MERCOSUL

Challenges for strengthening Mercosul financial integration – lessons from the European experience

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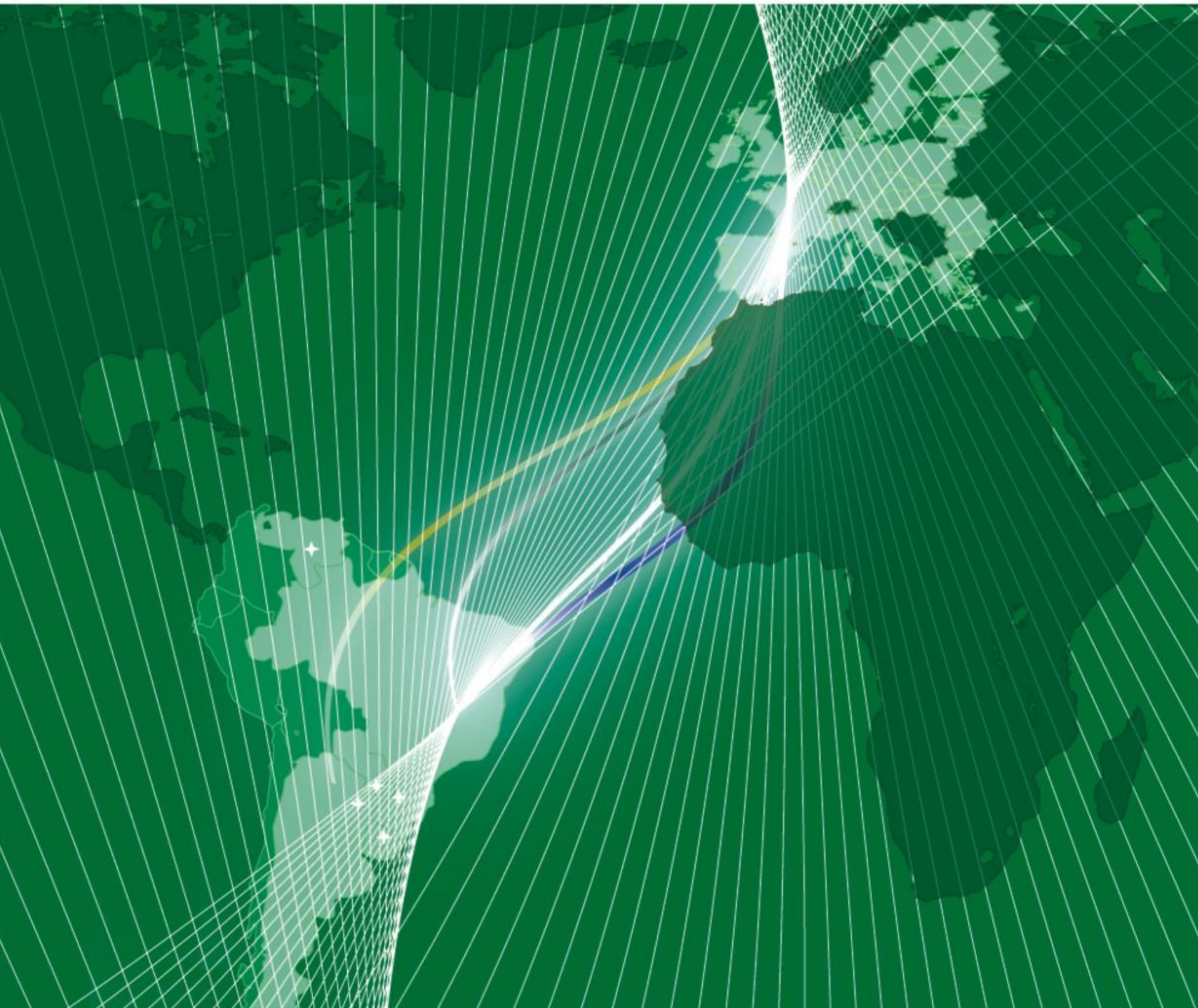

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"Challenges for strengthening Mercosul financial integration – lessons from the European experience": Executive Summary[1]

This report identifies lessons to be learnt from European financial integration for the Mercosul. This has been done by providing a comparison of developments in this broad policy area in the two regions. While the emphasis has been on Europe in order to understand which lessons are to be learnt, key developments in the Mercosul have also been discussed in order to identify which lessons are appropriate for Mercosul. Indeed, although not the subject of this report, Europe most definitely have lessons to be learnt from the Mercosul with regard to financial integration as evidenced by the recent response to the global financial and economic crisis.

