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Financial Integration in Central America: Prospects and Adjustment Needs

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Abstract

We assess the current barriers to trade in financial services in the six Central American countries seeking a free trade agreement with the United States (the CAFTA) and examine the relative merits of regional and multilateral liberalization. Even though there are few formal barriers, deficiencies in regulatory and competition standards and in the judicial systems still restrict the participation of foreign institutions in the financial systems in the region. A greater presence of such institutions could support other objectives of trade and investment liberalization, though it would require several adjustments in prudential supervision at national levels and greater cooperation between members of the CAFTA.

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I. Introduction

For small developing countries, trade and financial linkages with the rest of the world are closely interrelated. Complementarity between trade and finance explains the inclusion of provisions on trade in financial services in numerous bilateral and regional trade agreements, and most notably in the World Trade Organization's (WTO) 1997 agreement on financial services.

On the surface, provisions on financial services trade are mainly in the interest of financial institutions in industrialized countries seeking a larger presence in foreign markets. A more transparent and predictable regulatory environment will facilitate trade through local subsidiaries or across borders. Yet, the greater participation of foreign institutions can be an important factor in the reform of financial systems and, hence, help create an enabling environment for exporters and foreign direct investors. Nevertheless, international financial integration is more often resisted than promoted. The presence of foreign financial institutions presents regulators and supervisors with important challenges in managing a more vigorous competition; and where financial services are provided across borders, they may necessitate capital account opening and expose the economy to external shocks.

In this paper, we assess these potential implications for the financial sectors of the six Central American countries currently negotiating in the U.S.-Central American Free Trade Agreement (CAFTA): Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua. The scope of CAFTA is likely to be similar to recent, comprehensive trade agreements, along the lines of the North American Free Trade Agreement (NAFTA) or the U.S. bilateral agreements with Chile and Singapore. Compared with most other U.S. trade partners, however, Central America's starting point could hardly be more different. Financial systems are relatively shallow, and large shares of nonperforming loans in total credit expose a lack of credit culture which puts outsiders at a disadvantage vis-à-vis incumbents in enforcing claims in these financial systems. Complex and often obscure business regulations and contract enforcement discourage potential entrants and favor incumbents. Even though we found only few formal barriers to market entry in financial sectors, de facto barriers appear to discourage foreign providers who hold only small market shares and are primarily from other countries within the region.

Our paper is structured as follows. Section II describes the current state of international financial integration, with regard to both barriers to market entry and barriers to capital flows that could impede cross-border trade in financial services. Section III then sets out some possible features of financial services provisions in CAFTA and compares such preferential liberalization to the options available under the WTO. In Section IV, we assess the likely impact of CAFTA on financial integration and the risks arising from it, and identify a number of adjustments that could help make the six economies more resilient to financial vulnerabilities arising from CAFTA. Based on this, Section V concludes with a number of recommendations on how Central America could harness the opportunities from CAFTA while minimizing the risks.

II. Financial Integration at Present

As any other service, financial services can be traded internationally through a number of "modes of supply." U.S. data suggests that for developing countries provision through commercial presence is the dominant form, followed by cross-border trade. The former is often associated with positive spillovers, and superior technology and risk management practices, the latter with the risks inherent in capital account liberalization. These concerns may explain why the liberalization commitments within the WTO of developing countries—as well as of Central American countries—reveal a clear preference for local provision of financial services, and a reluctance to commit to market entry through cross border trade in financial services.

In the case of the six Central American countries negotiating within CAFTA—hereinafter the "CAFTA-6"—information we collated from national regulators suggests that only few

barriers remain (Table 1).[2] All countries allow foreign banks to establish subsidiaries in their jurisdictions, which receive the same treatment as other domestic banks. All countries but Costa Rica also allow branches of foreign banks to operate, but impose capital requirements on them. In addition, Guatemala maintains a requirement that 90 percent of employees must be local and that 85 percent of the wage bill should be paid to Guatemalan nationals.[3]
El Salvador imposes limits on foreign ownership though this seems in large part motivated by prudential reasons; investors from outside Central America are only allowed if prudential regulations and supervision in their home countries conform with the relevant international practices and they are rated as "first-grade" by international rating agencies.
The absence of de jure market entry barriers does not of course imply that foreign institutions account for large shares of domestic financial markets. If defined narrowly foreign participation in the region is still fairly limited, underlining that substantial de facto barriers persist. In El Salvador, for instance, majority foreign ownership is estimated to account for no more than 14 percent of the assets of commercial banks. However, financial conglomerates and strategic alliances are important ways to gain a foothold in foreign financial markets, and conglomerates would generally warrant consolidated supervision according to Bank for International Settlements (BIS) and IMF guidelines.[4] Including such non-equity participations, the share of foreign controlled assets in domestic financial systems rises to an estimated 32 percent in the case of Nicaragua, 35 percent in Honduras, and about 80 percent in Guatemala and El Salvador. Nevertheless, this foreign participation originates almost entirely within the region.

[2] At the time of writing the status of Panama in the negotiations was unclear, and this country is hence not considered here.

[3] This requirement is entered in the WTO schedules of commitments, and the application in practice of this requirement could not be verified.

[4] The conglomerate Grupo Financiero Uno has established local banks under the same name, Banco Uno, in Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua. The Conglomerate Corporacion UBCI has opened banks under the name of Banco Cuscatlan in Costa Rica, El Salvador, and Guatemala. Other banks have established strategic alliances, like that including Banco Agricola from El Salvador, Banpro from Honduras, and Caley Dagnall from Nicaragua.

