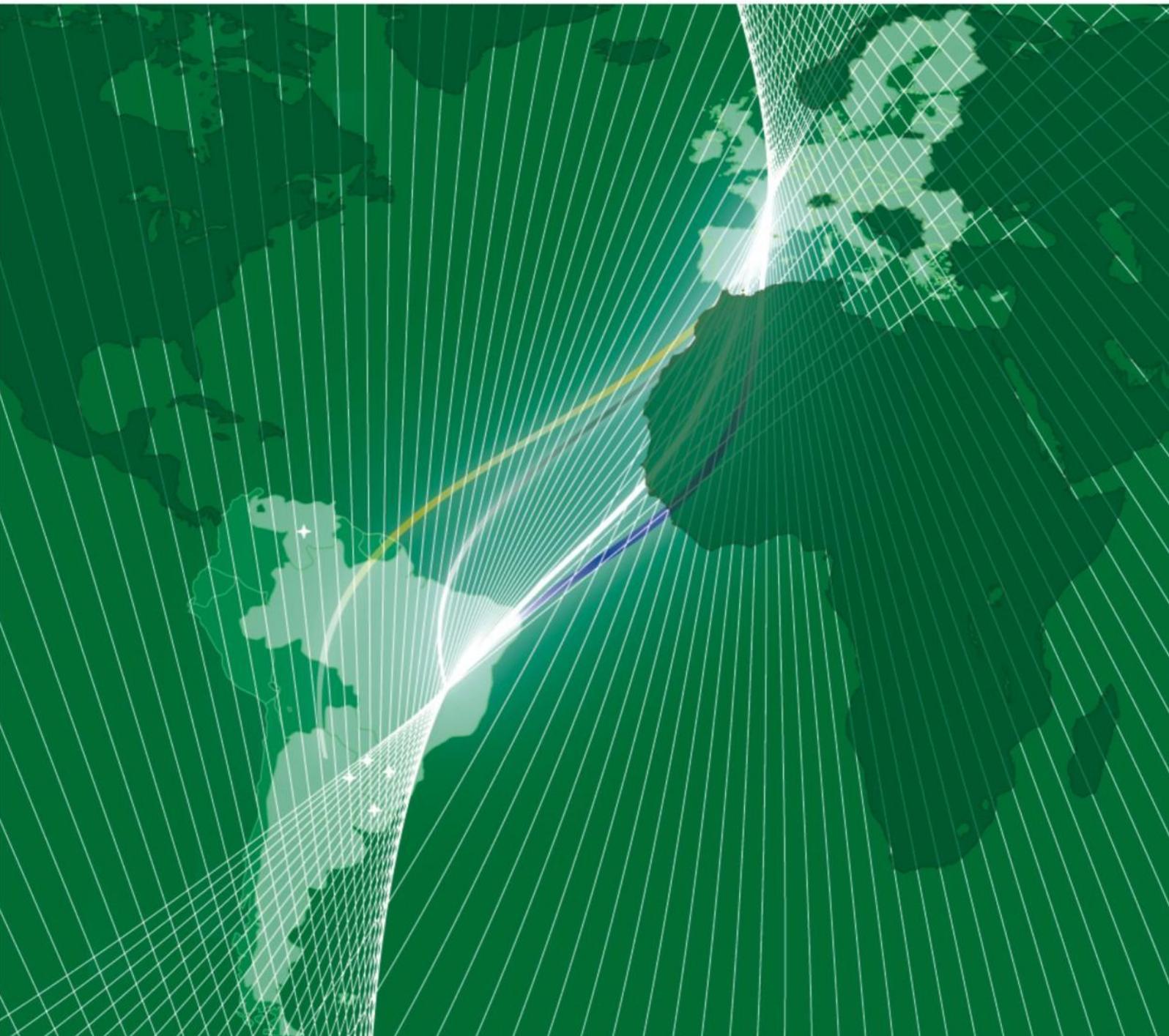




Challenges for strengthening Mercosul financial integration – lessons from the European experience

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BANCO CENTRAL DO BRASIL

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Contents

Acronyms

Executive Summary

1) Introduction

- 1.1 Report Background
- 1.2 General Approach
- 1.3 Summary of Findings
- 1.4 Disclaimer and Acknowledgements

2) Analytical Framework

- 2.1 Introduction
- 2.2 Political Economy of Regional Financial Integration
- 2.3 Financialisation, Financial Fragility and Preventative Regulation
- 2.4 Negative Integration and Positive Integration
- 2.5 Internal and External Integration
- 2.6 Path-dependent and Path-breaking Policy-making
- 2.7 Public- and Private-led Governance and Epistemic Communities
- 2.8 Conclusion

3) Pre-1998 Financial Integration

- 3.1 Introduction: Bretton Woods and the Origins of Financial Integration in Europe and the Southern Cone
- 3.2 The European Coal and Steel Community and European Economic Community
- 3.3 The Latin American Free Trade Area
- 3.4 The European Monetary System and the European Exchange Rate Mechanism
- 3.5 The Latin American Integration Association
- 3.6 The Single European Act
- 3.7 The Treaty of Asuncion (Mercosul) and the Montevideo Protocol
- 3.8 Maastricht and the European Economic and Monetary Union
- 3.9 Conclusion: Crises and Booms

4) 2000-2007/8 – Accelerating Financial Market Integration

- 4.1 Introduction and the Lisbon Strategy
- 4.2 The Lisbon Strategy
- 4.3 Giovannini Barriers
- 4.4 Financial Services Action Plan
- 4.5 The Lamfalussy Process

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- 4.6 Basel II and the Capital Requirements Directive(s)
- 4.7 Mercosul
- 4.8 Conclusion

5) 2008- Crises Responses

- 5.1 Introduction: G20, Bailout and Eurocrisis
- 5.2 TARGET II
- 5.3 TARGETIISECURITIES
- 5.4 Economic Policy Governance and the European Stability Mechanism
- 5.5 European Systemic Risk Board
- 5.6 European Banking Authority and the European Banking Union
- 5.7 European Securities and Markets Authority
- 5.8 European Insurance and Occupational Authority
- 5.9 Mercosul
- 5.10 Conclusion

6) Conclusion

- 6.1 Summary of Findings
- 6.2 Ten Measures and Policy Recommendations

References

Acronyms

ANNA	Association of National Numbering Agencies
CAP	Common Agricultural Policy
CARD	Consolidated Admissions and Reporting Directive
CCM	Mercosul Trade Commission
CCPs	Centre Counterparty systems
CEBS	Committee of Banking Supervisors
CESR	Council of European Securities Regulators
CMC	Mercosul Common Market Council
CPC	Joint Parliamentary Commission
CUCP	Customs Union Consolidation Program
EBA	European Banking Authority
ECB	European Central Bank
ECSDA	European Central Securities Depositories Association
ECU	European Currency Unit
EDC	European Defence Community
EEC	European Economic Community
EMU	Economic and Monetary Union
EP	European Parliament
EPU	European Payments Union
ERM	European Exchange Rate Mechanism
ESCB	European System of Central Banks
ESM	European Social Model
FCES	Mercosul Consultative Forum on Economic and Social Issues
GMC	Mercosul Common Market Group
GSP	Growth and Stability Pact
HFT	High Frequency Trading
ICD	Treaty of Integration, Cooperation, and Development
IPMA	International Primary Market Association
ISI	Import-Substituting Industrialisation
LACM	Latin American Common Market
LAIA	Latina American Integration Association
LAFTA	Latin American Free Trade Area
NATO	North Atlantic Treaty Organization
OMC	Open Method of Coordination
OTC	Over-The-Counter
SAM	Mercosul Administrative Secretariat
SEPA	Single Euro Payments Area
SMPG	Securities Market Practice Group
SSP	Single Shared Platform
T2S	TARGET2 Securities
TARGET	Trans-European Automated Real-Time Gross-Settlement Express Transfer
UCITS	Undertakings for Collective Investment in Transferable Securities

Executive Summary¹

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 has 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 centre stage 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 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

¹ See Disclaimer and Acknowledgements, sub-section 1.4.

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.

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

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 (SWG4) 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-presidential” (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 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.).

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 Larosiere 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.

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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.

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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, SWG4 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, SWG4 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 national 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 SWG4 as policy orientation and policy language platforms diverge.

This Executive Summary 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

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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, Buitert (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.

