CHAPTER 8

Regional Initiatives to Achieve Financial Integration

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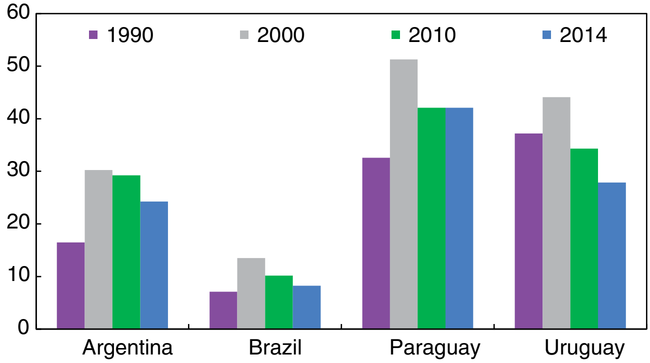
This chapter takes stock of existing efforts at regional financial integration. Integration initiatives have a long history in Latin America; however, many have lost momentum after initial enthusiasm. This chapter looks in particular at two ongoing regional initiatives that—among other objectives—are aiming at financial integration. It finds that prospects are good for both of them, and that they may be the most suitable vehicles for taking the integration process forward at this time.

MERCOSUR

Mercosur was established in 1991 through the signing of the Treaty of Asuncion by the presidents of Argentina, Brazil, Paraguay, and Uruguay. Venezuela joined in 2012 and Bolivia in 2015. Mercosur's founders were inspired by the example in Europe and aimed to go further. They intended the alliance to also be a tool to strengthen democracy as its members recovered from the dictatorships of the 1980s and hoped it would drive political integration. Progressive preferential trade liberalization among member countries took place from 1991 to 1994, and by the time the common external tariff was established in 1995, tariffs among members had been reduced for the most part. As a result, trade among Mercosur countries increased across the board throughout most of the 1990s (Figure 8.1). The establishment of a common external tariff was expected to lead to a customs union. However, the period from 1996 to 1999 saw a reversal in trade liberalization owing to external shocks such as the Brazilian financial crisis in 1999, as well as unilateral changes in the common external tariff by Brazil and Argentina. Both countries also introduced new nontariff barriers: import licensing requirements and antidumping measures. As a result, trade among Mercosur countries has declined since 2000.

In the Montevideo Protocol (1997), members made commitments to the liberalization of services, including financial services. The principles guiding the liberalization process were similar to those established in 1995 for multilateral liberalization in the General Agreement on Trade in Services (GATS) of the World Trade Organization (WTO). For example, modes of provision, rules of market access and national treatment, and complete liberalization were envisaged over a 10-year

Figure 8.1 Goods Trade within Mercosur
(Percent of national good trade)



Source: IMF, Direction of Trade Statistics.

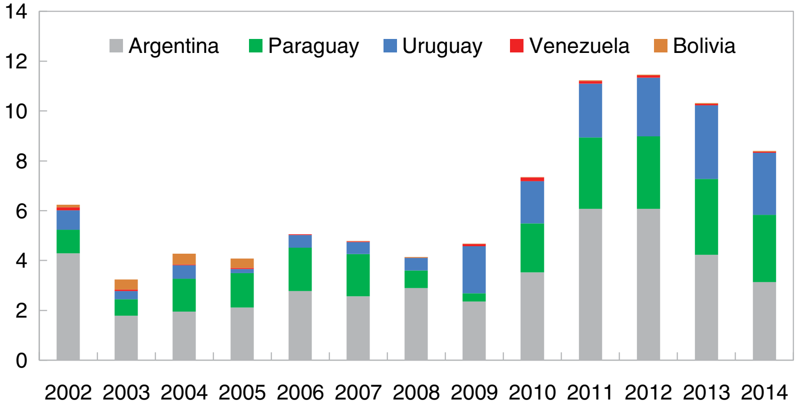
period. The list of initial commitments to liberalization under the Montevideo Protocol was marginally more extensive than the list negotiated in GATS. Argentina and Brazil maintained the liberalization levels they committed to in GATS, Paraguay committed less than the amount negotiated in GATS, and Uruguay increased its commitments, particularly regarding the presence of firms and of natural persons. Finally, Mercosur has a technical forum for financial issues—Financial Mercosur (SGT-4)—tasked with advancing the financial integration agenda.[1]