Table 1. Capital Controls in Central America [1/]

Controls on capital transactions	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua
Controls on					
Capital and money market instruments					
Securities of a participating nature					
Purchase locally by nonresidents				X	
Sale or issue abroad by residents			X		
Bonds or other debt securities					
Sale or issue abroad by residents	X				
Collective investment securities					
Sale or issue locally by nonresidents				X	
Derivatives and other instruments					
Credit operations					
Commercial credits					
To residents from nonresidents	X			X	
Financial credits					
By residents to nonresidents	X			X	
Guarantees and financial backup Facilities					
By residents to nonresidents	X				
To residents from nonresidents			X	X	
Direct investment					
Outward direct investment					
Inward direct investment	X	X	X	X	X
Liquidation of direct investment					
Real estate transactions					
Purchase locally by nonresidents				X	
Personal capital transactions					
Transfer abroad by emigrants	X				
Transfer into the country by immigrants	X				
Transfer of gambling and prize earnings	X				
Provisions specific to					
Commercial banks and other credit institutions					
Borrowing abroad	X	X		X	
Maintenance of accounts abroad				X	
Lending to nonresidents				X	
Differential treatment nonresident deposits					
Reserve requirements	X				
Investment regulations					
Abroad by banks					X
Institutional investors					
Limits on investment portfolio held abroad		X			

Source: IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions* (*AREAER*).
1/ Data for Costa Rica were not available.

Internationally active banks are as yet a minority, limited to the high end of corporate customers.[5]

Where foreign providers lack a local presence—or establish no more than a representative office—the cross-border provision of financial services will depend on unimpeded capital mobility. Again, few formal barriers can be found (Table 1). External transfers for legally permissible transactions are essentially free of capital account restrictions. In all six CAFTA countries controls remain on foreign direct investment (FDI) related transactions and for some banking-specific transactions.[6]

III. Options for International Agreements

While Central American countries are relatively open to foreign financial service providers, this opening has largely been achieved in the absence of formal international agreements on market access and standards of treatment. Even though the Central American Common Market includes provisions on services trade, these have not been put into force. However, effective international agreements may strengthen financial liberalization that is already in place by enhancing transparency and predictability, specifying the events that justify regulatory measures deviating from the agreement, and by providing mechanisms for dispute resolution and arbitration. Where provisions on services trade form part of a broader trade agreement, dispute settlement will be more effective and credible, as the penalty for noncompliance will be larger once the entire commercial relationship is at stake. Central American countries have two options before them: multilateral liberalization in the WTO and regional liberalization in the context of CAFTA and subsequently in the Free Trade Area of the Americas (FTAA). Each has its limitations, and may give rise to legal conflict with obligations under the other.

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[5] For instance, Citibank is established in El Salvador, Guatemala, Costa Rica and the Dominican Republic; (the Canadian) Scotiabank in El Salvador, Costa Rica, and the Dominican Republic; and the British Lloyds in Honduras and Guatemala.

[6] No detailed information was available for Costa Rica.

A. The WTO's Financial Services Agreement

Following close on the heels of the Uruguay Round's General Agreement on Trade in Services (GATS), the 1997 Financial Service Agreement (FSA) laid down broad disciplines on market access and national treatment, and specific commitments in individual sectors. As in other service sectors, obligations are grouped under four modes of market access: cross-border supply, consumption abroad, supply through commercial establishment, and temporary movement of professionals. WTO members entered limitations to both their general and their specific obligations in their schedules of commitments.[7] While in principle the commitments under the GATS are irreversible, the agreement allows for various situations that justify flexibility, among others to adopt prudential measures safeguarding financial stability, to pursue the objectives of domestic regulation or to safeguard the balance of payments. To date, these so-called carve-outs have been left fairly ill-defined, possibly leaving scope for interventions to the detriment of the agreement's original objectives.[8] Relatively few countries export financial services, and hence take an interest in market access conditions. At the time the FSA was negotiated—three years after the end of the Uruguay Round—there was no scope for the traditional cross-issue tradeoffs that lie at the heart of the more comprehensive GATT/WTO trade rounds. Despite the relative dearth of bargains in a single-issue negotiation, many WTO members sought to enhance transparency and predictability of market access conditions in their financial sectors.

[7] See Mattoo (2001) or Kireyev (2002) for analyses of the WTO Financial Services Agreement.

[8] The so-called prudential carveout in Article 2 (a) of the GATS is fairly broad, and at present there is no formal agreement on what constitutes prudential measures. It states: "Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement."

The CAFTA-6 have shown widely different levels of engagement in the FSA. El Salvador and Nicaragua entered commitments in a large number of sectors, Guatemala, however, only for reinsurance and financial information services. All six countries reveal a clear preference to commit to disciplines for the commercial presence mode, over all other modes of supplying financial services. As mentioned above, this is true for developing countries in general. Looking more narrowly at commitments under the commercial presence mode, as summarized in Table 2, reveals a preference for banking services, where all but Guatemala have entered commitments, followed by financial leasing and information services (four out of six), and insurance. These commitments are of course subject to limitations, and our summary of market access restrictions from national sources in Box 1 largely reflects what has been entered in WTO schedules.

