remarks

NAFTA was sold to the citizens of a North American community as a policy that would bring growth, prosperity and stability through commercial and financial integration of its three regions. This integration has occurred but, as we have seen, only by strengthening tendencies that have actually made the three economies more vulnerable to shocks, regardless of their source, and to ensure that, if a problem occurs in the U.S., its international transmission is even more immediate not only to its NAFTA partners but to the rest of the world. Interestingly, as we saw with the Canadian banking sector, the fact that Canada was able to retain somewhat better control of its banking industry would explain why the latter was in a better position to weather the financial storm than the Mexican banking sector which is in disarray. However, the most fundamental trouble with the NAFTA model of ELG was that the problem of effective demand was never taken into consideration in its design. The current financial crisis opens the opportunity to address this design flaw by not merely attending to legitimate concerns regarding labor and environmental standards as identified by the Obama administration. What are needed are inward-looking policies that boost domestic demand and ensure that the fruits of greater integration are not calculated on the basis of the jobs that they create through downward competitive pressures but rather on the basis of the real income growth that would be spread to the vast majority of the population of North America within a full employment environment.

Notes

1. This is also recognized in Blecker (2003) in a table similar to Table 2.

2. That is to say, there was greater long-term growth in the services industry where earnings distribution is much more widely dispersed than in the traditional manufacturing sector with a bipolar distribution of earnings clustered around "good" and "bad" jobs.

3. *N.B*: Table 3 derives data from two sources. The first column provides data from the traditional national accounting measure of the saving rate, which is simply the difference between personal disposable income and consumption as a percentage of the former. However, in the national accounting definition of consumption, there are also included implied expenditures out of income in kind (such as food grown and consumed on the farm and imputed rents on owner-occupied dwellings). The saving rate by income quintile was obtained instead from the Surveys of Family Expenditure and of Household Spending which pertains only to household expenditures by Canadian residents both at home and abroad while the data from the national accounts also include expenditure of unincorporated business and refer to the personal expenditure of both residents and non-residents. The Survey of Family Expenditure includes such items as public medical insurance and interest on consumer debt as part of total current consumption while being treated as transfers in the national accounts. Hence, although the two sets of data on the saving rate listed in Table 3 (i.e, the aggregate rate from the national accounts and the disaggregated data for income groups) are not quite commensurate and thus cannot easily be compared, we believe that they still serve to shed much light on household spending by income groups.

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