European integration is the most ambitious project of regional integration that the world has seen. Since the early days of the signing of the European Coal and Steel Community in 1951, European integration has travelled far on the road to regional integration. This process has involved a considerable shift of policy and regulatory capacity from national level to regional level with substantial losses in member state autonomy and policy capacity through institution-building at the supranational level. Indeed, the process has frequently been designed so as to provide strong lock-in effects in the pursuit of integration, or at least *post hoc* intellectualised as such. European integration has, albeit initially intended to safeguard peace on the conflict-ridden continent, focused strongly on the creation of a common market, including that of a common financial market.

The construction of the single financial market received a momentous push forward with the creation of the European Monetary Union in the Maastricht Treaty of 1991. Seeking to take advantage of monetary integration, the Financial Services Action Plan was actioned at the 1999 Cologne Summit and took centrestage in the ambitious 2000 Lisbon Strategy to create a financial system capable of supporting the development of "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion" (Presidency conclusions, Lisbon European Council, 23 and 24 March 2000). Remaining barriers to a single financial market were to be removed and the regulatory system to secure its stability introduced.

Meanwhile, Mercosul came into being in 1991, not altogether dissimilarly from its European counterpart, to provide political stability in a region characterised by tension between Argentina and Brazil.[2] Of course, economic gains were also part of the incentives behind regional integration in terms of the promotion of intra-regional trade liberalisation and a strengthened presence internationally. Quickly, Mercosul turned into an example of regional integration "only surpassed by

[1] See Disclaimer and Acknowledgements at the end of this Executive Summary

[2] The history of regional integration in the Southern Cone, of course, predates the foundation of the Mercosul. With the Latin American Free Trade Agreement (LAFTA) of 1960 and the Latin American Integration Association (LAIA) of 1980, most notably, it is almost as old as European integration.

the European Union in terms of the depth of the integration process" (Kaltenthaler and Mora 2002: 73). Again, the initial means to this end was the liberalisation and re-regulatory integration of trade, including the integration of trade in financial services, to create a common market with a common external tariff, but without an internal such. Indeed, Mercosul did see substantial trade integration in the 1990s.[3]

Mercosul constructed its own financial services action plan through the Montevideo Protocol in 1997, that is two years earlier than Europe. This should not be seen as extraordinary for the Mercosul. In fact, the Sub-Working Group for Financial Affairs (SGT4) started its work a year ahead of the Treaty of Asuncion to prepare integration in what was acknowledged as a sensitive policy area with ramifications for the integration process as a whole. The idea of regional monetary integration took on greater significance at that point, especially in Brazil. However, integration of the Southern Cone was designed to be an intergovernmental, or as Malamud has called it "inter-presidental" (2005), process with little national sovereignty transferred to supranational institutions (Giardini 2011: 189). To sacrifice monetary sovereignty was at this time a step too far. The Brazilian crisis of 1998 and the Argentine crisis of 2001 provided valuable lessons for further Mercosul integration. Apart from demonstrating the flaws of the Real (Brazil) and Convertibility (Argentina) Plans, it demonstrated to great effect that the region was profoundly susceptible to the whims of global