B. Preferential Liberalization: CAFTA and FTAA

With the CAFTA Central America will enter an agreement whose architecture is likely to differ fundamentally from that of the FSA. While negotiations are still ongoing, trade agreements that the United States has concluded recently provide some pointers. Both the NAFTA of 1994 and the recently concluded bilateral agreements between the United States on the one hand and Chile and Singapore on the other have followed a similar architecture, and the two bilateral agreements follow closely the authority granted to U.S. negotiators through the Trade Promotion Authority.

Under all three agreements, financial services are dealt with in a separate chapter, though obligations from the investment chapters are also relevant, in particular with regard to the free transfer of funds. Parties entered into broad obligations for nondiscriminatory treatment (both national treatment and most-favored-nation treatment) for cross border supply and locally established providers with regard to other parties to the agreement. Unlike in the WTO's Financial Services Agreement these provisions apply to all financial services sectors subject to certain explicit exemptions (a so-called negative list approach). All three U.S. agreements contain strong provisions on the transparency of regulatory measures, and on the

Box 1. Banking Market Access Restrictions in Central America

Costa Rica	Foreign banks are allowed to establish wholly owned subsidiaries of foreign banks, but not branches.
Dominican Republic	Foreign banks may establish subsidiaries, branches, or agencies when authorized by the Monetary Board. Foreign branches are subject to capital requirements. They must submit a feasibility study justifying the economic need. In its commitments under the 1997 Financial Service Agreement (FSA), the Dominican Republic indicated that the equity participation of foreign investors in banks is restricted to 49 per cent of the subscribed and paid-up capital.
El Salvador	Foreign banks may establish subsidiaries, branches, or representative offices. Foreign branches are subject to capital requirements. At least 75 percent of ownership of shares in banks or finance companies must be maintained for the following persons: (a) Salvadorian or Central American natural persons; (b) Salvadorian legal persons whose shareholders or majority members are the natural persons referred to in the preceding subparagraph; (c) Central American banks in whose country of origin there is supervision in accordance with relevant international practices and which meet the legal and regulatory provisions in force in their country of origin; and (d) Foreign banks and other financial institutions in whose country of origin there are prudential regulations and supervision in accordance with relevant international practices and which are classified as first grade financial institutions by internationally recognized risk rating companies; as well as companies controlling first grade foreign banks and other financial institutions subject to consolidated supervision in accordance with relevant international practices.
Guatemala	Foreign banks may establish subsidiaries, branches, and representative offices. Foreign branches are subject to capital requirements. In its commitments under the 1997 Financial Service Agreement (FSA), Guatemala indicated that employees must consist of 90 percent Guatemalan workers who must receive 85 percent of total wages. In addition, training of Guatemalan personnel is required in specialized fields.
Honduras	Foreign banks may establish subsidiaries, branches, and representative offices, subject to authorization from the Central Bank of Honduras (BCH) and a National Commission. The BCH can refuse such authorization when the home country does not grant reciprocity. The types of entry restrictions on foreign banks depend on how they deliver financial services (through branches, subsidiaries, representative offices, etc.). Subsidiaries and branches can undertake the same operations permitted for domestic banks. The legally-established branch offices are subject to the same laws, regulations and resolutions as national entities, including capital requirements, except where international treaties to which Honduras is a party stipulate otherwise. Foreign bank representative offices can only conduct asset operations (granting credit or making investments) not liability operations in the country.
Nicaragua	Foreign banks may establish subsidiaries, branches, and representative offices. Before opening, the foreign branch has to meet all the prerequisites established for banks to operate in Nicaragua. The branch will be considered a resident of the state for any legal purpose and must abide by all the laws in Nicaragua, including capital adequacy requirements. Representative offices can issue credits and invest in the country but can not accept deposits from the public.

Sources: Country authorities and country schedules under the 1997 WTO Financial Service Agreeement.

Table 2. Central America: GATS Market Access Commitments in Financial Services[1]

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua
A. All insurance and insurance-related services						
a. Life, accident and health insurance services		x			x	x
b. Non-life insurance services		x			x	x
c. Reinsurance and retrocession		x			x	x
d. Services auxiliary to insurance (including broking and agency services)		x			x	x
B. Banking and other financial services (excl. insurance)						
a. Acceptance of deposits and other repayable funds from the public	x	x	x		x	x
b. Lending of all types, incl., inter alia, consumer credit, mortgage credit, factoring and financing of commercial transaction	x	x	x		x	x
c. Financial leasing	x	x			x	x
d. All payment and money transmission services					x	x
e. Guarantees and commitments						x
f. Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following:						
- money market instruments (cheques, bills, certificate of deposits, etc.)						
- foreign exchange			x			x
- derivative products incl., but not limited to, futures and options						
- exchange rate and interest rate instruments, inclu. products such as swaps, forward rate agreements, etc.						
- transferable securities			x			
- other negotiable instruments and financial assets, incl. bullion						
g. Participation in issues of all kinds of securities, incl. under-writing and placement as agent (whether publicly or privately) and provision of service related to such issues		x				
h. Money broking						
i. Asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial depository and trust services						
j. Settlement and clearing services for financial assets, incl. securities, derivative products, and other negotiable instruments						
k. Advisory and other auxiliary financial services on all the activities listed in Article 1B of MTN.TNC/W/50, incl. credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strate				x		

Source: World Trade Organization.

