CHAPTER 1

Introduction

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Many factors indicate that now may be the time for Latin American economies to work toward greater regional financial integration. This would not be a substitute for wider integration in the world economy; some Latin American economies are among the most active in global initiatives. However, given the recent economic slowdown in much of the region, limited progress in pursuing global agreements, and the widespread withdrawal of global financial institutions from emerging markets (including those in Latin America), regional financial integration could help buttress the economies of Latin America, enhance competition, and—over the medium term—lead the way toward global integration.

Regional financial integration could not only facilitate inward investment and enable Latin American markets to achieve minimum viable size, but it would also add a dimension of diversification, so that these economies would not rely solely on domestic or global developments to progress. In particular, regional financial integration would enable Latin American economies to reap benefits from the economic stability of other countries in the region, facilitate the adoption by Latin American economies of best practices in areas such as supervision and accounting, and serve as a step toward wider integration at a later stage.

Important public initiatives are currently fostering financial integration in Latin America. Since 2011 the presidents of Chile, Colombia, Mexico, and Peru have met regularly to further the agenda of the Pacific Alliance. On July 2, 2015, they issued the Paracas Declaration, reaffirming their commitment to foster market integration among their countries. In June 2016 the rotating leadership passed to Chile, and the presidents met in Puerto Vargas on July 1. Countries in Mercosur (a more long-standing organization comprising Argentina, Brazil, Paraguay, and Uruguay plus, more recently, Bolivia and Venezuela) may also revive the momentum of its financial integration agenda.

Regional private sector endeavors are underway as well. Banks, particularly those of Brazil and Colombia, are establishing themselves as regional institutions. Stock exchanges are establishing a regional presence; for example, the Latin American Integrated Market (MILA) initiative aims to foster equity and bond market integration across the Pacific Alliance countries, and the Brazilian stock exchange has bought 8 percent of the Santiago exchange, perhaps as a step toward greater Brazil/Mercosur/Pacific Alliance links. Nonfinancial firms are also expanding across the region, especially retail institutions from Chile and conglomerates from Brazil and Mexico.

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An understanding of the evolution of financial sectors in Latin American economies can help elucidate the relevance of regional financial integration at this juncture. Between 1982 and 2002, all major Latin American economies suffered economic and financial crisis—in many cases, repeated crises—including the Mexican crisis of 1994 that IMF Managing Director Michel Camdessus called the first crisis of the 21st century. In nearly all cases, the countries undertook IMF adjustment programs (see Table 1.1) that over time contributed to fundamental transformations of their economies. The current financial systems of Latin America are to a large extent legacies of the manner in which the various countries responded to crises. Usually this response involved the initial nationalization of a significant part of the banking system, followed in many cases by sales to foreign banks, particularly those in Europe and North America. Mexico was an extreme example, with only one large bank remaining in domestic hands. At the same time, the crises forced many countries to reduce their vulnerability to losses of confidence. For example, Brazil and Mexico placed tight limits on residents' holdings of foreign currencies as well as on banks' exposures to foreign currencies; many of these limits remain in place.

The opening of their economies to global financial institutions reflected a view in many Latin American countries after the crises of the 1980s and 1990s that this strategy could protect them from regional instability, provide much-needed capital, and help them import managerial and technical skills. The strategy worked well and, aided by gains from the commodity boom and improvements in macro management, growth recovered strongly in most countries. No large Latin American country needed financial support during the global financial crisis, despite their exposure to global banks. Indeed, foreign bank subsidiaries in Latin America, buttressed by their reliance on domestic deposits, in some cases were a source of strength for their global balance sheets, including through the provision of liquidity to their overseas parents. From 2002 until recently, the region has experienced sustained growth: GDP in 2014 in the seven Latin American countries covered in this study is estimated to have been 52 percent higher in real terms than in 2002, compared with 25 percent for the United States and 16 percent for the countries of the European Union.

TABLE 1.1

IMF Lending Arrangements with LA-7 Countries since 1982

Country	Number of Programs	Total Borrowing (Billions of SDRs)
Brazil	6	41.3
Chile	3	1.4
Colombia	3	0.0
Mexico	5	17.9
Panama	7	0.4
Peru	9	1.1
Uruguay	10	2.8
All IMF programs	371	314.5

Source: IMF staff compilation.