[3] Liberalisation cannot be understood in the process of regional integration without clearing up possible misunderstandings of its relationship to the notion of "regulation". This "misleading term" has to be clearly defined (Majone 2009: 11; see also Majone 1994). It is helpful to start the clarification by pointing to how it is approached from key approaches in economic policy-making. From a developmentalist perspective (e.g. that which was central to LAFTA), regulation is seen as an essential part of a collective defence policy against external competition to domestic production of goods and services. "Keynesian" commentators, perceiving "de-regulated" markets to set dangerous "animal spirits" free (speculation) on financial markets, have pointed to the need for "re-regulation" in response to the global financial and economic crisis understood to be caused in important part by speculation. (Neo-)Liberals, in contrast, promotes 'de-regulation'. This is broadly stipulated to involve public institutions' retreat from markets and social life. De-regulation and trade liberalisation here have the objective of allowing markets rather than the state to allocate the optimal allocation of resources. Trade liberalisation and de-regulation are here sometimes seen as different phases in a broader process of constructing competitive and efficient markets. The global financial and economic crisis should from this perspective not be allowed to inspire 'more regulation', but rather further "de-regulation", less 'red tape' and less state intervention. Regional integration, both internally and externally, should from this perspective be export-led as it stimulates domestic competitiveness and efficiency. Regional integration from this perspective thus turns into an offensive strategy (Manzetti 1993/4: 112).

The usage of de-regulation and re-regulation above is misleading because it suggests that liberalisation necessarily leads to less regulation, or that excessive liberalisation requires a pendulum movement towards re-regulation. Market construction inevitably involves public involvement in regulation with states performing the role as enforcers of rules. Indeed, 'de-regulation' requires extensive rule-making; in fact, liberalisation tends to generate *more* regulation. For instance, to create the European single market, European regulators aim at creating a single and comprehensive rule-book for financial markets. The 'rule-book' has thus become much thicker and more detailed. Therefore, to create liberal markets, what is required is not de-regulation. If a move away from liberalmarkets is the policy goal, the regulatory outcome is not necessarily a thicker and more detailed rule-book. Rather, all regulation is designed in relation to previous regulation. Regulation is therefore inherently 're-regulation' (Picciotto 1999, 64-6). To use the implementation of the European Financial Services Action Plan (FSAP) of the 2000s as an example, the global financial and economic crisis proved that it had left gaps in the regulatory framework and was inadequately lax in its regulatory standards (e.g. for cross-border financial activities by large European banks; see the De Laroisiere Report 2009). Yet, the plan had not involved the reduction in the size of the regulatory framework or rule-book, but rather re-regulation from the regulatory framework already in place. Indeed, the rule-book grew significantly with the FSAP.

financial markets with volatile capital flows capable of causing great damage to the economies of the region. The policy autonomy conceded to the international financial institutions in resolving such deep crises led to considerable social and political upheaval. It also showed the value of the flexibility provided by the interpresidential mode of integration and the absence of monetary integration. Not to the same extent possible in the more institutionalised integration process in Europe, integration agreements could be temporarily suspended in favour of domestic intervention to tackle crises (ibid.).

The left-oriented government shifts in Argentina, Brazil and Paraguay that followed brought a somewhat new direction in Mercosul integration in favour of turning it into more of a political union. As former Brazilian diplomat Rubens Barbosa, involved in the creation of the Mercosul, recently stated, although somewhat provocatively: "What we have today is a political and social forum, and micromanagement of trade" (Economist, 2012). However, caution should be taken when presenting Mercosul integration in such a way.

Firstly, critics of Mercosul integration since the Millennium point out with reference to the success of Europe that the success of the integration process requires deepened institutionalisation (e.g. Malamud and Schmitter 2010). While this may to an extent be true, European integration is a very different set of countries and economies than those on the Southern Cone. Perhaps most importantly, European integration benefits from a membership of more stable democracies with scope for greater societal input and thus legitimacy than in the Mercosul. That said, and this Conclusion will return to this issue, European integration continues to suffer from a significant democratic deficit and the lack of a shared European identity fundamental to a sense of European solidarity that could facilitate fiscal integration in the region. Moreover, policy influence in the form of lobbying remains deeply skewed in favour of corporate interests. In the policy area of financial integration, this has proven particularly problematic as the swiftly changing regulatory landscape of financial markets and the technical language regulation is framed in have precluded input from lobby organisations representing "the public interest". Certainly, material resources are here a key source of unequal access. With financial regulation coming under heightened scrutiny as a result of the global financial and economic crisis, public distrust in regulatory and supervisory bodies is a fundamental problem.