[1]The specific commitments can be found in the individual country schedules, electronically available at *http://www.wto.org/english/tratop_e/serv_e/finance_e/finance_commitments_e.htm.*

introduction of new financial products, and grant exemptions for measures taken for prudential reasons. Unlike in the FSA these prudential measures are fairly narrowly circumscribed. The definition from the U.S.-Singapore agreement for instance refers to the "maintenance of the safety, soundness, integrity or financial responsibility of *individual* financial institutions or cross-border financial service suppliers" (emphasis added). Under the agreements, neither party may stipulate targets for the nationality of senior managerial personnel, a provision that is much broader than what WTO members committed to under the GATS. Moreover, investors may initiate state-to-state or investor-to-state dispute settlement before panels which will reach final and binding arbitration.

The architecture of the NAFTA and the U.S. bilateral agreements is arguably more transparent than the positive list approach adopted under the FSA in which only individual sectors are entered for market access commitments, subject to exceptions. However, in principle both approaches can result in the same level of market openness, and neither necessarily constrains regulators' flexibility to adopt prudential measures. Mexico, for instance, had only begun liberalizing its financial system in the late 1980s, and under NAFTA laid down a number of limitations on the market shares of foreign providers, with a transition period up to 2000. However these limitations were subsequently dismantled ahead of time when, following the financial crisis of 1994, Mexican banks required fresh capital and technologies.[9] With hindsight, the NAFTA is today generally credited for the substantial increase in the foreign presence in the Mexican financial system since the mid-1990s.

C. Implications for Capital Account Restrictions

Both the FSA and the U.S. bilateral agreements have generated considerable debate on the implications for capital flows, and for policies designed to control such flows. The implications of financial services trade for the capital account depend on the nature of the service that is supplied, and its mode of supply. Liberalizing the cross-border supply of

[9] Inter-American Development Bank (2002).

deposit taking, for instance, essentially requires the liberalization of the corresponding flows in the capital account. By contrast, financial advisory services should not have important implications for the capital account. Indeed, there is only mixed evidence in the empirical literature that the presence of capital controls stymies financial development.

The provisions in the GATS only require that those capital inflows be permitted that are "essential" for the cross border supply of services, and "related" to the establishment of a commercial presence in any sector that has been included in the schedules of commitments. Hence the implications only depend on the sectors and modes scheduled. Moreover, GATS also contains a number of safeguards to give authorities sufficient autonomy to reimpose capital account restrictions, in case of balance payments problems, or should this be necessary to safeguard financial stability.

Provisions in the U.S. bilateral agreements, such as the U.S.-Chile agreement, are much broader. "Transfers" refer to transactions in both the capital account (inflows and outflows related to most forms of direct and financial investment), and the current account (dividends, interest, royalty). The investor may effect the transfer immediately, in a freely usable currency, and at the market rate of exchange. The NAFTA contains similar language, though this may be overruled in situations of balance of payments difficulties, or at the request of the IMF.[10] Under the U.S. bilateral agreements parties may still restrict transfers, though such measures would subsequently be subject to compensation as determined in dispute settlement procedures following a "cooling off" period of one year (six months in the case of long term flows). The country will be subject to compensation should the measure be in effect for less than that period but impede the operations of the investor substantially, and in all cases where the measure is in effect for longer.[11] These clauses are of course open to interpretation which will need to be developed in future dispute settlement cases.

[10] The balance of payments safeguard in Article 2104, NAFTA.

[11] The nature of controls that "substantially impede" transfers is set out in a side letter to the Singaporean authorities, but leaves room for interpretation in dispute cases.

Recent experience suggests that there are a number of preconditions for the liberalization of short term capital flows, among them macroeconomic stability, appropriate exchange rate policies, and adequate financial supervision, in particular of the risk management capabilities of banks.[12] Such requirements are broad, and can only be assessed for each country individually. However, where these preconditions are not in place countries can still liberalize those financial services and those modes of supply that are less dependent on external capital. Insurance services, for instance, or provision through the commercial establishment mode should not put financial stability at risk.

As shown previously in Tables 2 and 3, Central American parties to the CAFTA currently impose very few capital controls. Indeed, such measures are typically a feature of developing countries with more mature financial markets than those found in Central America. Hence, committing to standards on free transfers as they are currently defined in the U.S. bilateral agreements should not change the status quo substantially, though surrendering the option to impose such measures in future may well raise concerns about the ability to manage macroeconomic crises.

D. The Case for "Open Regionalism"

The financial services chapter of the CAFTA is likely to differ substantially from the FSA, by virtue of its more transparent negative list approach, the stronger commitments with regard to free transfers, and dispute settlement procedures. For countries in Central America the CAFTA will cover an important trade relationship, whereas market entry from other WTO members is less certain. The incentives for Central America—and the negotiating stance of the United States—hence clearly point towards a financial services agreement that will exceed commitments under the WTO, and which may discriminate against suppliers from third countries. However, there are important efficiency and legal considerations that argue in favor of making balanced and coherent obligations under both agreements.

[12] IMF (2000).

Preferential liberalization within the CAFTA may have a number of advantages in the short term. Permitting more liberal access to financial markets—where the Central American countries have little export interest—may be required as a trade-off for gaining improved access to U.S. goods markets, in particular in agriculture. Also, arguments in favor of preferential liberalization of services trade tend to be rooted in the particular market structure of service sectors and the corresponding need for efficient regulation. Preferential liberalization of financial services trade may facilitate regulatory cooperation, and in the context of greater regulatory predictability individual suppliers may be more inclined to incur the up-front fixed costs required for market entry.