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Nevertheless, although Latin America was less affected by the global financial crisis than other regions, the crisis demonstrated that extreme volatility could originate from outside the region and that the region would not go unscathed. Weakened in the global financial crisis and facing the costs of additional regulatory demands, reduced profitability, and increased funding costs, European and North American banks have been downsizing. In this process, some major global financial institutions have left countries in Latin America and other emerging markets or have markedly reduced their exposures. No new bank from Europe or North America has established a significant presence in Latin America. The withdrawal of global banks has led to increased consolidation among leading local banks (for instance, in Brazil), potentially undermining the competitiveness of the banking systems and liquidity in the local markets. The pressure on global banks to withdraw may increase further as regulators implement a range of reforms, including the systemic banks' capital surcharge requirements, the requirements of the Key Attributes of Effective Resolution Regimes of Financial Institutions, over-the-counter derivatives reforms, and ring-fencing. Recently, Deutsche Bank announced its withdrawal from investment bank activities in 10 Latin American countries, including some in which it has had a presence for over a century.

The nonbank financial sector is also challenged. Volumes and liquidity in a number of exchanges are declining as U.S. regulations for derivatives trading have increased the cost of doing business in emerging markets. For some exchanges, their continued viability on a stand-alone basis is in doubt. For pension funds and insurance companies, regulatory restrictions constraining the bulk of their activities to domestic markets are causing increasing friction and may create bubbles, especially among the region's smaller markets.

Regional initiatives are not substitutes for further integration with the rest of the global economy. Latin American countries are deeply involved in major global initiatives. However, the ongoing retrenchment of global institutions from the region could leave countries underfinanced or with less competitive systems unless they are able to attract new institutions. Global agreements, particularly on financial integration, are not reached quickly; substantial mileage may be achieved by going further and faster on a regional basis. Indeed, to the extent that regional integration involved raising financial standards generally, it could facilitate wider integration in the future. Moreover, regional integration initiatives bring greater visibility, and more investment, to Latin American economies: in September 2015 the presidents of the Pacific Alliance conducted a joint road show around major global financial markets, and the Pacific Alliance was invited as an observer to the Association of Southeast Asian Nations meetings in the Philippines in November 2015.

Currently, Latin America as a region is less integrated across national financial markets than other parts of the world (see Chapter 2). Various factors—including size, history of crises, and regulatory structures—may contribute to this. Integration can help foster depth, and deeper financial markets have been shown to positively affect growth, at least up to a certain point. The usefulness of deep

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and strong financial markets becomes ever more apparent as prospects for growth in a number of Latin American countries (for instance, Peru) currently hinge on large infrastructure projects financed mainly through public-private partnerships.

Many Latin American economies are under strain, which is partly conjunctural. With the end of the commodity super-cycle boom and the slowdown in China (which had been the key impetus for much of the growth experienced in the region, particularly for countries in South America), countries need to find new drivers for economic growth. Among the possibilities, financial liberalization and regional integration may help new growth sectors emerge. The current strain is also the result of structural factors. For instance, investment restrictions are hampering synergies between the rapidly growing pension and insurance funds in the region and countries' needs for long-term and large-scale financing. Legislative and regulatory reforms in a number of Latin American countries—most significantly Chile—have generated rapid growth in these funds, but domestic capital markets do not provide sufficient investment opportunities. In addition, the infrastructure needs of the region require large investment initiatives, and domestic funds might be unable to invest enough and still avoid overconcentration, thereby jeopardizing the viability of such projects.