Secondly, while institutional innovation and the amount of rule-making activity in European integration are undeniably impressive, that which particularly impresses is the ability of member states to acquiesce to supranational integration in the direction of a "United States of Europe". What is striking about European integration today is however its lop-sidedness in terms of the economic asymmetries in the composition of its membership and in the institutional framework in place. Monetary integration went ahead in the 1990s without accompanying fiscal and political integration, and an effective structural convergence programme, in the belief European integration was strong enough to address the sources of future potential problems over time and in the event of a crisis (see Gros and Thygesen 1998: 544-566). Yet, these compensatory developments did not come to pass in time for the global financial and economic crisis. Indeed, in the absence of effective macro-economic coordination, fiscal and political integration, Europe has been unable to contain the impact of the global economic and financial crisis. Indeed, it was rather widely predicted by economists, both orthodox and heterodox, on the basis of the optimal currency area thesis (see Eichengreen 2012). As a consequence, while European integration has always sought to be respectful of member state autonomy in fiscal matters, core European Union member states have in quite dramatic fashion become the *ad hoc* bailiffs promising bailouts against shock deflations, or “internal devaluations” as it is called in its ostensibly more politically correct terminology to suggest the retained autonomy of its peripheral peers. Indeed, it is the way in which European integration has been institutionalised thus far that has brought European integration to the brink of economic collapse and political dissolution. Here, the lop-sidedness and unevenness of financial integration are very much part of the causes of the Euro crisis.

To assume, like many leading thinkers on European integration have been somewhat arrogantly doing for a long time, that European integration has been some kind of rational process which other regions should seek to copy is to say the least problematic. Instead it should be recognised that Europe is now undertaking a political high wire act trying to sustain processes of internal devaluation in many of the peripheral economies, while seeking to appease a growing sense of anger by means of selectively politicising reforms in the regulatory and supervisory landscape to reassure electorates in both core and periphery that a second Euro crisis will not happen. Yet, still, financial integration remains lop-sided as outlined by a knowledgeable interviewee for this report (Interviewee anonymised 2012):

1) The wholesale interbank market is quite integrated in that the infrastructure is there, but national barriers remain.
2) Money markets are non-existing
3) Retail market integration is limited
4) Monetary integration is only partial. What is in place is a currency union rather than a monetary union. Banking union is desperately needed here to prevent national ringfencing of liquidity.
5) Big differences in securities and solvency laws remain. Here, there is a lack of common securities law. Moreover, all Giovannini barriers are not removed. Integration in this area is currently at a tipping point of resistance to harmonisation.
6) Bonds and listed derivatives markets are less integrated than equity markets.
7) There has been an opening up of pan-European equity trading, but trading has not meaningfully expanded because there is a lack of harmonisation.

In this context,
Mercosul’s more flexible and slower, but cumulative, integration process appears significantly more reasonable. However, this intergovernmental process is also proving to have its limits.

In the area of financial integration, since the Montevideo Protocol, SGT4 has overseen the laying of the foundations for a common financial market. The 2000s have seen a substantial upswing in financial market activity and integration in the region. However, the foundation for this has been a process of cautious liberalisation with the crises of the 1990s and early 2000s fresh in mind. Financial liberalisation is undertaken simultaneously with the reinforcement of regulation and supervision to prevent overheating and speculative flows. It oversaw amongst many other policy developments, the preparation for the accession of Venezuela, the establishment of norms and practices of transparency and information-sharing, the regional interpretation of the WTO’s General Agreement on Trade in Services, the creation of and initiation of work by the Money Laundering and Terrorism Financing Prevention Committee and the development of a Framework Agreement on clearing and settlement systems by the Capital Markets Subcommittee.