However, the special characteristics of trade in financial services do not defeat the traditional case for nondiscriminatory market liberalization. In entering a foreign financial market, providers incur fixed costs that are specific to that particular location (for instance branch networks, or local licenses). Preferential liberalization may hence confer first-mover advantages to providers that are not necessarily the most efficient, and deter subsequent market entry from outside the agreement. Moreover, early commitment to preferential liberalization is likely to erode bargaining power in subsequent multilateral service negotiations. Where providers from within a regional trade agreement have already secured dominant positions, outsiders have little to gain.[13] Eventually, the small financial markets in many of the Central American countries may only sustain a limited number of institutions. It is, however, impossible to discern the origin of competitive suppliers ex ante, and early multilateral liberalization is most likely to facilitate the emergence of an efficient market structure. In sum, opening the market on a preferential basis is likely to undermine some of the benefits that countries seek to obtain from subsequent multilateral liberalization in the GATS. These considerations may have induced Mexico, for instance, to bind its NAFTA commitments to market access in the insurance sector in the context of the WTO's 1997 Financial Services Agreement.

[13] Mattoo and Fink (2002).

Whatever the efficiency considerations that will determine the sequencing of liberalization, the financial services agreement under the CAFTA will also need to comply with the GATS' legal requirements on regional agreements (GATS Article V). This article, which closely mirrors the corresponding article for goods trade in the GATT, stipulates that regional agreements must cover substantially all trade, result in the removal of substantially all discrimination between the parties to the agreement and not raise the overall level of barriers to trade in services to suppliers from countries outside the agreement.[14]

Furthermore, the liberal rules of origin that parties to a regional agreement are bound to implement under the GATS dilutes potential discriminatory effects from preferential liberalization. GATS Article V. 6 stipulates that "a service supplier [...] that is a juridical person constituted under the laws of a party to [an economic integration agreement] shall be entitled to treatment granted under such agreement, provided that it engages in substantive business operations in the territory of the parties to such agreement."[15] As any internationally active service provider is likely to be established in the U.S. market, this therefore in principle opens the Central American markets to providers from all origins. This is also what happened under NAFTA. While on paper Mexico discriminated between NAFTA and non-NAFTA service suppliers, in practice financial firms that provide financial services in any one NAFTA country—as most internationally active firms do in the United States—receive the same treatment as other firms that are headquartered in a NAFTA country.[16] This liberal rule of origin, applied under Mexican financial laws, indeed appears to have helped European providers enter the Mexican market via their U.S. subsidiaries.

[14] There have been only few notifications to the WTO of economic integration affecting services trade, and the substantive provisions for determining compliance are as yet ill-defined; Stephenson (2000).

[15] This is notwithstanding Article V 3 (b) under which in regional agreements that are comprised *solely* of developing countries members may discriminate in favor of service suppliers that are owned or controlled by natural persons of the parties to such an agreement.

[16] Dobson and Jacquet (1998).

For efficiency reasons—and to maintain leverage in the multilateral context—Central American countries are hence best advised to expeditiously table offers corresponding to their CAFTA commitments under the ongoing GATS negotiations. There is likely to be some delay between concluding CAFTA—scheduled for end 2003—and the conclusion of the WTO negotiations. However, by offering such concessions and announcing them early, Central America would gain negotiating leverage in other areas within the WTO, and avoid legal uncertainty for service suppliers seeking to enter their markets.

IV. Potential Effects and Adjustment Needs

Assessing the effects of CAFTA on the financial sectors in the six Central American countries is inevitably speculative. The substance and transition periods in the agreement are as yet unclear, and in any case foreign participation in financial systems is a function of numerous variables, some of which are themselves endogenous to the effects of trade liberalization on the real sector. If we assume that current market access restrictions can be justified on prudential grounds, and are continued once CAFTA comes into effect we are left with the effects of enhanced regulatory clarity and predictability, and of greater investor confidence due to more transparent dispute resolution mechanisms.

A. Impediments to Financial Integration

In assessing effects, the literature on the determinants of foreign bank entry provides a convenient starting point. Not surprisingly, foreign banks are attracted to profitable markets. Market size also appears to be an important consideration, due to fixed costs and the attendant economies of scale. Foreign banks establish in those foreign markets with which their home country has strong links in terms of nonfinancial trade and foreign direct investment—a finding in line with the observation that “banks follow their clients”.[17] Importantly, different regulatory environments discourage foreign bank entry. Corruption and inefficiencies in contract enforcement and in the judiciary raise the costs of doing

[17] See Brealy and Kaplanis (1996), Moshirian (2001), and Galindo and others (2003).

business by requiring adjustment to a business environment inferior to that in the bank's home base.

Given the relatively small size of financial markets in the region, the quality of financial sector regulation, contract enforcement and the judiciary are likely to be even more important than in other markets. Easiest to discern is CAFTA's likely impact on risks to contract enforcement. In writing financial contracts, foreign market participants deal with financial systems subject to diverse regulatory and supervisory standards, accounting standards, payment systems, legal and institutional frameworks, mechanisms for the settlement of disputes, and exchange regulations.[18] By setting common standards for transparency, enshrining transfer rights and providing for recourse to independent arbitration, CAFTA is likely to reduce risks associated with the last three factors, in particular, risks that financial contracts will not be honored (credit risk) and that changes in exchange regulations would make it difficult for residents to repay financial obligations (transfer risk).[19]

CAFTA may also be seized upon as an opportunity to harmonize regulation, and to strengthen cross-border supervision within Central America itself. Convergence of regulatory standards would enlarge the effective size of financial markets within the region, potentially raising the efficiency of financial intermediation and making these markets more attractive to foreign providers. The literature on the location of multinational bank subsidiaries has shown that banks are deterred by obscure regulatory regimes, or by regimes that are inferior to those in their home countries. Regulatory harmonization across the region is hence likely to benefit entrants from outside the region over incumbents from within the region.