Financial services in Mercosur member countries were liberalized unilaterally in the 1990s, either simultaneously with or after the Mercosur agreement, which led to an increased presence of global foreign banks. The unilateral moves toward liberalization followed the Argentinean hyperinflation episode. Argentina instituted the "convertibility plan," which led to the deregulation of domestic markets, privatizations, trade liberalization, elimination of capital controls and a stable macroeconomic environment conducive to foreign investment. The Brazilian "*Real* plan"—introduced in 1994 to stabilize the economy after a bout of hyperinflation—led to the restructuring of banks, privatizations, and liberalization of the financial sector. To facilitate foreign bank entry, Brazil eliminated the restriction that the minimum capital for a foreign bank had to be twice as large as that required for a national bank.

Foreign claims of Brazilian banks[2] on Mercosur countries provide some evidence of increasing regional integration since 2008 (Figure 8.2). They rose from an average of 4 percent of total foreign claims over the period 2002–08 to a peak of 11 percent in 2011–12, after which they declined owing to a reduction in foreign claims on Argentina. Currently, foreign banks from Mercosur countries do not have important market shares in Brazil and Argentina, but they do hold 10 percent and 20 percent of assets in Uruguay and Paraguay, respectively (Figure 8.3). Seventeen percent of Brazilian Itaú's operations in Latin America are in

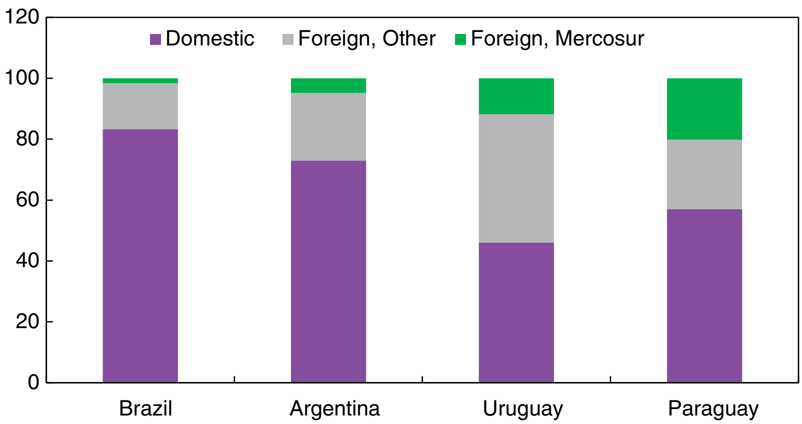
[1] The ultimate objective of SGT-4 is to create a single regional market for financial services while maintaining stability in the monetary and financial system.
[2] Brazil is the only Mercosur country that reports to the Bank for International Settlements (BIS).

Figure 8.2 Foreign Claims of Brazilian Banks on Mercosur
(Percent of total, immediate borrower basis)



Source: Bank for International Settlements, Consolidated Banking Statistics.

Figure 8.3 Mercosur: Commercial Bank Ownership
(Mercosur bank assets in percent of total assets)



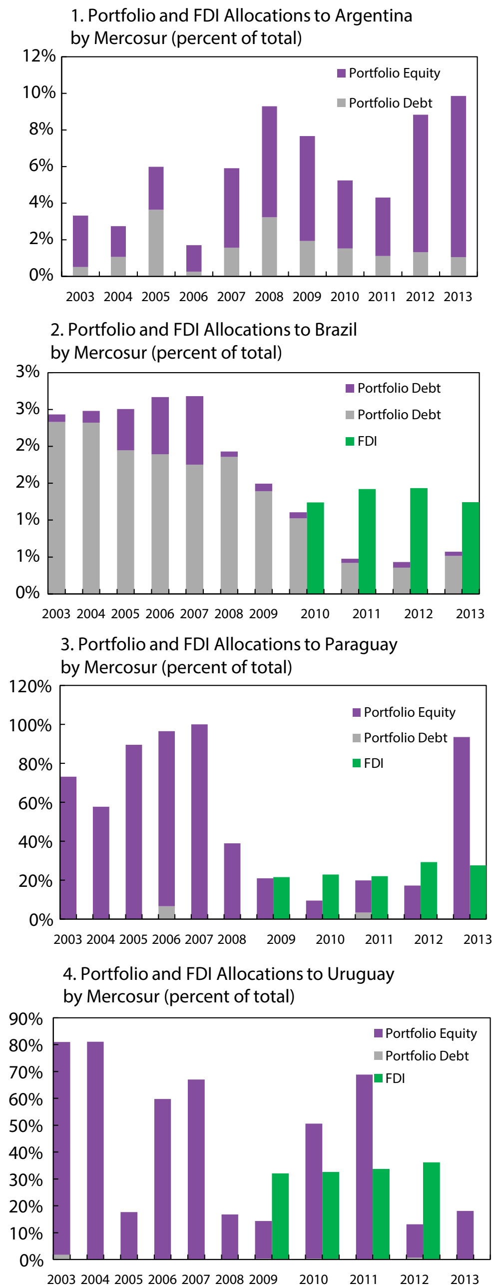
Sources: Bankscope; and Bureau van Dijk.