Since the onset of global financial and economic crisis, SGT4 has continued its previous cautious liberalisation approach, but with even greater emphasis on regulation and supervision, partly in response to tendencies towards overheating and 'hot money' seeking the higher returns on offer in the region. Liberalisation and harmonization efforts have continued with a clear focus on regional systemic asymmetries in regulation and supervision, and the completion of macroprudential supervision. Having established a degree of consensus on how to interpret the crisis and its regional impact, the working programme has revolved around analysing the impact of the crisis globally and on financial markets regionally. However, significant attention has also been paid to the accession of Venezuela as well as the formation of a clear and united regional platform in international negotiations. The medium-term Mercosul agenda may include a payment and settlement platform focusing on the interconnection of the nationals payment systems. The design would aim at assuring the necessary technical and governance requirements to avoid and mitigate systemic risks.

On a more intergovernmental level, Mercosul has introduced a number of important agreements and quasi-institutions. Argentina and Brazil (negotiations are also underway with Uruguay) have created a local currency payment system (Sistema de Pagamentos em Moeda Local - SML) enabling trade transactions to be settled in local currency rather than in the first instance through US Dollars. Banking regulation is strong across the region. Yet, there is little fiscal integration in the region. Indeed, if anything should be learnt from the Euro crisis, cross-border financial activities require not only cross-border regulation and supervision but also a regional bailout fund. In Mercosul, there is no regional recapitalisation fund in existence yet. As Buiter (2011: 18) has recently commented in relation to the Euro Crisis: "Finance is global, banks are global...but regulation is national. Whenever the span of the market and the domain of mobility of financial institutions exceed the span of control of the regulator, you will, sooner or later, have a mess." However, there are ongoing discussions regarding the setting up of a "financial defense" of South America based on significant liquidity funds and a deeper technical discussion about the financial defence of the region, including a regional swap safe net, a regional fund and others. Moreover, there are ongoing discussions in the Mercosul about creating a liquidity-providing swap arrangement.

Mercosul's intergovernmental mode of integration, the lessons learnt from past crises in retaining plenty of circuit-breakers, its willingness to adopt Keynesian-style countercyclical expansionary policy and its lack of monetary integration have thus far enabled it to avoid major contagion. Very significant in the recovery has also been the strong internal market, partly facilitated by a significant credit expansion. In a global context, greater policy autonomy has been created through trade diversification and a reconsideration of internationally dominant policy regimes. This has given the region the freedom to respond in this more effective manner to the crisis.

However, the limited degree of integration in the region and the historical flexibility towards suspensions of integration agreements is also a cause of tension. Firstly, there is tension in the region arising from Argentina's recent reversion to a more protectionist stance also in relation to the region, but also Brazil's. Secondly, with hot money knocking on the Mercosul door, pressures to deviate from the focus on strong and harmonised regulation and supervision are apparent. Financial integration policy must remain focused on the regulation and supervision of systemic risk despite these pressures. Thirdly, the accession of Venezuela presents great challenges to the work of SGT4 as policy orientation and policy language platforms diverge.

The report concludes with 10 policy recommendations for the Mercosul. However, the recommendations are potentially also meaningful for individual member states:

Recommendation 1: Counter Pro-cyclicality in the Financial System by Strengthening Macroprudential Analysis

The amplification of the global financial and economic crisis in Europe was not first and foremost the result of an institutionally incomplete monetary union. It was fundamentally enabled by the systemic risks allowed to develop in the financial system. Irresponsible lending and poorly regulated cross-border financial activities provided the Minskyite notion of "amplification risk" (Tymoigne 2011). Finance is inherently unstable because it involves the "trade in promises expressed in units of abstract purchasing power – money. Such activities can be scaled, both up and down, far too easily" (Buiter 2009: 15). Financial markets tend to become more risk-prone in economic upturns and move from relatively sound "hedge units", expected to be serviced from the net cash flow of routine economic operations (the going concern of firms or wages for households) or monetary balances, towards "speculative" and "ponzi units" expected to be increasingly financed through "position-making operations", which involves servicing debt by refinancing or liquidating assets at growing asset prices. Therefore, for the proper functioning of financial markets macroprudential analysis capable of identifying "amplification risk" is essential to enable early intervention.