1) Introduction

- 1.1 Report Background
- 1.2 General Approach
- 1.3 Summary of Findings
- 1.4 Disclaimer and Acknowledgements

1.1 Report Background

The European Union and the Mercosul are examples of significant regional integration. While differences are considerable, not least with regard the depth of integration with the EU so far going further in many areas, there are many similarities. Within these processes, financial integration in both regions has long, albeit different, histories. In the recent two decades, policy-makers, regulators, supervisors, business communities, other special interest groups and the general public have started to pay deepened attention to financial integration. Financial globalisation has not only made national economies and regions more interconnected but also more vulnerable to financial flows. While benefits to the real economy can be accrued from financial integration, financial systems are crisis-prone and require caution to be heeded especially by regulators and supervisors tasked with their stability and utility. While the Mercosul countries have suffered from a series of financial crises previously, the region has dealt well with the global financial and economic crises. However, the European Union, and particularly the Eurozone, has coped less well. It is in this context that the idea for this report emerged.

This report was commissioned as an integral part of the execution of the activities under the Project Trade Liberalisation and Economic Development in Mercosul (PPY BRA 1018). This project emerged out of an agreement between the Brazilian Central Bank and the British Embassy in Brazil. Targeting the representatives of Mercosul SWG4, responsible for the structural and technical issues arising from Mercosul negotiations both internally and externally in relation to financial markets in the broad areas of banking, insurance, capital markets and anti-money laundering and the countering of terrorist financing, the report was stipulated to compare analytically the financial integration processes in the European Union and the Mercosul, including a thorough study of the applicability of measures taken by the European Union to promote financial integration among its members. Indeed, this is where the expertise of the author lay, to which due recognition was made. It was also intended to provide suggestions for measures and policies able to improve integration among the membership of the Mercosul, especially emphasizing the enhancement of financial sector competitiveness, reliability and crisis prevention capacity.

A presentation of a report draft was made on 24th of October, 2012, at the one-day seminar “Challenges for strengthening Mercosul financial integration – lessons from the European experience” under the auspices of a SWG4 meeting in Brasilia. The report was to reflect on the comments of the regulators at the seminar and build on technical visits done by representatives of the Brazilian Central Bank in the preceding years to the Bank of England, the Bundesbank and the European Central Bank under the framework of the project “Financial Integration and Economic Development in Mercosul”. The latter visits increased the awareness of the relevance of financial infrastructure integration, as well as understanding the needs to establish institutions that promote integration from a supranational perspective were two other perceived results of the visits. In addition, the need to consistently develop a normative framework to provide legal certainty to the integration process was confirmed as critical for the process. In addition, further technical visits and field interviews were made by the author of this report to the European Central Bank, the *European Insurance and Occupational Pensions Authority*, *Centre for European Policy Studies*, *Finance Watch*, *the European Council and the European Commission*. *The writing of the report benefited, as initially*

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stipulated, from open and exploratory discussions with the Brazilian Central Bank at the seminar of 24th of October and a series of telephone conferences and email communications. This communication was coordinated by the British Embassy to Brazil.

1.2 General Approach

The analytical framework adopted in this report is an international political economy approach refusing to distinguish between the political and the economic in practice and taking global as well as more local processes into due account. Developed to be able to make sense out of continuity and change in the complex and in-flux financial integration processes of the EU and Mercosul, the framework is afforded with a rich set of concepts. The conceptual framework is intended to add simplifying meaning to this complexity. It is designed to enable consideration of different directions and purposes of financial integration in the greater context of regional integration. To achieve this, and in recognition of the methodological complications arising out of a comparison of two such diverse and, in the end, different processes, the account provided will be historical and partly narrative. A degree of subjectivity is inevitable. It will also provide insights into the mode of policy-making, that is, is policy-making in the financial realm led by private actors or public regulators with significant consequences for policy orientation and accountability. Finally, the framework adopts an appreciation for the regulation of “amplification risk” of shocks to the financial system. This emphasises macroprudential regulation and sensitises it to both endogenous and exogenous ‘causes’ of financial and economic crises. The framework will be applied gently throughout the report as it is acknowledged that while intended to simplify, a rich conceptual framework can also come at the expense of readability.

1.3 Findings

On the back of a relatively detailed, albeit necessarily selective, historical overview of the financial integration processes in the two regions as contextualised within the broader frameworks for regional integration and the global political economy at large, the report presents 10 measures and policy recommendations suggested for consideration in Mercosul financial integration. These recommendations draw on a wide range of lessons learnt from European financial integration. They cover: monetary integration (or rather a dissuasion from a deepened such); an emphasis on macroprudential analysis; the significance of public and public-led regulation as opposed to the private and private-led regulation witnessed in Europe in the run-up to the recent onset of crisis in Europe; the significance of promoting the creation of lobby groups representing the public interest to provide balance in the financial integration process; the formation of supervisory colleges to monitor the activities of cross-border Financial Institutions; the creation of a regional recapitalisation fund; preventing the emergence of financial institutions that are too big to fail; strengthening regulation of the incentive frameworks for corporate managers; Brazil’s assumption of a benevolent hegemonic role in financial integration; and, confident interventions in international fora on the back of bottom-up discussions and harmonisation processes.

1.4 Disclaimer and Acknowledgements

Este documento não representa necessariamente a opinião do Banco Central do Brasil.

The views expressed herein do not necessarily represent the views of Banco Central do Brasil.

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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Any errors and opinions remaining despite their generous support and comments over countless emails and Telephone Conferences are mine and mine alone. Indeed, despite this report having benefited from the opinions and interviews with Central Bank officials, this report represents the author's analysis and is not necessarily representative of the BCB, the Mercosul or the British Embassy to Brazil.

2) Analytical Framework - Perspectives on the Mechanisms and Purposes of Financial Market Integration

- 2.1 Introduction
- 2.2 Political Economy of Regional Financial Integration
- 2.3 Financialisation, Financial Fragility and Preventative Regulation
- 2.4 Negative Integration and Positive Integration
- 2.5 Internal and External Integration
- 2.6 Path-dependent and Path-breaking Policy-making
- 2.7 Public- and Private-led Governance and Epistemic Communities
- 2.8 Conclusion

2.1 Introduction: Direction, Purpose and Content of Financial Integration

Regional financial integration can provide a stabilizing force against the market failures arising from unregulated globalization. However, the global economic and financial crisis has required policy-makers, regulators and other analysts in both the EU and the Mercosul to revisit the notion of regional financial integration. Rather than being primarily concerned with harnessing its benefits, the risks of financial globalisation, and the risks inherent in the liberalisation of regional financial flows in particular, have become increasingly significant in regional deliberations. European financial integration of the 2000s became heavily politicised by the crisis. However, as this report suggests, the regulatory drive in Europe spells more continuity with the preceding policy paradigm than change. Less liberalised, less integrated and lacking a shared monetary transmission belt, Mercosul had greater policy capacity to fight the potential impact of the crisis. Utilising a range of countercyclical tools and back stops, it has so far been better able to weather the crisis. In the Mercosul, policy-makers, regulators and analysts continue to see European financial integration as a source of inspiration. However, a significant shift can be noted: Mercosul is increasingly looking at European financial integration, not as a roadmap but for learning lessons from the mistakes committed. Still, on both sides of the Atlantic, a learning process is ongoing; the direction and purpose of regional financial integration in the two regions are no longer as clearcut. The analytical framework summarised below provides a conceptual toolkit for comprehending the continuities and changes in the direction, purpose and content of financial integration. It also serves as a starting point for identifying key lessons to be learnt from the European experience for Mercosul financial integration.

In Europe, although the picture is complicated by the “two-speed” process of monetary integration and non-monetary integration, liberalisation continues to be the fundamental direction that financial integration is taking. Keynesian re-regulation is uneven and thus only partly disruptive of the process established by the Financial Services Action Plan (FSAP) of 1999. The purpose remains largely the same as stipulated by the FSAP: to remove remaining barriers and thus complete the single financial market. With much of level one and two legislation has been adopted, the content is increasingly “technical”. Yet “new” issues receiving high levels of political attention have emerged throughout the crisis, which have warranted attention.

While the Europe-inspired direction of liberalising financial integration in Mercosul was set in the Treaty of Asuncion of 1991 and clarified by the Montevideo Protocol of 1997, liberalisation is no longer the necessary direction of Mercosul integration, but broadly speaking Keynesian and Developmentalist alternatives have come to exercise greater influence. The purpose of financial integration has become more closely aligned with socio-political objectives. The financial integration

has become more open-ended. This is fundamentally due to the intergovernmental form of governance in the Mercosur, which has enabled more reflexivity in interpreting the consequences of the crisis as well as the recent incorporation of Venezuela as a member state.