Regional financial integration could thus be an important response to Latin America's current economic challenges and circumstances, for the following reasons:

- Growth for most of Latin America has been closely related to the expansion of the Chinese economy, which drove both higher volumes of commodity exports and the resultant higher prices at which they were sold. With the slowdown in China and the end of the commodity super-cycle, growth through commodity exports may no longer provide sufficiently strong support to the region's economies. The prospect of tighter global financial conditions further complicates the economic outlook. New industries will require financing, which in turn will require strong financial markets, in terms of both banking (which still dominates the financial sectors of all Latin American economies) and capital markets (where pension funds in particular are growing rapidly and could potentially supply much of the financing for the emerging needs of the region).
- The global banks that have been major players in many Latin American economies have been withdrawing since the global financial crisis; a number of them were weakened in their home countries and have been forced to retrench, and the global regulatory agenda has increased the cost of prudential compliance in response to the global financial crisis. Insofar as the departing banks are not replaced by cross-border institutions, concentration will increase in domestic banking systems, with a potential loss of competitive forces. For instance, the purchase (announced in July 2015) of HSBC's retail operations in Brazil by Bradesco, Brazil's second-largest private bank, will add

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to the consolidation of the Brazilian banking sector. More recently, Deutsche Bank announced its withdrawal from investment banking activity in 10 Latin American countries.

- Although the intent of the international regulatory agenda has been to reduce overall risks, in its initial stages it appears to have inflicted a number of unintended consequences on emerging markets. The increasing cost of cross-border activities (for instance, by requiring haircuts on cross-border collateral and centralizing business on exchanges) and of dealing in markets outside major financial centers has led to shifts in capital market activity toward exchanges in advanced economies. A withdrawal from Latin America by global institutions and markets could affect the region's ability to develop new products, which could in turn increase costs of and reduce access to finance (particularly for second-tier institutions) and transfer intermediation fees outside the region.
- Trade links in the nonfinancial sector are increasing across Latin America, not primarily through trade among Latin American countries but through the cross-border establishment of Latin American firms, including some of the major conglomerates. Companies from Brazil, Chile, and Mexico have been particularly active in this regard.
- Increasingly, size matters in building and maintaining financial infrastructures. For instance, the information technology, legal representation, and compliance costs needed to achieve competitive parity with the major financial centers may be prohibitive on a national scale in all but the largest Latin American countries. Without the integration of regional markets, prospects for maintaining active markets may be limited in some Latin American countries.
- In the nonbank arena, the ongoing rapid growth of pension and insurance funds in a number of Latin American economies threatens to overwhelm domestic capital markets. Given the dearth of domestic investment opportunities for these funds, the limited pool of assets in these markets may be largely held by the funds to maturity, depressing liquidity and limiting investment opportunities for smaller retail investors.
- As a corollary, the next phase of growth in Latin America is likely to involve projects with large financing needs (for instance, infrastructure), and it will be challenging to finance these projects solely through domestic markets. Countries' domestic pension and insurance funds, which are generally subject to concentration limits, may provide an insufficient pool for financing on the required scale. Permitting increased cross-border investments by pension funds and insurance companies, at least within the region, will enable them to diversify their risks and thus facilitate the financing of large projects. Of course, such an increase in cross-border investment would need to be accompanied by appropriate risk management.

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- Increased integration would not be risk-free. Cross-border activity without robust risk management can potentially threaten financial stability, but it is possible to mitigate such risks. Enhanced cross-border consolidated and conglomerate supervision should enable supervisors to keep track of banks' and financial conglomerates' complex cross-border activities. Careful monitoring of intragroup transfers and ring-fencing capital should dampen spillovers from the home countries of parent institutions. Higher quantity and quality of capital and liquidity requirements should make banks safer. Supervisory and resolution colleges, together with memorandums of understandings (MOUs), should provide early warnings of problems and help deal with those that occur. With this expanded toolkit, countries may be more willing to accept the benefits of regional integration, notwithstanding the initial costs of enhancing the regulatory regime to protect financial systems from systemic risks.
- Although ensuring domestic protection from potential cross-border spillovers by looking outside of the region may have been the most prudent response to the Latin American crises of the 1980s and 1990s, regulatory reforms since then provide a complementary route for protection. In addition to tighter bank capital, liquidity, and disclosure requirements, regulators have increasingly recognized the need for consolidated supervision. Consolidated supervision and conglomerate supervision, together with upgraded MOUs and colleges of supervisors for all banks with significant cross-border activity, are designed to mitigate the risks of cross-border activity. Macroprudential measures too are increasingly being adopted and refined to address systemic risk concerns and to limit spillover risks from global market volatility.
- Finally, differences across the region in the speed of application of the new global regulations, as well as continuing limitations on the range of permissible activities, generate their own costs and lead to anomalies. In an environment of consolidated supervision, each institution has to follow both home and host country regulations, putting banks from countries with more advanced regulations at a competitive disadvantage. And while banks from some countries are able to make cross-border investments, their home countries may not be very accessible for inflows. Brazilian Banco Itaú, for example, takes an explicitly regional perspective for its operations; however, its expansion might be more welcomed in target countries if institutions in those countries found it easier to enter and do business in Brazil.