Creating the conditions for financial integration remains a challenge. The regulatory, judicial, and institutional frameworks in several Central American countries lag well behind those of

[18] Ingves (2001).

[19] Johnston and Ötker-Robe (1999).

other countries seeking to attract financial FDI. Central American countries normally score low in comparative indicators of governance measuring the rule of law, or the control of corruption. On the other hand, newly released indicators of restrictions on business operations present a more mixed picture. Five countries among the CAFTA-6 have inefficient bankruptcy procedures, yet for several countries scores for contract enforcement and information disseminated in credit markets are on a par and at times higher than in Mexico.[20]

There have been criticisms of the judicial process in several countries. Delays in the enforcement of creditor rights—for instance in the execution of guarantees, repossession of collateral, or foreclosure—impede the extension of credit throughout the region. Other problems arise from inadequate competition standards. Where the corporate sector is highly concentrated, firms are more likely to take undue influence on contract enforcement within the government or judiciary. In many countries the financial sector is dominated by conglomerates which include commercial banks, finance companies, insurance companies, and other financial and nonfinancial entities. The potential abuse of such dominant positions, or inadequate supervision on a consolidated basis, may confer advantages to incumbents that deter potential entrants. Through the gradual process of trade and investment liberalization, and the upgrade of regulatory and competition standards, the CAFTA may initiate a process that will increasingly erode the dominant positions of incumbents, and their capture of the regulatory bodies and of the judiciary.

Numerous deterrents are country specific. Most notable is the prominence of three state-owned banks in the Costa Rican banking system—accounting for over half of assets—and the public sector's monopoly in the insurance industry. The three banks enjoy a full state guarantee on their liabilities and tax exemptions on their dollar deposits. While directed credit is no longer a problem in Central America, in Honduras legally mandated debt

[20] See *http://rru.worldbank.org/DoingBusiness/default.aspx*.

restructurings in the agricultural sector have provided debt forgiveness and interest relief to certain borrowers. Such government interference in private contracts may raise expectations of government bail-outs more widely, and undermine the credit culture.

B. Benefits and Risks of Foreign Entry

The above clearly presents a less than convincing case that the financial provisions within CAFTA will indeed induce greater foreign participation in Central America's financial systems. Yet, the confidence enhancing effects of the agreement are impossible to quantify, and other parts of CAFTA may by themselves bring about greater financial integration, for instance due to increased nonfinancial FDI, or growth of nontraditional exports to the United States. To fix ideas assume that CAFTA will indeed result in further foreign market entry in the financial systems of the CAFTA-6 and an attendant increase in capital mobility. How could the six countries benefit and, more importantly, what potential risks do regulators need to prepare for?

Most tangible may be the benefits from increased foreign participation in financial systems. A greater presence of strong foreign institutions can upgrade skills and technology in the local industry and enhance competition in local financial markets. Empirical studies substantiate the positive effect of the presence of well run foreign institutions in reducing interest margins and in enhancing the access of domestic firms to external finance.[21] Strong foreign financial institutions may also reduce volatility in the domestic financial system. Due to backing by their parents, superior risk management systems and home country supervision, foreign institutions are likely to hold higher quality assets. If a crisis of confidence sets in, depositors have the option of shifting their funds to reputable foreign banks rather than to accounts outside the country.

[21] Barth and others (2001).

Assessing the implications of greater capital mobility would of course move us squarely within a long-running yet inconclusive debate. The benefits from overcoming market segmentation and facilitating intertemporal consumption smoothing have proven elusive to substantiate in the empirical literature. Yet, note that greater scope for risk sharing may be particularly important for the CAFTA-6. On the whole Central American economies are open though relatively undiversified and subject to common terms of trade and weather-related shocks. Moreover, the financial and business conglomerates that operate throughout the region—and only within the region—could easily transmit these shocks and aggravate the correlation of crises across the region. In this environment, foreign owned financial institutions are likely to be more resilient not just due to their better risk management practices, but also by virtue of being part of larger and better diversified financial structures.

Needless to say, both aspects of financial liberalization bring with them a number of financial and macroeconomic risks. Greater capital mobility may induce greater real exchange rate variability, and financial risks from unhedged foreign exchange liabilities. The effects on domestic activity may be aggravated where the subsidiaries of foreign banks cut their credit lines in parallel with those extended to their host countries by their parents.[22] As competition in the financial system intensifies, the franchise values of domestic banks will diminish, possibly inducing them to borrow excessively abroad and expand domestic credit at the cost of impairing loan quality and risk. This will be particularly problematic where there are still weaknesses in prudential supervision, or where prospects for public bail outs aggravate moral hazard problems.

C. Adjustment Needs

Financial reform in Central American countries has come a long way in recent years, as evidenced for instance in efforts to integrate offshore banks in the regulated system. Yet, should the real and financial sector provisions in the CAFTA induce greater financial

[22] Mathieson and Roldós (2001).

integration on a scale anywhere near to what we sketched above, supervisors and policymakers will have a long catalog of adjustment needs before them. Weaknesses and adjustment needs can be quite easily targeted. Five of the six Central American parties to CAFTA have undergone Financial Sector Assessment Programs—the so-called FSAPs—and in one country financial sector analysis led to conditionality under a Fund program. For obvious reasons these reports remain confidential, though a number of common themes apply throughout the region.