2.2 Political Economy of Regional Financial Integration

While South Americanists, both scholars and policy-makers have had plenty to say about regional integration at least on the South American continent (e.g. ECLA 1969; Tussie 1982; Manzetti 1993/94; ECLAC 1995; Phillips 2004; Gomez-Mera 2009; Giardini 2011), regional integration studies have been dominated by Europeanists. The orthodoxy of European integration studies is constituted by two approaches: Neofunctionalism and Intergovernmentalism. Quite arguably, European integration has been directed by the Community Method of seeking supranational technical and economic solutions to the political problem of continental conflict (Haas 1958; Mitrany 1966; Schmitter 1969; Haas 1992; cf. Milward 1994; cf. Moravcsik 1998). Here, integration involves conceding national powers to supranational legal processes and bodies, not least the European Commission, the sole European body granted the power to initiate legislation, and the European Court of Justice, whose rulings have precedence over national courts. The solutions lead to so-called “spill-overs”, “problems” in new policy areas which also require solutions. Running the risk of simplification, the integration process is supposed to proceed until reaching the federal endpoint: a United States of Europe. Neo-Functionalism as such provides a normatively laden intellectualisation of the integration process. Still, it subscribes in the positivist spirit to an instrumentalist understanding of actors, which translates into that the integration process itself is in-some-general sense rational. It can only be disproven by the total collapse of European integration and thus normalises crises in the integration process as nothing else than moments of spill-over to be addressed in a technical manner. In the South American context such a linear theory of integration is even less applicable since the “balance between the push of formal institution building and the pull of informal interactions tends to be unstable and fragile” (van Klaveren, 1993: 133).

Intergovernmentalism is an analytical approach that attributes great significance to the struggles, and in some liberal variations also institutionalised cooperation (Moravcsik, 1993), between states, especially those in the Franco-German core. The negotiation of national purposes is at the forefront of the integration process with institutions and economic policy the outcome of such struggles (and cooperation). Actors (i.e. states) are rational with the integration process the outcome of instrumental deliberations. This problematically oversimplifies not only the dynamics between core and periphery in Europe, but also the complexity of the state and its relationship to markets and civil society more generally (e.g. Wincott 1995). Again, it renders European integration a rational outcome, or at least the outcome of rational state decisions. In the report, I will also refer to intergovernmentalism as a regional mode of governance of deliberations at a high level. This is particularly relevant in the Mercosur case where an extreme such “interpresidentialism” has been influential (Malamud 2005).

Considerable deficiencies arise from these two approaches to the study of regional integration in Europe, but also beyond, when considering the Euro crisis. Or rather, they barely consider it at all. As Ryner argues (2012), none of the two approaches predicted the Euro crisis. Intuiting that this may lead to a healthy degree of reflection, surprisingly neither approach has much to say about the crisis or, for that matter, the failure of prediction. Considering the major event this is for European integration, this represents a striking lack of predictive ability and a peculiar lack of concern. The way in which politics and economics are made to appear separable by the orthodoxy is only plausible in times of market upturns. He argues convincingly that the two approaches, constituting the traditional mainstream of European integration studies, have a blind spot. This blind spot derives from its shared instrumentalism. More fundamentally, it is due to a lack of consideration of that

European integration itself, and monetary and financial integration in particular, is embedded in a forcefield of global power relations. Instead, European integration represents, then, a kind of rationality-in-general.

The international political economy approach to integration adopted here instead is heterodox recognising that social or economic action is of a bounded rational kind, grounded in institutional rules that are socially embedded and in a context of macro-economic diversity. Social and economic outcomes are thus often unpredictable and unintended. The framework is thus specifically designed to consider crisis and change, without, for that matter, neglecting continuity (Aglietta 1979). At its core, there is an understanding of the political and the economic as indistinguishable in practice. Economic institutions, including markets, are ongoing social and political constructions with economic developments feeding back into the construction process. Economic developments are uneven and partly the outcome of multileveled power struggles over the design of these institutions. According to this perspective, regional supranational integration processes shape national forms of organisation of the social relations between labour and capital/business through regional level legislation, institutionalisation and habitualisation of regional level practices. At the same time, states remain “relatively autonomous” from these social relations to the effect that states, to an extent, have their own path-dependent wills that feed back into regionalisation. However, while in many ways formally equal, regional integration processes take place among unequals (Höpner and Schäfer 2012). The relationship between regional integration processes and national developments is thus complex with each acting upon each other in historically specific ways. Yet, this interaction contains “the generative mechanisms and destabilising dynamics” constitutive of crises (Ryner 2012: 661).

Crises in regional integration processes however also have exogenous drivers. Regional integration unfolds within a global forcefield. During the period studied in this report, this global forcefield has revolved to varying extents around the US. The report makes use of two terms to capture these dynamics: “integral hegemony” (Cafruny 1990) and “minimal hegemony” (Cafruny and Ryner 2007: 20-21). Integral hegemony, on the one hand, refers to the firmest and most consolidated form of power. While requiring compromises to subordinate groups (social forces or fractions pervading states, capital, labour), the interests of the leading or hegemonic group can be satisfied along with those of the system as a whole. Integral hegemony thus is characterised by a strong, typically institutionalised, sense of common purpose and absence of open conflict between different groups (although contradictions remain and some forms of resistance feature). The hegemon’s interests are relatively universalised or consented to. The obvious example in the context of this report is the “embedded liberal” post-World War II order dominated and enabled by the US and subscribed to and supported by dominant groups in Europe (Ruggie 1982). Minimal hegemony, on the other hand, suggests an order of power in which the hegemonic social forces are no longer capable of universalising their interests. However, subordinate groups are incapable of formulating and coordinating the creation of an alternative international order due to material and organisational weaknesses. A parallel reason is that the elites of subordinate groups may enjoy considerable material benefits from the status quo. While domination, rather than consent, features more prominently in minimal hegemony, consent remains prevalent giving this order of power a hegemonic character. In addition to these two power orders, there are also relations of domination in the global economy. Here, coercion replaces consent as the prevalent characteristic of social relations. To enforce specific relations in the global economy, dominant social groups impose particular outcomes on subaltern groups backed up by the explicit threat of coercion or its actual exercise (Guha 1992; Arrighi 2005). To make sense of regional growth strategies therein, the report makes use of three linked concepts: (neo)liberalisation, keynesianism and developmentalism. The framework concerns itself with financial integration policies within varying national, regional and international adoptions of such concepts (e.g. Chang 2002).

Yet, none of these concepts can be understood without clearing up possible misunderstandings of their relationship to the notion of “regulation”, a “misleading term” (Majone 2009: 11; see also Majone 1994). From a developmentalist perspective, regulation is seen as an essential part of a collective defense policy against external competition to domestic production of goods and services. Regional integration in the Southern Cone from the Latin American Free Trade Area (LAFTA) 1960s up to the signing of the Treaty of Asuncion in 1991 can to a significant extent be understood with the help of this concept. Attempts at integration in this period were conceived as closely related to strategies of import-substituting industrialisation (ISI). Without industrialisation, South American economies would remain at the bottom of global supply chains focused on the production and export of primary commodities, the global market prices of which were deemed especially volatile. This would cement these economies’ position at the periphery of the global political economy and would render them highly vulnerable to price volatility. Strongly advocated and supported by the United Nations body the Economic Commission for Latin America (ECLA), known better in the region as Comision Economica para America Latina or CEPAL, regional integration could serve the purpose of creating large enough markets to provide economies of scale. Economies of scale would in turn support the import-substitution process. Depending on the level of economic development of individual member states, regional non-reciprocity and preferential treatment were to be granted. Regional production would be protected by tariff and non-tariff barriers against external competition to enable regional goods to compete more effectively against imports from outside the region. Thus, regional production would be protected against adverse price volatility in world markets (Rosenthal in Manzetti 1993/4: 111-12). Regulation is according to this perspective forming part of a defensive strategy.

The broadly Keynesian perspective advocates the international coordination of a gradual facilitation of liberalisation of trade regimes, in which states could combine internal development after the world wars with the construction of an international liberal trade regime. It is commonly argued, albeit somewhat mistaken (see Ruggie 1982), that the Bretton Woods system comprising the International Monetary System revolving around a fixed value of the Dollar relative to the value of gold, the General Agreement on Tariffs and Trade, the International Monetary Fund and the World Bank represented such coordination. “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. Regulation is thus understood as desirable to enable national economies to pursue the gradual shift towards a more liberal economy. Indeed, in the light of the current global financial and economic crisis, “Keynesian” commentators have pointed to the need for “re-regulation”.