Mercosur countries; Itaú has market shares in the Paraguayan and Uruguayan banking systems of 18 percent and 11 percent, respectively.

Although the member countries committed to liberalizing financial services in the Montevideo Protocol, various indices suggest that certain restrictions to market access remain.[3] Argentina liberalized the most, but it maintained some level of protection in cross-border supply of financial services and presence of natural

[3] Hoekman (1995a; 1995b), Dee (2005), and Berlinski (2012) have constructed indices of restrictions for market access across the following modes of supply: cross-border supply, consumption abroad, commercial presence, and presence of natural persons, assigning values to liberalization commitments made by countries.

Figure 8.4 Portfolio and FDI Allocations to Mercosur by Other Mercosur Countries, 2003–13



Sources: IMF, Coordinated Portfolio Investment Survey and Coordinated Direct Investment Survey.
Note: Mercosur includes Argentina, Brazil, Paraguay, and Uruguay. FDI = foreign direct investment.

persons. Brazil made no commitments to liberalize cross-border supply and consumption abroad, and kept some restrictions in commercial presence and presence of natural persons. Uruguay also had some restrictions across all modes of supply, while Paraguay had the most restrictions. Other indices of barriers to integration suggest some restrictions with respect to licensing for foreign banks (Brazil and Uruguay), foreign bank entry (Brazil), and movement of people (Argentina, Brazil, and Uruguay). Some indicators suggest an increase in restrictions to foreign bank entry and banking activities permitted in Argentina (Barth, Caprio, and Levine 2006, 2007), while restrictions on banking activities were lowered in Brazil from 2000 to 2006.

The Political Mercosur and the Commercial Mercosur are facing problems, but the Financial Mercosur is achieving some progress, especially on the convergence of the members toward best practices. Working Group No. 4 (SGT-4) comprises financial sector regulators (banking, securities markets, and insurance) from all Mercosur member countries to oversee the integration process. The ultimate goal is to create a regional common market in financial services.

Figure 8.4 shows the extent of cross-border portfolio and FDI allocations in four Mercosur countries.

This moment may be propitious for taking the process further. President Mauricio Macri of Argentina referred during his 2015 election campaign to the need to restore momentum to the Mercosur process. Regional integration may be a productive way for Argentina to begin to reintegrate into the global economy. In the coming years, Venezuela may face similar—albeit far more difficult—reintegration challenges. Meanwhile, members of Mercosur continue to integrate their economies. On December 2015, Paraguay and Uruguay signed an agreement to create a bilateral local currency payment system;[4] on April 20, 2016, Brazil and Paraguay signed a similar bilateral agreement. This followed an initial agreement between Argentina and Brazil in 2008; over the next five years, transactions using the Brazilian currency for invoicing trade and services between the two countries grew ninefold. These are voluntary agreements under which exporters may receive payment in the importer's home currency. The currency is remitted to the central bank, which nets the balances and pays the exporter in the home currency at the prevailing rate against the U.S. dollar. Over time such arrangements could perhaps become multilateral, allowing multilateral netting, perhaps based on the Brazilian currency. (The countries would have to take care not to violate their obligations under Article VIII of the Articles of Agreement of the IMF.[5])

[4] These agreements are known as SMLs, from their Spanish language acronym for the system of payments of local currency (Sistema de pago en Moneda Local).

[5] Article VIII covers restrictions on current payments, discriminatory currency arrangements, and multiple currency practices.