In sum, regional integration of banking and capital markets could help counter the negative conjunctural and structural factors presently affecting Latin American countries. Integration would create a larger internal market, thus enhancing competition and potentially fostering economies of scale. It would reduce the costs of the withdrawal of global institutions and diversify the risk exposures of Latin American economies, making them less vulnerable to volatility in global markets. Capital market integration would allow pension and insurance

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funds to diversify their investments and enable large projects to find a wider range of potential investors. Deeper markets would likely be more liquid, reducing costs and increasing access for participants generally. Increasing access for regional banks to operate across borders would enhance competition and enable the spread of best practices. Some form of "passporting" broker-dealers recognized in one country would help the process of establishing a unified capital market, as long as the passported firm is subject to full supervision in both home and host jurisdictions. Retaining financial intermediation within the region would help markets develop new products, facilitate access for second-tier companies (for whom intermediation on global markets may be difficult), and generate income from financial market activity. As a prelude, harmonizing tax, regulatory, and accounting frameworks would help provide a level playing field and would also likely stimulate investment into the region from overseas.

Ongoing initiatives may provide a model for taking regional integration forward. The combination of political and market enthusiasm may make the Pacific Alliance a more successful initiative than earlier regional attempts. For example, the integration through the Pacific Alliance of Mexico (a large manufacturing country) and the three medium-sized commodity exporters (Chile, Colombia, and Peru) could bring particular synergies. Among the Pacific Alliance's various plans for integration, the MILA initiative, which seeks to establish a unified capital market, is worth highlighting. Although MILA activity so far has been minimal and the process has come under criticism for achieving few results, the impediments are interrelated and would benefit from a comprehensive and coordinated approach to making the market work. With strong political support, this would be a good time for Pacific Alliance countries to make a push for enhancing financial integration among themselves and more widely by removing remaining barriers. Meanwhile, the Mercosur alliance has been a vehicle for integration among its members for many years. Although it has been relatively dormant lately, factors such as the recent changes in external economic policies in Argentina suggest that this may be a propitious moment for its revival.

The argument of this book is that financial integration within Latin America, with appropriate management of the risks, could bring needed diversification to Latin American financial sectors and set the stage for further integration into the global economy as conditions permit. The aim of the book is not to propose measures that artificially stimulate financial integration in Latin America if there is no underlying economic case. Rather, the book seeks to identify barriers to integration that are a legacy of measures introduced for other reasons and whose removal could pave the way for regional financial integration and thereby support growth.

The analysis in the book covers seven Latin American economies: Brazil, Chile, Colombia, Mexico, Panama, Peru, and Uruguay (LA-7). All are at a relatively similar stage of economic development and have taken steps to liberalize in recent years. Five are among the biggest Latin American economies; the other two are much smaller but are closely related. One—Brazil—represents almost half of the entire Latin American economy and is somewhat separated from the others,

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partly because of geography and language but also owing to its regulatory regime. Four of the countries—Chile, Colombia, Mexico, and Peru—are actively engaged in an integration strategy through the Pacific Alliance and its capital markets component MILA; their efforts are now at a critical stage. Finally, the two smaller countries (Panama and Uruguay) have large financial systems relative to their size, are closely related to their regional neighbors, and have economic prospects that will be greatly influenced by regional relationships.

The book first quantifies the possible benefits of regional integration. It then covers prospects for integration in the various sectors of the financial markets in the seven countries: banking, pension funds, insurance, and capital markets. The book identifies regulatory and legal barriers to regional integration and describes possible measures to contain the risks arising from integration. Recommendations are provided for each section and are summarized at the end of the book. Appendices briefly describe the state of the financial systems in the seven countries.

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