Recommendation 2: Create lobby groups to represent the public interest in financial integration.

The absence of sufficiently funded lobby groups able to represent the public interest in the financial integration process is a problem. This absence may lead to unbalanced policy-making. Leading up to the crisis in Europe, an ideology of self-regulation took hold in regulatory bodies leading to private-led processes. This ideology involved the oxymoronic demand on markets to correct market failure (see Persaud (2000). Policy-making turned in the direction of dogmatism, secrecy and opaqueness preventing civil society from gaining a real insight into the policy process and the latter's content. The policy tendency was towards self-regulation, short-term gain and pro-cyclicality. Lobby groups representing the public interest and long-term perspective can provide a counterweight to the influence of the financial sector lobby in the financial integration process. Such lobby groups must be composed by experienced and knowledgeable staff with the resources and channels to influence policy-making. This is crucial for the legitimacy of the financial integration process. European parliamentarians took this step in 2010 following the realisation that there were no such organisations by creating Finance Watch (see http://www.finance-watch.org/).

Recommendation 3: Regulation Needs to be Performed by Public Bodies; Rating Agencies Should Not be Regulators

Capital risk-weightings in Basel II affords the role of external ratings to credit rating agencies. This asks markets to regulate themselves, which is an oxymoron. In the run-up to the global financial and economic crisis, there was a significant tendency towards private-led regulation. It proved to be dangerously pro-cyclical. Regulation must be public-led, although input from a healthy range of viewpoints is welcome.

Recommendation 4: Create Mercosul Supervisory Colleges for Cross-border Financial Institutions

With financial integration progressing in Mercosul, the activities of various financial institutions increasingly cross borders. These institutions are typically very large and influential in their domestic constituencies. In the Euro crisis several such institutions have collapsed causing considerable difficulties in resolving the fiscal situation arising. There was no effective regulation to this end and there was no supervisory body with the remit to monitor these institutions. In response to this scenario, Europe has created the regulatory framework and has established independent colleges to supervise these institutions. Mercosul ought to follow suit and create supervisory colleges composed of representatives of the regulatory bodies of each member state.

Recommendation 5: Create a Regional Recapitalisation Fund for Cross-border Financial Institutions while Minimising Moral Hazard

As the crisis continues and risks remain in the region, there is a growing need for a regional bailout fund dedicated to recapitalising *crossborder financial institutions of a systemically important nature* and thus to prevent the emergence of fiscal problems resulting from large bailouts shouldered by individual member states. This must be achieved while minimising moral hazard by setting clear access limits, conditionalities and adequate forms of surveillance. While there is the Chiang Mai Initiative and the extended FLAR idea in UNASUL, there is no such provision within the Mercosul and questions remain about the coverage provided by these initiatives. If no agreement for a Mercosul fund can be created, fiscal burden sharing for the costs of recapitalisation should be set in an ex-ante binding agreement.

Recommendation 6: Prevent the Emergence of Financial Institutions that Are Too Big to Fail

Financial integration creates economies of scale and opportunities for the expansion of financial institutions. However, such expansion can come to create systemic risks, which in turn becomes a potentially significant fiscal problem. Europe has seen several examples of this since the onset of the crisis. To address this, Buiter (2009) has suggested several potentially complementary solutions:

- progressive capital requirements (the bigger the institution, the larger the percentage of capital requirements);
- strict competition policy (although this requires a strong regional body able to supervise it);
- requirement on big financial institutions to develop bankruptcy contingency plans; and,
- prohibition on universal banking and similar organisation forms amongst financial institutions.