THE PACIFIC ALLIANCE

On April 28, 2011, then-President Alan Garcia of Peru—together with the presidents of Chile, Colombia, and Mexico—signed the Lima Agreement, which pledged the four countries to work together as the Pacific Alliance (PA) to foster "deep integration" in a wide range of areas. The signers agreed to the immediate abolition of tariffs on 92 percent of merchandise trade and made a commitment to abolish the remainder by 2020. Together the countries represent 36 percent of Latin American GDP, and they are the four largest exporters from the region.

The PA continues its high-level political commitment with biannual presidential summits. At a summit in Paracas, Peru, on July 2, 2015, the presidents reaffirmed their commitment to the PA and laid out new avenues for integration. On July 20, 2015, the framework agreement for the PA came into force. With the rotating presidency moving to Chile in 2016, the presidents met in Puerto Vargas on July 1, following a high-level business summit held in Santiago in June.

The Alliance has garnered wide international attention, and 34 countries are now observers at the PA meetings. Several smaller countries in the region are proceeding through the membership process or considering doing so. It has been suggested that the greatest achievement of the alliance is its ability to draw inward investment.[6] The PA explicitly sees itself as outward-focused and presenting an integrated economic face to the world. For example, the Association of Southeast Asian Nations (ASEAN) has been an observer at PA meetings, and the PA met with ASEAN in May 2015 and was an observer at the ASEAN summit in the Philippines in November 2015. In May 2016 ASEAN and PA officials met in Bangkok, along with academic and private sector participants. They agreed to define a general framework of cooperation between the two organizations' integration processes; this agreement was adopted during the subsequent third interregional ministerial meeting.

There is as yet no specific overall financial sector stream for integration among the PA countries, but it has taken over a private-led initiative for capital market integration. The stock exchanges of Chile, Colombia, and Peru agreed to merge under the Latin American Integrated Market (MILA) initiative (see Box 8.1). The initiative has received considerable publicity, and in 2014 Mexico joined, with an initial trade on December 2, 2014, of shares in Chilean retailer Falabella executed in the Mexican stock exchange. The Mexican stock exchange also bought 6.7 percent of the Lima stock exchange. The joint exchange is the second largest in Latin America, slightly smaller than Brazil's BM&F BOVESPA.

Actual results from the capital market initiative are minimal so far. Total trades in the five years since MILA was established are less than the volume traded in Mexico alone in a week. Two explanations have been put forward. The first is that MILA is redundant, as capital market needs can be serviced either domestically or outside the region, particularly in the United States. The second explanation is that the integration process so far has been insufficiently ambitious and that a

[6] *The Economist*, March 14, 2015.

Box 8.1 Integrated Securities Markets in the Latin American Integrated Market (MILA) Initiative

Background

Regional integration and cooperation in securities markets for LA-7 countries is crucial to address the increased intensity, growth, and importance of transnational and intraregional financial services. In particular, regional integration would intermediate the rapid growth and size of foreign direct investment (FDI) in financial institutions and cross-border transactions. Domestic securities markets in many LA-7 countries are restricted in size, in part owing to large fixed costs in setup and a lack of economies of scale. In addition, the limited nature of liquidity and risk diversification in such markets plays a significant role. MILA was announced in September 2009 and launched in May 2011 with the intention of bolstering trading volumes in three stock markets—Chile, Colombia, and Peru—and providing an alternative to the larger markets of Mexico and Brazil. Mexico joined MILA in December 2014. MILA exchanges are first in Latin America in the number of listed companies, second in market capitalization, and third in traded volumes.

Liquidity

Investors, issuers, and broker-dealers are less likely to participate in illiquid markets. Investors who hold securities in their portfolios require certainty of valuation and execution of sales of securities from such markets under appropriate pricing conditions should they decide to offset their positions. Liquid markets enable investors to meet these needs while benefiting from lower transaction costs. Large volumes and higher frequency of issuance of individual equity securities are necessary to create proper liquidity pools, attract investors, and generate a larger volume of transactions. This is a prerequisite for the development of efficient pricing in secondary markets. Moreover, liquid markets help investors diversify their risks.