(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 on the basis of free competition. 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. Trade liberalisation and de-regulation are here sometimes seen as different phases in a broader process of constructing competitive and efficient markets. Whiting states (1993: 23), that “trade liberalization maximizes the gains from inherited comparative advantage and encourages efficiencies from specialization and economies of scale”. In the Mercosul context, the integration strategy of the 1990s sought to go on the offensive by creating regional economies of scale through regional free trade integration to overcome the problem of small domestic markets, and thus creating larger markets, expanded trade volumes, and opportunities for specialization. By liberalizing first together with your neighbors, given that they are significant trading partners, efficiency benefits can be secured while regional protection, albeit gradually reduced, protects against more efficient global producers (Whiting, 1993: 24). Regional integration,

both internally and externally, should from this perspective be export-led as it stimulates competition 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 Larosiere 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.

Regional financial integration policy gains its overall significance from the contextualisation of such overarching global growth strategies. It is the "institutional complementarity" between different policies and institutions, i.e. their mutual fit as opposed to policy-specific international best practice, which renders a growth strategy coherent and potentially viable. The viability of the most coherent of regional growth strategies, however, is related to its negotiated place in a global context. The outcome of this complex process of regional integration and insertion into the global political economy are uncertain and replete with unintentional outcomes. Yet, by implication, this also means that a variety of capitalisms is viable in a global economy (e.g. Amable and Petit 2001).

To distinguish politics and economics in times of crises is much more challenging when the political and social limits of markets are laid bare. The crisis has reminded analysts of that financial integration, for long seen as purely economic and technical by most, is also political with normative foundations. In other words, an international political economy approach that is capable of grasping the purpose of policy, its socio-economic (*Pace* "technical") content and thus the general direction of policy is required. The approach thus both attributes and acknowledges normativity. As Cox (1993) claims: every theory is for someone for some purpose. While endeavouring to outline the direction of policy developments and analysing discrepancies between claims to the purpose of policy developments and their actual outcomes, it is led by the two inseparable questions: who is policy-making for and what is its socio-economic content? In other words, how is policy-making shaped by both material interests and ideas, and how do these impact on the everyday life of firms and households? This translates into particular understandings of finance, financial markets and financial integration.

2.3 Financialisation, Financial Fragility and Preventative Regulation

The approach taken in relation to financial regulation and supervision here draws on work inspired by Hyman Minsky, which focuses on what could be termed “amplification risk” (esp. Tymoigne 2012) and reinforces the importance of the state in working towards financial stability. It also emphasises the significance of incentives and public-private relations in governance bodies. As such, it concerns the risk of amplification of a shock via debt deflation rather than the risk of a shock or crisis as such. This is especially relevant with regards macroprudential analysis and enables early intervention. While decentralised financial markets, constituted by the activities of financial intermediaries, play a necessary part of any capitalist economy, of whatever variety, they are inherently unstable. Financial markets enable the intertemporal allocation of resources and the allocation of resources across states of nature. This occurs as savings can be decoupled from investments, resources can be efficiently transferred from units in financial surplus to units in financial deficit, and risk trading is permitted. As such, financial markets are desirable (Buiter 2009). Yet, finance is fragile and prone to debt deflation. The structure of finance, emerging out of the type of loans made by bankers, can, if unsound, destroy the cyclical stability upon which the economy as a whole depends (Minsky 1986: 233). This is because finance 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 turn 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 appropriate regulation is essential. This is not to suggest that credit or liquidity risk are unimportant objects of regulation. Rather, it emphasises the significance of preventative regulatory intervention to avoid the build up of speculative or ponzi finance in the financial system.

Such preventative state intervention shone with its absence in the US and in Europe in the run up to the crisis. Financial fragility was allowed to build up through financialisation, the commodification and rendering tradable of financial relationship, through for instance securitisation under a regulatory regime influenced by the notion that financial markets are best left to their own self-regulatory devices. Financialisation, built upon the considerable influence of Chicago School financial economics and its translation into the shareholder value paradigm in corporate governance (e.g. Jensen and Meckling 1976), justified perverse incentives to managers of financial and non-financial firms alike. This spread unevenly across Europe with its core in financially developed economies such as UK and the Netherlands. Buiter (2009: 3) summarises perceptions of this period: “the Great Moderation, Great Stability or Mervyn King’s ‘Nice Decade’: high and reasonably stable growth, low and reasonably stable inflation, high profits, steadily rising prices of ‘outside’ assets and extraordinarily low risk spreads of all kinds”. From a Minskyian perspective, these conditions were ideal for the build up of financial fragility.

2.4 Negative Integration and Positive Integration

The approach adopted must also be able to distinguish between different ways in which financial integration is designed to change the relationship between states, markets and societies. Meaningful concepts for connecting institutional, legislative and democratic developments within the integration process are “positive integration” and “negative integration” (Scharpf 1999: 43-83). The former refers to the removal of barriers for market operations by private market actors whereas the latter refers to the shifting of regulatory and market interventionist capacity from member state to regional level. In other words, these concepts relate policy direction to future capacity to bring about socio-economic legitimacy through compensation for market developments. Positive

integration can of course be achieved through a financial integration of agenda of harmonisation to enable regional level regulatory and supervisory capacity. However, it can also be achieved through for instance the creation of regional investment funds, serving fiscal, redistributive and developmental purposes to varying degrees and in various ways. From a Keynesian perspective, such funds can provide counter-cyclical stimuli. From a developmentalist perspective, such funds can provide a way to substitute, at least in part, for foreign direct investment (Rosero and Erten 2009: 240).

2.5 Internal and External Integration

While these concepts primarily equips the analyst with the toolkit to grasp the “internal” dimension of the integration process, the analyst of any regional integration process, not least in the context of global financial flows, must consider the “external” dimension of integration. External integration relates to the extent to which a regional integration process is concerned with how it confronts financial globalisation as well as participates in international policy-making and the making of international soft law. The ability to conceptualise both the internal and external dimensions of regional financial integration aids the framework’s capability to grasp regional financial integration to the policy direction of regional integration at large. This is also directly connected to the two linked notions of liberalisation and developmentalism.

2.6 Path-dependent and Path-breaking Policy-making

With the two processes of regional financial integration under permanent (re)negotiation, the approach has to be able to identify policy continuity and change. Adopting an institutionalist language, the framework has thus to be capable of distinguishing between path-dependent and path-breaking policy developments. The concept of path-dependence implies that feedback mechanisms from previous critical junctures strengthen the recurrence of a particular pattern of developments in the future. The reversibility of this particular developmental pattern is thus limited. Alternatively, alternative paths at previous critical junctures, which were not taken, become inconceivable, whether in terms of imagination or feasibility, in the future (Pierson and Skocpol 2002). While appearing to refer to policy inertia, it can describe a highly dynamic process. Path-breaking policy developments are not necessarily anti-thetical to path-dependence, but involves a substantial shift in the development path of policy. While appearing to involve a highly dynamic process, inertia in policy-making may actually lead to such a shift as a given policy path becomes decreasingly feasible or available. Within a particular policy context, inertia may eventually take policy-making to a point of no return with important path-breaking consequences (Andersen, 2002).

2.7 Public- and Private-led Governance and Epistemic Communities

Policy direction, purpose and content are directly related to the actors participating in the policy process. Regional integration processes, and especially financial such, have become increasingly delegated to networks of experts as regulation seeks to keep pace with financial innovation. Professional elites, deemed to possess policy-relevant experience, recognised expertise and

competence as well as a claim to knowledge-based authority, have thus come to fill the “technical” content and enforcement of policy, but also drawn into the legislative process at an earlier phase to provide advice or even to draft legislation. The report will draw on the concept of “epistemic communities” (Haas 1992) to strengthen the account of the impact of such networks. To be able to consider the shifting influence of epistemic communities in the area of financial integration, the framework should provide a sense of the source of leadership in regulatory agenda-setting. The framework adopts a conceptual continuum between private (market) interests and public policy-makers, so that regional agenda for financial integration can be seen as being set by a leadership on a scale running from public-private to private-public (Dorn 2012).

2.8 Concluding Summary

This section has outlined the analytical framework of the report. The framework adopted is an international political economy approach refusing to distinguish between the political and the economic in practice as well as between the regional and the global. Developed to be able to account for continuity and change in the complex and in-flux financial integration processes of the EU and Mercosul, the framework is afforded with a rich set of concepts. The conceptual framework is intended to add simplifying meaning to this complexity. It will enable consideration of different directions and purposes of financial integration in the greater context of regional integration. It will also provide insights into the mode of policy-making, i.e. is policy-making in the financial realm led by private actors or public regulators. Finally, the framework adopts an appreciation for the regulation of “amplification risk” of shocks to the financial system. This makes macroprudential regulation concerned with both endogenous and exogenous “causes” of financial and economic crises. The framework will be applied gently throughout the report as it is acknowledged that while intended to simplify, a rich conceptual framework can also come at the expense of readability.