Macroeconomic Policies

Trade and capital account liberalization, even within the context of regional integration, raises numerous challenges for macroeconomic policy which we will not assess here.[23] With respect to financial sector vulnerabilities a key prerogative will of course be to manage financial market expectations, and avoid mistaken impressions of exchange rate stability that could induce a build up of unhedged foreign exchange liabilities. More importantly, several studies suggest that exchange rate regimes in the region—predominantly crawling pegs, and in the case of El Salvador dollarization—may constrain lender of last resort functions of monetary authorities. Fiscal policy hence needs to provide adequate funding for liquidity support schemes that may need to muster credible responses to incipient banking crises.

Prudential Policies

Supervisors will face a more daunting agenda in controlling financial sector risks. Over time this should involve the convergence of incentive structures across Central American countries. The development of financial groups operating across Central America has outstripped the reach of supervisors, with the incumbents utilizing the regulatory complexities to their advantage. Their presence underscores the need for effective consolidated supervision, including of their offshore banks. The prominence of financial

[23] See for instance Inter-American Development Bank (2002).

conglomerates may well increase under the CAFTA, and in the absence of effective consolidated supervision the weakest supervisory authority may attract the largest risks. This harmonization could be indirect through the adoption of international standards and best practice, but the aim should ultimately be even closer cooperation between supervisors. The CAFTA may not only provide the necessary stimulus for national policy makers, but also facilitate this process through provisions on regulatory cooperation, such as reciprocal information exchange, or through technical assistance in support of regulatory reform. At the national level, supervisors will need to focus on adjustment requirements in four areas.

Capital Adequacy. Strong and sufficiently flexible capital provisioning puts in place cushions to absorb losses and provides incentives for owners to carefully manage risks. Both functions are crucial in an environment of increased capital mobility, and intensifying competition in the financial sector. Capital adequacy requirements are set at 10 percent of risk adjusted assets in Costa Rica, the Dominican Republic, Guatemala, Honduras, and Nicaragua. In El Salvador, they are currently at 11 percent, but will be increased to 12 percent by 2005. In all countries this is well above the Basle Committee standard of eight percent of risk adjusted capital. Yet, prudence may be more apparent than real. Equity capital is a residual claim, hence enforcing minimum capital requirements requires adequate accounting and auditing standards, especially for asset valuation, loan classification, provisioning, and depreciation.[24] It also requires close analysis of loan portfolio quality through on-site supervision and harmonization in prudential regulation across types of financial institutions and consolidated supervision to avoid cosmetic accounting that hides problem assets in the unsupervised financial sector. The FSAPs exposed important weaknesses in many of these aspects across the region. The most important weaknesses—the lack of effective consolidated supervision of financial conglomerates—casts doubt on the validity of reported capital figures. While banking laws in Costa Rica, Guatemala, and El Salvador, and Nicaragua now

[24] Most Central American countries have adopted or encourage the use of *International Accounting Standards* (IAS). Nevertheless, the FSAPs found important deviations from these standards, even in countries that are reportedly IAS consistent.

require consolidated supervision of financial conglomerates, in practice the ability to conduct such supervision varies widely. In addition, the FSAPs found that loan classification and provisioning rules were often not up to international standards, being relatively lenient, relying excessively on collateral, and being based only on past performance rather than on the repayment capacity of borrowers. Rules for preventing, identifying, and correcting the "evergreening" of loans were absent in several cases.

Prudent risk management. A key function of prudential regulation over the coming years will be to impose and enforce limits on the financial institutions' scope for taking exchange rate risk. This will be particularly important against the background of high and increasing dollarization in the region, which raises significant solvency and liquidity risks.[25] Substantial currency depreciation could affect bank solvency when banks or their borrowers are exposed to currency mismatches on their balance sheets or income streams. Our summary of current practices in Table 3 suggests that all countries except Nicaragua and Honduras currently impose limits on net open foreign exchange positions. However, only Honduras and the Dominican Republic appear to impose limitations that are based directly on the borrower's capacity to honor such obligations.[26] Such an analysis of borrower-specific risks to foreign exchange loans can yield important results in reducing foreign exchange risks, but is yet to be adopted more widely in the region. Foreign exchange risk will be a particularly important consideration for El Salvador, which by virtue of its full dollarization could easily become a springboard for capital flows into the region.

[25] Outside El Salvador, the share of foreign currency deposits in total deposits was substantial in Nicaragua (71 percent), Costa Rica (43 percent), and Honduras (33 percent), see De Nicoló and others (2003).

[26] In the case of the Dominican Republic, for instance, banks may grant loans in dollars up to the entire stock of their foreign exchange deposits to importers and exporters only where the loan is trade-related. In addition, they may only extend loans and guarantees to a single borrower for up to 10 percent of their paid-in capital and reserves, and up to 20 percent of capital and reserves, if such operations are secured with first-rank mortgages or real guarantees. In Honduras, up to 50 percent of foreign exchange deposits may be lent for export-related activities and up to 15 percent of this amount may be lent for other purposes. The other fifty percent are subject to a 12 percent reserve requirement and a 38 percent liquid asset requirement, which must be kept at foreign banks.