Harmonization Challenges

MILA is a cross-border initiative to integrate equities markets without any real corporate merger of stock exchanges or depositories; it has enabled cross-listings and the use of technological tools to allow standardization of regulations on trading and custody across the separate MILA countries. Fuller integration would require deeper regulatory and supervisory harmonization, including delineated responsibilities for various securities supervisors, harmonization of regulatory standards, and supervisory approaches to best practice levels. The creation of a fully integrated regional equity market would require that all investors benefit from equivalent legal treatment and that a protection regime exists for all transactions made through MILA. Further tax and pension fund investment regime harmonization and unified resolution frameworks are important for more extensive integration of equity markets. There has been little or no progress in integrating fixed-income (bond), currency, derivatives, repos, and securities lending markets, partly because the rules for such securities are extremely challenging to integrate and, unlike equities, many of these securities are not fully traded electronically on exchanges, so the majority of trades are still over the counter (OTC). Foreign investors are not very actively involved in MILA, preferring to access local markets through well-established relationships with local custodians and broker-dealers; in this way they also benefit from tighter foreign exchange spreads when currency is converted and from delivery-versus-payment settlement (DvP).[1]

(*Continued*)

[1] DvP is a securities settlement mechanism that links a securities transfer and a funds transfer in such a way as to ensure that delivery occurs if and only if the corresponding payment occurs.

Box 8.1. (*Continued*)

Post-Trade Settlement and Counterparty Risk

MILA has so far been a trade-driven initiative with limited focus on essential back-office settlement issues to address settlement and counterparty risk. This operational factor is a major element restricting greater trading volume growth. Currently, counterparty risk is carried by local broker-dealers when they settle cross-border trades. This can result in contagion and systemic risk concerns if one of the broker-dealers cannot fulfill its payment or delivery obligations. Specifically, cross-border trades in MILA are conducted on a free-of-payment basis, in which the cash and securities do not move together on the settlement date. In fact, cash moves ahead of securities. For example, assume a Chilean broker-dealer buys Colombian equity for its Chilean investor through a Colombian broker. If the Colombian broker were to become insolvent and unable to deliver the securities, the Chilean broker would be liable to its Chilean investor. If the Chilean broker-dealer could not meet its obligations it could also fail and, if the failure was systemic, it could cause contagion and loss for other brokers and investors, and potentially cause wider systemic financial distress. Thus, a multilateral process is required for settling cross-border trades between brokers in MILA on a DvP basis. So far, options to facilitate that process through a regional clearinghouse or through the use of local custodians or central securities depositories have not materialized. One way forward would be to establish a mini regional bank under MILA auspices.

Conclusion

MILA represents an important staging post for further integration of securities markets in Latin America, increasing economic growth in the region through enhanced financial intermediation and financial resilience arising out of deeper and more liquid securities markets. Further integration of securities markets should involve harmonization toward best practices at an international level.

more comprehensive set of integration policies would enable the initiative to achieve "lift-off."

The number of actual integration measures to date has been limited. For instance, trades still have to be placed with a broker-dealer in the investor's country, who must then contact a broker-dealer in the investment's country. Also, the initiative covers only equities, although it is being expanded to cover government and corporate bonds. There has been no harmonization of operating hours and procedures, nor harmonization of tax systems to avoid double taxation. And—possibly most important—institutional investors in the participating countries, particularly pension and insurance funds, have limits on the shares of their portfolios they may invest across borders, including in fellow PA countries.

This would be an opportune time to use the political mileage achieved through the PA to implement a comprehensive set of interconnected measures to accelerate regional capital market integration, including through MILA. Such measures could include relaxing the share of portfolios that pension and insurance funds may invest cross-border or, preferably, allowing cross-border investments in other MILA countries to be counted as domestic. (For example, Chile restricts cross-border investment on the basis of country ratings; it might switch to using corporate ratings and foreign exchange position limits instead.) In addition, operational procedures—including all aspects of listing requirements—could be harmonized.

The PA agenda is carried forward largely by finance ministry officials in the country that holds the rotating presidency. This arrangement has a number of advantages—including keeping initiatives in line with national objectives—but it also has drawbacks. Primarily, the setup limits the administrative resources that can be put into the initiative and may limit it to moving forward through ad hoc measures. All the officials involved already have a full portfolio of other tasks, so PA work may at times be crowded out. And the periodic rotation of presidencies means an inevitable stop-start as the new team succeeds the old.

The authors therefore recommend that a small secretariat be established in one of the PA countries (see Box 8.2). The secretariat would not be an alternative to the rotating presidency but rather an instrument to make the presidency more

Box 8.2 The Pacific Alliance Secretariat

The Pacific Alliance Secretariat (PAS) would have overall responsibility for designing and providing advice on the operational requirements for the PA redefine financial sector work stream; it would translate the high-level pronouncements of the member country presidents (such as in the Paracas Declaration of 2015) into specific action. In establishing a secretariat, the PA would be following the practice of other regional bodies, such as the Association of Southeast Asian Nations (ASEAN), which established a secretariat in Jakarta in 1976 and has progressively assigned it additional functions.