3) Pre-1998 Financial Integration

- 3.1 Introduction: Bretton Woods and the Origins of Financial Integration in Europe and the Southern Cone
- 3.2 The European Coal and Steel Community and European Economic Community
- 3.3 The Latin American Free Trade Area
- 3.4 The European Monetary System and the European Exchange Rate Mechanism
- 3.5 The Latin American Integration Association
- 3.6 The Single European Act
- 3.7 The Treaty of Asuncion (Mercosul) and the Montevideo Protocol
- 3.8 The Maastricht Treaty and the Creation of European Economic and Monetary Union
- 3.9 Conclusion: Crises and Booms

3.1 Introduction: Bretton Woods and the Origins of Financial Integration in Europe and the Southern Cone

This section will provide a very brief comparative historical overview of financial integration in Europe and the Southern Cone. This will be contextualised within the broader integration processes in the two regions. These are in turn considered as both responses to and constitutive of the world economic order (see Section 2 for the analytical framework). As this story starts in the post-World War II period, it inevitably involves the consideration of the Bretton Woods System, the name of which was inspired by the New Hampshire, US, location of the 1944 conference between the victorious powers in World War II. This system consisted of a series of innovations in terms of institutions and the international monetary system. Institutional innovations emerging in the post-WWII period included the General Agreement on Tariffs and Trade (GATT), the World Bank (WB) and the International Monetary Fund (IMF). The international monetary system replaced the British Pound Sterling with the US Dollar as the international reserve and trade currency, whose value was to be fixed to the value of 35 ounces of gold. This fixed exchange rate system was intended to provide the necessary stability for national economies to reconstruct and develop in the aftermath of half a century of destruction. In turn, nation-states were to open up gradually in the construction of a liberal international economic order. The status of the Dollar was considered reliable as the economic power of the US was unparalleled. The GATT was supposed to provide the framework for the liberalisation of trade; the WB was to provide financial and technical assistance for development, conceptualised according to the modernisation paradigm; and, the IMF was to provide financial assistance in the case of balance of payment problems arising from gradually liberalised trade relations and enable structural (re-)adjustment to the international economic order (Ruggie 1982). In Europe, this system combined with the US Marshall Plan which provided the funds to kick-start industrialisation and economic development. This international set-up enabled political economic stability of European varieties of capitalism with their specific welfare state systems and forms of social citizenship: liberal (e.g. UK), conservative (Germany) and social democratic (Sweden)(Esping-Andersen 1990). Yet, political instability and protectionism remained as huge obstacles for sustained social and economic growth as well as peace on the continent (Milward 1994). European nation-states needed a stronger supranational framework that could stabilise the region.

In the Southern Cone, World War II demand and the post-War commodity boom driven by the reconstruction effort drove considerable growth in the region. When the growth period came to an end in the mid-1950s, political tensions and foreign trade problems arose as small domestic markets provided poor substitute for foreign demand. Also, the historical hemispheric hegemon, the US, had turned its attention, including its financial assistance, away from South America and towards Europe and East Asia. South America was too looking for supranational solutions. Against these somewhat different backgrounds, the two regions sought answers in regional integration.

The section commences by briefly outlining the early forms of integration in the two regions the European Coal and Steel Community (ECSC) and the European Economic Community (EEC) in Europe and the broadly developmentalist Latin American Free Trade Area (LAFTA) relevant for the Mercosul. It subsequently turns to the failed attempts in Europe to create and sustain a European Monetary System and a European Exchange Rate Mechanism. The section then turns to the successor of LAFTA, the Latin American Integration Association (LAIA). From LAIA, the section moves to a discussion of the highly significant 1986 Single European Act in Europe signalling a fundamental neoliberal shift in European integration. We then turn to the early stages of Argentine-Brazilian integration and the Treaty of Buenos Aires in the same year as well as the establishment of the Mercosul with the 1991 Treaty of Mercosul led by Presidents Menem of Argentina and Collor de Mello of Brazil. Heading back to Europe, we focus on the Maastricht Treaty and the creation of the European Economic and Monetary Union. We subsequently explore the Real and Convertibility Plans as well as the Montevideo Protocol of 1997 impacting profoundly on the policy landscape for Monetary and financial policy in the Mercosul in the 1990s and beyond. The section concludes with a brief account of the crises that followed in the Mercosul around the turn of the Millennium as well as the ‘Europhoria’ in Europe setting the stage for financial integration in the two regions in the 2000s.

3.2 The European Coal and Steel Community and the European Economic Community

The Marshall Plan had stipulated that in return for aid, Europe had to find a path towards integration that provided political stability and enhanced opportunities for aid to be turned into growth (Story and Walter 1997: 3). The 1949 creation of the Council of Europe quickly turned to disappointment as intergovernmental struggles prevented cooperation. Seeking to tie the bitter antagonists France and Germany in war upon war on the European continent closer to one another, the European Coal and Steel Community was created through the May 1950 signing of the elaborate Paris Treaty. With political union as a longterm objective, the Treaty stipulated the close integration of German coal and French steel production, the core commodities and goods for industrialisation. Italy and the three Benelux countries (Belgium, Luxembourg and the Netherlands) joined too with their respective production complexes (especially Belgium) and marketplaces. In addition, a common market was stipulated, albeit only partly introduced. It was however created at significant cost in terms of unemployment, particularly in Belgium, but substantial social provisions and retraining were supplied to mitigate against this (Milward 1994). The integration of core production processes and markets was to be so significant so that a split-up would render economic development close to unfeasible. Payment settlements for the transactions within the ECSC were facilitated by the 1950 creation of the European Payments Union (EPU) with each central bank settling accounts and

extending credits to each other in gold, Dollars or credits from countries in trade surplus to trade deficit (Story and Walter 1997: 4). Four institutions were set up: the High Authority as the main executive body and responsible for implementing the treaty composed of non-elected representatives of the member states; the Assembly constituted by national parliamentarians yet with primarily supervisory and advisory duties; the Council consisting of one representative per national government was to provide a coordination role in the relations between governments and the High Authority, along with some decision-making (in case of a crisis arising due to a decline in demand for the goods produced and in response to unforeseen developments which would be deemed to require a response by the High Authority) and consultative powers; and, the Court of Judges made up of nine judges to enforce the treaty. The significant power assigned to the High Authority has led to many commentators referring to the ECSC as a supranationalist integration process (e.g. Majone 2005: 3). Indeed, the ECSC is often identified as the foundation of the “Community Method” and is close to the origins of neo-functionalism as this method’s intellectualisation.

Political union was quickly sought through the idea of a European Defence Community (EDC). Proposed by the French and welcomed by the Germans, the British rejection of the initiative uncomfortable with the degree of supranationalism and preferring the more intergovernmental and US-led North Atlantic Treaty Organization (NATO) eventually led to the EDC’s rapid decline (Story and Walter 1997: 5). Political Union had been drafted in conjunction with the EDC effectively turning the membership into a Federation, but this was quickly shelved along with the EDC. The six member states proceeded nevertheless in 1957 to create cooperation around nuclear energy (EURATOM) and the European Economic Community (EEC) by signing the Treaties of Rome. The institutional structure of the EEC resembles that of the ECSC: the Commission (equivalent to the High Authority); the Council of Ministers; the Assembly (similarly powerless to the Assembly of the ECSC); and, the Court of Justice. The significant difference lay in the shifting of decision-making powers from the High Authority to the Council of Ministers. However, the Commission ‘retained’ the not insignificant power of initiating proposals, implementing legislation and supervising compliance with the laws of the Community. The Court of Justice assumed greater powers than the ECSC’s Court of Judges as the Treaties of Rome were less elaborate, leaving substantive policy choices intentionally open-ended and thus requiring more interpretation. The resulting dialectic between these different bodies, especially the Commission’s initiative, the Council’s response and the Commission’s synthesis, constitutes the core of the so-called ‘Community Method’ (Majone 2005: 6-7). The EEC set out the creation of a customs union by 1970 with a Common External Tariff, thus turning the Commission into a significant negotiating partner of the US in the GATT. Goods produced within the EEC were to move freely without tariff or non-tariff barriers as well as persons, services and capital. Potentially in response to rash supranationalisation, pragmatism reigned in the design of these treaties. While EURATOM was devised according to supranationalist principles again to promote sectoral integration, exceptions were inscribed to address national susceptibilities in the more general EEC.⁴ More cautiously, the EEC was envisaged to create the longterm conditions for political unification by promoting market integration. Customs union would lead to the integration of markets in goods and capital, which in turn would drive calls for a single currency to remove currency or risks arising from exchange-rate fluctuations (albeit very limited under the US Dollar-Gold standard). Monetary

⁴ This divergence has created tensions within the European project of integration ever since, albeit arguably quite fruitful.

integration would however only be possible given that member states would be willing to concede national autonomy in the area of macroeconomic policy (Story and Walter 1997: 6). The idea of monetary integration was not mentioned in the EEC treaty as it was associated too strongly with loss of national sovereignty. Yet, notably, four decades later such caution seemed to have been gone as the European Economic and Monetary Union was created with limited concessions in this policy area.