Recommendation 7: Ensure the Appropriate Incentives and Time Horizons for Managers of Financial Institutions

Perverse incentive structures of financial institutions have proven a recipe for systemic risk in Europe as financial institutions operate in accordance with short-term gain rather than supporting a long-term growth perspective of the real economy. The appropriate internal incentive structure of financial institutions must be secured starting from the top managerial level. This includes wage levels and bonus systems. This is a job for the regulator as a range of risks can become embedded in the strategies of financial institutions. The European Union has recently regulated incomes in the financial sector by stipulating that annual bonuses cannot exceed annual wages. Reward systems should be tied to responsible, yet steady, lending and the performance of investments in the real economy. If such a system can be devised, credit crunches could potentially also be averted. Brazil already has a resolution for this (3921/2010) with further consideration of managerial incentives a significant objective for the region.

Recommendation 8: Adopting a Common Currency Can Be An Objective, But Should for Now Remain a Distant Such

Monetary integration is of course closely linked to financial integration as it promises significant gains in terms of reduced transaction risks and costs. While, the gradual introduction of shared payments systems, like that which was envisaged with the SML (Sistema de Pagamentos em Moeda Local), is a welcome innovation in order to reduce transaction costs, the lesson learnt from the Euro crisis is that deeper monetary integration is potentially very harmful to the economy at large and the legitimacy of regional integration. It also requires the overcoming of very significant political challenges, which Europe was not ready for in the early 1990s when institutionalising it, and still is not. As Optimal Currency Area theory suggest, political integration, fiscal integration, macroeconomic policy convergence and infrastructural development to facilitate intra-regional trade are all required before monetary integration becomes a safe and meaningful project. In other words, a common currency should at best be a distant policy objective.

Recommendation 9: Brazil Has to Remain a Benevolent and Financially Responsible Hegemon

As the by far largest economy in the Mercosul, Brazil has to continue to play the role of the benevolent hegemon, especially in being generous to its smaller neighbours for the purpose of macroeconomic coordination and reduction of economic asymmetries. Regulatory and supervisory coordination is here a significant element with considerable value created by technical cooperation for solving knowledge asymmetries in the region. This can create a sense of regional solidarity, which will be essential for the legitimacy of further integration. Germany's role in the Euro crisis has undermined the legitimacy of further integration in Europe and a disastrous loss in whatever solidarity there was at a European level prior to the crisis. Providing substantial forms and funds for regional redistribution and infrastructural development to facilitate the growth in intra-regional trade is essential to this end.

Moreover, Brazil has seen a substantial expansion of consumer credit in the 2000s, partly as a consequence of laudable financial inclusion policies, with a considerable increase in the credit to GDP ratio (from 25% in 2003 to more than 50% in 2012) as a result. While steps have been taken to ensure that this does not translate into amplification risks, continued care has to be taken to prevent this from happening. The financial stability of Brazil is of course crucial to the region as a whole, including sustained trust in regional cooperation.

Recommendation 10: (Continue to) Play a confident role in international fora for standard-setting with regard to regulation and supervision and prioritise bottom-up harmonisation.

Despite the global financial and economic crisis being associated with “Anglo-American finance-led capitalism”, international fora remain dominated by Anglo-American interests. Argentina and Brazil played, as members of the ad hoc grouping of G20, significant roles in the early stages of managing the global financial and economic crisis. Building on this to play a confident role in international negotiations is key to safeguard regional and global interests. Mercosul must provide the knowledge platform for the confident negotiation of international standards as they continue to change in the volatile global policy environment. This is not least significant as a lesson from Europe is that international levers, such as international standards, are not always a great foundation for longterm legitimacy and stability. While benign international standards can provide useful external levers for regional harmonisation, the best foundation for longterm stability of the integration process is harmonisation from within and bottom-up. Such harmonisation should address the necessity of harmonization on (Mercosul) best practices.

Disclaimer and Acknowledgements

Considerable methodological difficulties have arisen in this undertaking as the asymmetries between and within each process of regional integration are formally insurmountable. The challenge presented has been tackled with a healthy dose of humility and by introducing a rich conceptual framework capable of grasping the complexity of each region. Moreover, it should be noted that the author is a Europeanist and not a specialist on the Mercosul.

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