Table 3. Regulations on Banks' Foreign Exchange Positions and Credit Operations

	Costa Rica	Dominican Republic	El Salvador	Guatemala	Honduras	Nicaragua
Open foreign exchange position limits	X	X	X	X		
Limits to lending locally in foreign exchange		X			X	
Differential treatment of deposit accounts in foreign exchange						
Reserve requirements						
Liquid asset requirements					X	

Source: IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions, AREAER,* and country authorities.

Financial sector and corporate discipline. Financial sector discipline is crucial in a more liberalized environment where increased competition may lead to consolidation in the financial system. Imposing financial sector discipline requires a strong institutional framework for the supervisory authority that establishes its authority and independence, and protects supervisors from legal action by troubled banks. It also requires an adequate legal framework for the resolution of bank problems. Key elements include policies for financial disclosure, timely corrective actions mandated by the supervisory authority, and appropriate bank exit policies. Corrective actions include bank intervention and management replacement when the supervisory authority detects unsound financial practices. Putting adequate bank exit policies in place may sometimes require a thorough modification of the legal framework for the financial sector. Where possible, insolvent institutions should be restructured, or otherwise liquidated. The five available FSAPs reveal profound deficiencies on this front. While important legal and regulatory changes have already taken place in some of the countries, political will to apply the new regulatory frameworks has been lacking, resulting in regulatory forbearance and creative rescue operations of troubled banks. In certain cases, the absence of legal protections for banking supervisors is undermining the very basis of the regulatory regime. A few countries in the region also face weaknesses in the monitoring of banks' internal controls, which have led to fraudulent activities that have created financial stress, as has been the case in the Dominican Republic and Nicaragua.

Viable deposit insurance and liquidity support schemes. Lender of last resort and deposit insurance schemes are key to sustaining confidence of depositors, and to save solvent but illiquid institutions. Moral hazard problems are of course pervasive as market participants may easily expect bail outs should problems arise. A large literature—disseminated not least through technical assistance from the international institutions—has examined the design of partial and incentive compatible insurance. Yet as our summary of the current situation in Box 2 demonstrates, practices differ widely. Five of the six countries have some form of explicit deposit guarantee in place, though in the Dominican Republic this covers only savings and loans institutions. Costa Rica provides a guarantee for deposits only in the three state-owned banks. Most of the explicit deposit insurance schemes have been introduced over the last few years and are still undercapitalized, presenting a substantial contingent fiscal liability, and undermining confidence in the financial sector as a whole.

V. Conclusions and Policy Recommendations

The financial services provisions in CAFTA will make market access to financial sectors in the region more transparent and predictable. It may also spur the integration of regional financial markets through the harmonization of regulatory standards. Apart from providing a framework for a potentially important component of trade with the United States, this presents an opportunity to underpin ongoing efforts at financial reform. Greater foreign participation in domestic financial systems is likely to strengthen risk-assessment standards, transfer new technologies, and enhance the efficiency of intermediation in the context of still relatively recent financial liberalization.

Yet, foreign participation in financial systems should come from the widest possible range of suppliers. Parties to CAFTA should therefore swiftly table comparable offers for market access within the WTO, whose current trade round is scheduled to conclude not long after CAFTA. The financial and real sector provisions in CAFTA, even when mitigated by macroeconomic and exchange rate policies, may also lead to a substantial increase in capital mobility in the region. Together with the more vigorous competition in the financial systems, this will heighten the need to strengthen a number of supervisory functions, which we have outlined above. The experience with financial liberalization in the region has been far from uniformly positive, and some of the six countries may very well see the need to reimpose temporary and selective capital controls during crises that arise. Still, if properly designed, greater real and financial integration, as governed by the regional trade agreement that is now on the table, will make such crises less rather than more likely.

Box 2. Deposit Insurance Schemes in Central America

Country	**Description of Deposit Insurance Scheme**
Costa Rica	Three state-owned banks enjoy full state guarantee on all their liabilities but no deposit insurance is in place for private banks. Draft amendments to the central bank and banking law presented to Congress at end-2002 sought to introduce, among other things a limited coverage, privately funded, deposit insurance for private banks.
Dominican Republic	While no explicit deposit insurance scheme exists, except for deposits in savings and loans, an implicit deposit insurance scheme seems to operate since the central bank has returned deposits in failed institutions.
El Salvador	A deposit insurance scheme is managed by the Deposit Guarantee Institute (IGD). The institute provides, in principle, limited deposit insurance to banks, but currently lacks resources since it is at its capitalization stage.
Guatemala	A limited deposit insurance scheme was instituted in 1999 by the Law for the Protection of Savings (FOPA Law). The explicit deposit insurance scheme contemplated under the FOPA Law has not started to operate because a number of banks has refused to agree to the contract creating the trust fund that will administer the banks' contributions.
Honduras	An explicit deposit insurance fund (FOSEDE) guarantees a maximum of L150,000 per depositor, per financial institution. A total of L308,959,217 was available as of December 31, 2002. FOSEDE collects fees from its members, but also has access to an unlimited and automatic line of credit from the central bank in case the required payment of deposits exceeds the amount of its available liquid assets. In addition, the government is responsible for the remainder up to the full amount of such deposit. The blanket guarantee will be reduced to 50 percent in September 2003 and then eliminated in September 2004, while the limited deposit insurance will remain unchanged.
Nicaragua	The explicit deposit insurance fund (Fondo de Garantía de Depósitos, FOGADE) covers up to US $ 20,000 per depositor.

Source: Financial Sector Assessment Reports, and national authorities.

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