Financial integration was considered in several ways, albeit limited by the context of capital controls, the pegged exchange rates of the Bretton Woods system and deeply fragmented financial policies. Firstly, Articles 59 to 66 which stipulated that banking and insurance services were to be liberalised in parallel with the liberalisation and movement of capital. This meant that services could be provided across national borders. Secondly, restrictions on capital movements related to current payments (only) were to be removed. Community residents should not be discriminated against on the grounds of nationality in this regard. A set of 'commitments' to the liberalisation of capital controls were made. Thirdly, exchange-rate policies were to be made in the 'common interest'. The practice of currency devaluations intended to distort conditions of competition was a cause of concern and currency convertibility was seen as a source of continuity. Currency realignments were seen as threatening the common market. Sudden crises in the balance of payments were seen as exceptional justifications for devaluation. The likelihood of such arising was to be reduced by coordinating economic and monetary policies. Yet, exchange rate policies along with monetary, credit and insurance policies were left in the hands of national authorities. Further re-regulation were achieved in 1960 and 1962 with regards capital movement liberalisation, the provision of legal cover for the reinsurance sector (1964) and non-life insurance (1973 (both already benefitting from international legislation) as well as motor insurance (1972) enabling the provision of coverage across the EEC (Storey and Walter 1997: 7-9).

While monetary integration was certainly flirted with during this period, it was constrained by concerns about national sovereignty in this area as well as macroeconomic policies. Financial services were in the Bretton Woods policy context not receiving much attention. Yet, liberalisation in some areas was accomplished. At the same time, regional integration in the Southern Cone took its first significant steps starting in the late 1950s.

3.3 The Latin American Free Trade Area

Economic integration in the Southern Cone started in the context of ideas to create Latin American cooperation in the 1950s coined by technocrats and reformist politicians. A structuralist thesis suggesting that the global political economy was characterised by a zero-sum game by development and underdevelopment, core and periphery had become the guide for the work of the United Nations Economic Commission for Latin America led by Raul Prebisch, the Commission's executive secretary. The thesis suggested that development required peripheral economies to create the economic structures for industrialisation in order to move away from commodities production, which were considered to be suffering from declining terms of trade (ECLA 1951). As things stood, the productivity gains secured in the commodity production of the peripheral Latin American economies were transferred to the industrial goods producing core advanced capitalist economies. Peripheral economies would thus suffer from a structural condition of underdevelopment as increasing volumes of commodities would have to be exported in order to generate the revenue

required to pay for imports. ECLA proposed a two-stage import substitution strategy (ISI) consisting of a primary stage of creating the capacity to produce consumer goods domestically and, once this stage was exhausted, a secondary stage of creating the capacity for domestic production at a higher skill level namely that of capital- and technology- intensive manufactured goods (Phillips 2004: 43). The (developmental) state was envisaged to play a central role in this process as the engineers of social, political and economic change. Indeed, adoption of ISI involved a considerable social transformation. As Phillips (2004: 44) puts it: ISI required “a genuine shift in the balance of power between the elements of the central triangle in capitalist systems (state, labour and capital) and a transformation in the nature of each of these constituent elements of the capitalist triangle.” New ‘developmentalist alliances’ had to be constructed. These new alliances were envisaged to encompass the state bureaucracy, a mobilised industrial bourgeoisie and the urban proletariat along with public sector workers and were to be pitted against exporting fractions in order to secure the capital and foreign exchange held by the latter for the industrialisation process (Cardoso and Faletto 1979:131). ISI also required the expansion of domestic demand as foreign demand had to be offset. Part and parcel of ISI was thus inclusion and empowerment strategies in urban areas in order to build a sizeable class of consumers (Phillips 2004: 44).

ISI faced several constraints. Firstly, the Bretton Woods system of trade liberalisation ostensibly worked against individual peripheral national economies as protectionist policies enabling the build up of industrial competitiveness behind trade barriers were combated. Secondly, population growth was strong on the continent and this consumed the productivity growth generated in the post-WWII period. Thirdly, yet the small size of most Latin American economies prevented offsetting foreign demand with domestic demand. Fourthly, states typically failed to find the ‘public capital’ required to fund industrialisation and tended to turn to transnational corporations for bringing about technology transfer. Yet, this tended to both be insufficient and serve to undermine the build up of a domestic skill base and capital goods. Fifthly, a dynamic agricultural sector remained central to generate the foreign exchange to pay for the capital goods required for industrialisation. This, of course, reproduced the dependence upon commodity exports with their ostensibly declining terms of trade and imports of foreign capital and technology with relatively rising terms of trade. Considering the continued reliance upon the agricultural sectors, the strategy of forging development alliances to struggle against these sectors created deep tensions as various controls on trade and financial flows were imposed. Finally, ISI appears in retrospect mistimed. The export scepticism at the foundation of ISI was paralleled by the golden three post-WWII decades of production and trade growth, which could have been of benefit to Latin American economies (Phillips 2004: 45).

In this context, liberalising economic integration appeared, albeit at first sight perhaps counter-intuitively, to be a powerful development strategy. Firstly, the constraints listed above could be overcome by creating economies of scale, especially larger consumer markets, pooling funds for investment into industrialisation and reducing dependence on the agricultural sectors. Indeed, with regards the latter, a regional economy would create the incentives for modernisation and specialisation that would support the move away from this dependence. While regional integration would be based on liberalising premises, the strategy still emphasised market protectionism and autonomous economic development. Rather than a national strategy, ISI became a regional strategy founded on the complementarity provided by diverse economies rather than on competition (Tussie 1982:401–3). The facilitating factor was the provision under GATT, in support of the ongoing integration process in Europe, that preferential trading arrangements were allowed on the condition that they facilitated the construction of customs unions or free trade areas. Later, this was succinctly and compellingly put by ECLA in the following way (1969: 1):

Latin America’s basic long-run development problems can be solved only if the following fundamental fact is recognized: Latin America, however great assistance it receives, however high

the rate at which its exports expand - and they cannot do so very rapidly - will be unable to carry out its development plans, will be unable even to regain the rate of growth achieved in the ten post-war years, unless it makes a sustained effort to establish within its own territory the capital goods industries of which it is in such urgent need today, and which it will require on a large scale during the next quarter of the century. . . . In order to produce these capital goods and dynamic industries. . . Latin America needs a common market.

Moreover, of concern to some politicians, regional integration would attract the attention of the US, which had come to focus on Europe and East Asia. The region's development problems appeared to be far down the list of priorities of the new global hegemon while its financial support was very much needed (Wionszek 1970: 52). Indeed, European integration quickly became seen as a defence of common interests, a challenge to which Latin American regional integration had to respond (ALALC in Phillips 2004: 47).

On broadly these premises, the Latin American Free Trade Area was established in 1958 with the Treaty of Montevideo signed in 1960 and operationalised in the subsequent year by all members of the present Mercosul, bar Venezuela which became members in 1970. It committed member states to facilitate economic integration and the complementarity of national economies, to reconcile their import and export regimes and harmonise their treatment of foreign capital, goods, and services. Industrialisation policies were to be progressively coordinated by the economic sectors affected. Intra-regional trade barriers were to be removed in order to create the Latin American Common Market (LACM) within 12 years of the treaty's implementation. Despite initial positive developments in terms of intra-regional trade (both tariff reductions and volumes), LAFTA must be seen, measured by its own objectives "having failed to produce any agreement on foreign trade and industrialisation policy or the treatment of foreign investment, or to generate any notable product diversification", as a failure (Phillips 2004: 49).