The location of the secretariat would be determined by the member countries. It could be placed in the largest country, or the smallest, or the country with the best transport links. Some regional organizations have deliberately located the secretariat in a city that is not a capital city, to reduce the risk that one member will acquire disproportionate influence. However, choosing a city with good transport connections that is not a capital would narrow the range of choices. Sometimes the decision is the result of trade-offs; for example, one country might host the secretariat while another provides its first head. If other secretariats or agencies are being set up at the same time (for instance, there might also be a dispute resolution commission), such agencies could be distributed across the membership.

The proposed secretariat might start with no more than a dozen staff, drawn from across the PA membership. Staff might be secondees from central banks or ministries, selected by open competition across the member countries, or a combination. Diverse expertise would be required so that all facets of the integration agenda are covered.

The alliance would have to determine the role of the PAS vis-à-vis the member countries.[1] Because the PA operates through consensus, the secretariat would have to maintain very close contact with the member countries, probably with the same country officials who were previously responsible for PA work. Coordination could be facilitated by periodic meetings—say, twice a year—among the PAS, the country counterparts, and the informal group of country representatives, as part of the handover of the rolling presidency and the accompanying meetings of the PA presidents.

[1] Coordination among outside providers of assistance and expertise to the PA could also be useful. An important part of the forthcoming agenda for PA countries is likely to be the harmonization of accounting and prudential standards and of trading practices. Such harmonization should be based on international best practices, so coordinated advice from the multilateral agencies could make an important contribution. This might be facilitated by the establishment of an informal group of PA country representatives at the IMF, Inter-American Development Bank, and World Bank.

effective. Specifically, the secretariat should have overall responsibility for providing advice and executing the operational requirements for a PA financial sector integration stream. Work would include preparing and disseminating a comprehensive framework or action plan for integration, including timelines and sequencing, so as to maintain momentum for the process, ensure consistency, and gain the benefits of proceeding through reciprocity. The secretariat could also be the external face of the financial side of the PA, helping to secure foreign investment and other integration with the rest of the region and the wider world.

There has been some resistance to the establishment of a PA secretariat, primarily because of the number of bureaucracies already in existence in other regional institutions. It would be important therefore that the PA secretariat work closely with the political and economic leadership and that the present intensive series of political and economic meetings and programs be maintained or even intensified.

POLICY RECOMMENDATIONS

It is recommended that both the countries of Mercosur and those of the PA intensify efforts at financial integration, both at a country level and at the level of these regional arrangements.

Mercosur

This is a good time for Mercosur to revisit its plans for financial integration and consider how to take them forward. Prioritization and setting realistic timelines would be important. Many of Mercosur's members are in economic slowdown or recession; regional integration could be a component of a general rebalancing strategy.

Mercosur could demonstrate its revitalization by increasing its international profile; for instance, through joint roadshows to international financial centers and participation with other regional groups. It could seek to integrate its capital markets while providing assurances to the smaller countries that such integration would not bring about domination by the larger countries. Not all member countries may be ready to move forward right now. They could move forward on a bilateral basis insofar as this is compatible with Mercosur; for instance, as with the recent spurt in agreements on local currency payment systems.

The Pacific Alliance

The PA would benefit from establishing a small secretariat to support it in making decisions and implementing plans. The secretariat could work in the following areas:

- Permitting pension funds and insurance companies to count cross-border PA investment as domestic. Replacing remaining ratings-based country limitations on pension fund investments across MILA countries with specific foreign exchange and corporate limitations. Ensuring safeguards for foreign exchange and credit risks.

- Completing MILA expansion beyond equities (primary and secondary markets) to include sovereign and corporate bonds. Positioning MILA to focus on back-office issues, in particular postsettlement and counterparty risk.
- Harmonizing operational procedures, including all aspects of listing requirements, for capital markets.
- Ensuring that all countries have signed International Organization of Securities Commissions memorandums of understanding.
- "Passporting" the licensing of broker-dealers while keeping them subject to host as well as home regulation.
- Enhancing contacts among national regulators and supervisors, including through staff exchanges and secondments to the secretariat.
- Examining the potential for expanding the geographic scope of the PA.

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