3.4 The European Monetary System and the European Exchange Rate Mechanism

Up until the late 1960s, the most substantial developments in European integration were the creations of the Common Market and the Common Agricultural Policy, indeed in relation partly to which LAFTA was created. Indeed, there was a general feeling of stagnation in the integration project. At this time too, the pegged exchange rate system designed at Bretton Woods started to show signs of instability. Two and a half decades of the US economy running a balance of payment deficit, a development severely aggravated by the massive expenditure incurred with the Vietnam War and fading competitiveness in relation to Germany and Japan, had brought the Nixon administration to 'temporarily suspend' the convertibility between the Dollar and gold in August 1971. The Smithsonian Agreement in December of the same year reinstated convertibility, but expanded the fluctuation band from 1% to 2.25%. This generated significant exchange rate volatility in Europe, which decided to jointly fluctuate against the Dollar. The metaphoric 'European snake' wriggling through the new 'Bretton Woods tunnel' was introduced. With the Dollar being allowed to float yet again in March 1973, the tunnel was removed. As the first oil shock striking in the Autumn of 1973, the snake came to be badly rattled by parity adjustments and member state exits and re-entries as national economies struggled with exchange rate instability, inflation and relative stagnating growth.

In 1969, the heads of state and government had called for a plan to reignite the integration process in the direction of economic and monetary union. The resulting 1970 Werner Report (named after the authoring Committee's chairman Luxembourg President) outlined an ambitious Plan. Economic union and monetary union would (Werner Report 1970: 9-10):

realize an area in which goods and services, people and capital will circulate freely and without competitive distortions without thereby giving rise to structural or regional disequilibrium...[as well as] the total and irreversible convertibility of currencies, the elimination of margins of fluctuations in exchange rates, the irrevocable fixing of parity rates and the complete liberation of movements of capital.

Monetary union could be accomplished in three stages by: a) reinforcing the procedures for policy coordination and consultation; b) accelerated liberalisation of capital movements and financial market integration; and c) reducing exchange rate fluctuations. Upon heated discussions within the Committee, it was recommended that these stages were not to be chronological steps, but rather simultaneous (Maes 2007: 33). While the Rome Treaty establishing the EEC had not mentioned monetary integration and had remained vague with regards financial integration, the Werner Report positioned liberal financial integration at the core of the integration project and made it a beneficial corollary to monetary integration. So when the Dollar standards started to crumble and create instability throughout the international economic order, the installation of economic and monetary union by 1980 became the European answer. However, divergent national economic and monetary policies as well as the German Bundesbank's decision to terminate currency interventions to stabilise the Dollar, following pressure from the US to restore competitiveness, resulted in that the Deutsche Mark started to float upwards with a number of smaller European currencies following suit (Storey and Walter 1997: 10). Still, capital controls were introduced by European authorities, even the conservative monetarists of Germany did so briefly. British (along with Danish and Irish) membership brought further distraction and divergence by launching Europe into a series of external trade negotiations. The Werner Plan was thus shelved. Financial and monetary integration made therefore very little progress during the 1970s. The few notable steps included the First Banking Coordination Directive of 1977 and a directive relating to the official stock exchanges' admission of securities in 1979 (Maes 2007: 34-8).

Yet, a significant institutional innovation was made in European integration: the 1974 creation of the European Council. Regular summits with ministers and heads of state laid the foundations for new developments. A crucial development for the area of monetary and financial integration and economic policy more generally happened partly as a result of the Council's intervention at the Rambouillet Summit in November 1975. Of particular significance, the summit addressed the role of the Dollar in the international monetary system. In the modified Articles of Agreement of the IMF, the Dollar retained considerable significance. Special Drawing Rights would no longer be valued in gold but in a basket of currencies, within which the Dollar was given a third's weight. To counter volatility in foreign exchange markets, governments would prioritise price stability. Convergence in national economic policies thus took on added significance, including the German economy's reflation (Storey and Walter 1997: 11). Moreover, direct elections to the European Parliament, a new enlargement phase as well as the launch of the European Monetary System in 1979 followed.

The European Monetary System was thus no longer intended to bring about financial integration, but focused on enhancing monetary stability. It consisted of three main elements: 1) the European Exchange Rate Mechanism (ERM) taking the form of fixed but adjustable exchange rates with a common float in relation to foreign currencies; 2) credit mechanisms; and, 3) the trade- and GDP-weighted basket currency the European Currency Unit (ECU) building on the idea of the pre-existing European Unit of Account (EUA). The initial period suffered from severe problems, partly as a consequence of a volatile global economy with a second oil shock in 1979 driving up inflation and the 1979 Volcker Shock of bringing it back down with the help of a significantly raised US federal funds rate and subsequent fiscal restraint, taking the form of realignments, coordination problems and poor convergence in inflation rates. While German economic policy remained conservative, French President Mitterand came to power on a socialist platform, but following speculation against the Franc made the famous 'U-Turn' and adopted austerity policies. This policy convergence had the

effect of reduced and converging inflation rates. The second half of the 1980s was characterised by relative stability on foreign exchange markets and financial markets.

Nevertheless, Europe had entered into a prolonged period of stagnation, frequently referred to as Eurosclerosis. Storey and Walter present four commonly made explanations for this phenomenon: 1) monetary conservativeness, led by the Bundesbank, suffocated growth; 2) mature welfare states had become too costly especially as a consequence of growing unemployment. Combined with continued constraints on the four freedoms resulted in structural impediments to growth; 3) declining savings rates combined with increased private and public consumption reduced investment rates; and, 4) declining corporate profitability and reinvestment rates. The second, third and fourth arguments were those which won the day as promoted by European Business and operationalised by the Commission (Storey and Walter 1997: 12; Van Apeldoorn 2002). Thus, as we shall see in sub-section 3.6, the Single European Act (SEA) of 1986 set out to reinforce the four freedoms and ostensibly promote corporate profitability and private as well as corporate investment rates in the creation of a European single market. The neoliberal shift towards monetarist policies and austerity policies combined with the SEA has been called the “second integrationist project” (Cafruny and Ryner 2007: 4). Meanwhile, in the Southern Cone, the Latin American Integration Association had come to replace LAFTA.

3.5 The Latin American Integration Association

In 1981, the Latin American Integration Association (Asociación Latinoamericana de Integración - ALADI/LAIA) replaced LAFTA. All five full current members of Mercosul became members of LAIA. LAIA provided a more flexible framework for integration, enabling more negotiation room for (temporary) preferential trade arrangements and operations. However, with a challenging policy context of macroeconomic imbalances, including budget deficits and high rates of inflation, and weak authoritarian regimes dealing with deep socio-economic crises, LAIA was soon doomed. Still, it presented the vehicle for further sub-regionalisation, and eventually facilitated the emergence of the Integration and Economic Cooperation Programme (Programa de Integración y Cooperación Económica - PICE) between Argentina and Brazil in 1986 and subsequently the Mercosul agreement in 1990.

LAIA provided a more flexible framework for integration, enabling more negotiation room for (temporary) preferential trade arrangements and operations. This was welcomed by LAFTA member states for four reasons outlined by Phillips (2004: 49-51). Ultimately, however, it led to sub-regionalisation. Firstly, administrative problems arising above all from the considerable differences in size and development levels across the region required the larger Southern Cone states to make concessions to the rest of the membership. Secondly, member state interlinkages remained limited as a result of LAFTA's failure to break down competitive protectionism and to create the institutional structures to facilitate their creation. The integration process here also suffered from the absence of the logistical infrastructure to connect trade between distinctly national economies. These two factors lay at the foundation of the Andean Community of Nations in 1969 (Comunidad Andina de Naciones - CAN/AC). Thirdly, and perhaps most significantly, considerable asymmetries and discrepancies in terms of trade flows, development levels, integration capacity and sense of purpose divided the region. Trade and industrial production in the region were concentrated to the Southern Cone economies which implied that their favoured integration approach was less ambitious than that proposed by ECLA. Their fundamental interest lay in preserving trade levels and overcoming the severe payments crises of the late 1950s. Elsewhere in the region, trade liberalisation was a stronger incentive for integration. Yet, the challenges to the smaller economies arising from the demands on macroeconomic convergence and social transformation in trade liberalisation, especially in financial and administrative matters, put demands on the Southern Cone economies to make concessions

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towards the rest of the membership while continuing to benefit from the regional terms of trade. These structural inequalities came to the fore with unilateral tariff reductions in the Southern Cone economies in the 1960s and 1970s. Consequently, there was an emerging realisation of the accrual of costs and benefits from the integration project.

This emerging divide between Andean and Southern Cone members brought about a tendency towards sub-regionalisation. However, there was no clear sense of common purpose amongst these new sub-regional formations. Nevertheless, it became increasingly clear that trade liberalisation splintered the project and undermined the initial consensus (Tussie 1982). The fourth significant reason derived from the decline of the ISI strategy at the core of LAFTA with the liberal shift in trade policy amongst the Southern Cone economies in the 1970s. The countering of foreign exchange bottlenecks at the core of the ISI strategy was undermined by growing demand for commodity exports and the greater availability of external financing for industrial projects. The basis for regional cooperation thus vanished (Wionczek 1970:61–2). Indeed, LAFTA integration never assumed structural relevance with industrialisation processes and development strategies remaining primarily national. Instead, sub-regional formations such as the Andean Community of Nations emerged in its place. Later on PICE and Mercosul followed too.

It is in this context that LAIA provided a more flexible and in principle more useful framework for integration. Established in 1981, it enabled more wriggle room negotiation room for (temporary) preferential trade arrangements and operations, and imposed less costs on members. However, the timing was the worst possible. Growing macroeconomic imbalances, including budget deficits and high rates of inflation, struck the region hard as commodity prices fell sharply and external credit became scarce and expensive as a result of the Volcker Shock and the European shift towards monetarist policies. Weak authoritarian regimes in the region were largely incapable of dealing with the resulting deep socio-economic crises. Latin America thus got caught up in the global 'debt crisis'. These developments contributed strongly to the inefficiency of LAIA. Still, while perhaps not providing a strong trend in the direction of economic or political integration, in so far as these dimensions can be distinguished, it provided the basis for continued Latin American cooperation and the vehicle for the creation of sub-regional entities through its more flexible framework. Sub-section 3.7 will return to the Southern Cone and key integration processes in the sub-region. In Europe, meanwhile, the integration project was being prepared for a significant push in the direction of creating an integrated single market.

3.6 The Single European Act

The SEA of 1986 constitutes a cornerstone of the second integrationist project in Europe, and a neoliberal shift in the overall framework for European integration. It aimed at the completion of the European single market. It did not only aim for the progressive realisation of economic union, but monetary union too (Storey and Walter 1997: 17). Moreover, the SEA included the first initiative by the Commission, after decades of hesitation, to create a single market for financial services as well. This generated proposals finding their expression in directives and regulations voted upon by the Council between 1986 and 1993 with most rules on the books by 1993. A Europe with a single market consolidated by monetary union would turn the continent into a power to be reckoned with in the international economic order (ibid.: 1).

A key institutional innovation devised to enable this process was the (re-)introduction of the principle of qualified majority voting in the Council on decisions pertaining to the harmonisation of national laws and regulation "which have as their objective the establishment and functioning of the internal market" (Art. 100A TEC). Replacing the principle of consensus, supranationalism thus

received a significant boost as a degree of disagreement could be circumvented for the purpose of creating the single market. Responding to member state concerns, a fourth paragraph (Art. 100A(4) TEC) was to grant member states increased flexibility in safeguarding national interests in case of implications for “public morality, public policy, or public security; the protection of health and life of humans, animals, or plants; the protection of national treasures...or the protection of industrial or commercial policy”, or the protection of the working environment. The Commission however could deem such claims to exception to be representative of arbitrary discrimination or covert restriction on trade between member states. The Court of Justice was the last port of call in case of disagreement (Majone 2005: 12). Moreover, the European Parliament (EP) was given a greater role in legislation through the introduction of the cooperation procedure: at the first reading of legislation, the EP was to issue its opinion upon which the Council would establish a common position. At the second reading, if the EP rejected the common position by a simple majority vote, the Council could still adopt the legislation but only by taking full responsibility for it (Majone 2005: 11). The legal principles adopted for the re-regulatory process were minimum harmonisation, mutual recognition and the home-country principle. The implication of this was that liberalisation would be based on minimal harmonisation with discretion left to national authorities on the basis of mutual recognition of each others’ regulatory systems (Storey and Walter 1997: 17). 27 draft directives were drawn up to ensure freedom of cross-border provision of financial services through removal of barriers to entry into national markets. Quite arguably, without these institutional innovations in the direction of ‘qualified supranationalism’, the SEA would probably not have come very far. Especially with regards financial services, there was plenty of resistance and struggle characterised the eight years of negotiations.

A good number of directives and regulations were agreed upon and implemented. Firstly and of considerable significance was the 1988 directive on the liberalisation of capital movements to be implemented by 1990. Freedom of capital movements would generate a more efficient allocation of savings, tax levels would be forced down and structural convergence necessitated. Secondly, in the area of banking, the second banking coordination directive of 1988 was introduced as well as the Single Community Banking Licence, according to which an institutions receiving accreditation in one country would be automatically granted the right to set up and conduct business in any other member state. This, somewhat controversially, included already established foreign banks. In the area of banking supervision, the Own Funds and Solvency Directives provided necessary harmonisation of bank supervision standards and introduced mutual recognition of licensing procedures. Harmonised, consolidated and regular accounting practices were given considerable significance by the 1991 collapse of the Bank of Credit and Commerce International, the activities of which spanned well beyond Europe and into a number of offshore havens. Annual and Consolidated Accounting standards were introduced in response. In order to open up insurance markets, life and non-life insurance directives were introduced. Negotiations in these areas were reasonably smooth.

Significantly more politicised and strugglesome to find agreement on were directives and regulations in the area of financial services. Here, trust between competing financial centres was lacking, differences in tax regimes constituted a major hurdle and, finally of considerable importance, there were differing understandings of the appropriate role of financial markets in the economy. On these grounds, conflicts arose almost across the board. These were intense with regard to capital adequacy rules for investment firms, rules concerning the issuance of bonds, insider trading and

information sharing between financial centres. Rules relating to mergers and acquisitions, competition law and social policy were also affected by these conflicts. Conflict was also rife in the liberalisation of European markets for corporate control. Here negotiations around disclosure rules for major shareholders, limits on banks' stakes in non-financial firms and banks' minimal capital standards were fierce. It also profoundly suggested the need for an EU-wide competition policy and deeper considerations of re-regulation's implications for the new European social charter (Storey and Walter 1997: 24-5). Struggle typically was fought between coalitions composed by broadly "southern" and "northern" member states and their financial sector constituencies (see Storey and Walter 1997: 1-27; Quaglia 2010). Notably, these alliances have remained largely in place to this day with the broad sticking points the same too.

While the SEA was primarily focused on the creation of a single market for the trade in goods, its impact on financial integration was significant, not least for getting it off the ground. The key feature of the SEA was that member states agreed to concentrate on accomplishing a unified market on the basis of mutual recognition of their diverse ways of conducting and regulating business. Protection would be flushed out and simply doing things differently was no longer a valid excuse. There was a clear determination to open up national markets. To popularly legitimate the push in the area of financial services, the Cecchini report (1988) was widely promoted. It stated the Community's GDP would grow by between 4 and 7%. As Storey and Walter (1997: 27) rightly point out, with a host of new and acceding member states (Denmark, Ireland and UK in 1973, Portugal and Spain in 1986, Austria applied in 1989, Sweden applied in 1991, Finland applied in 1992), Europe had come to account for 45% of world trade. With monetary integration firmly in their sights, Europe was aiming for greater power in the international political economy.

3.7 The Treaty of Asuncion (Mercosul)

There are a number of competing accounts determining the origins of the Mercosul (see Giardini 2011: 41-72). The account provided briefly here builds broadly on the recent account provided by Giardini (2011) which surveys Argentine-Brazil relations in the run-up to the signing of the Treaty of Asuncion and attributes particular significance to the Integration and Economic Cooperation Programme (Programa de Integración y Cooperación Económica - PICE) and the subsequent Treaty on Integration, Cooperation and Development (*Tratado de Integración, Cooperación y Desarrollo* – ICD) of 1988 and the *Acta de Buenos Aires* (Buenos Aires Act) of 1990 while contextualising these developments within the International Political Economy and the formative experiences of regional integration processes since the late 1950s.

By the mid-1980s, both LAFTA and LAIA had petered out into sub-regional divisions. Yet, these experiences had been shared by Argentina and Brazil and with that an appreciation for the opportunities presented by economic integration on the Southern Cone. Discussions of an economic integration programme (PICE) had commenced between Argentinian President Alfonsín and Brazilian President Sarney in 1985 with its signing taking place in 1986. The objective of PICE was to create a common economic area as the debt crisis and the Falklands/Malvinas conflict squeezed funding to the two economies and shrunk foreign demand. Sectoral protocols were to be negotiated to create the necessary conditions for establishing a common market, promote economic complementarities and stimulate investments. While the original PICE programme involved twelve protocols (incl. financial affairs, investment funds and economic studies) presidential summits doubled the number of protocols to twenty-four.

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PICE benefited from a much stronger shared understanding of the economic foundations for regional integration than the other Latin American attempts. Macroeconomic policy coordination was understood as an essential precondition as opposed to a desirable outcome of integration. Moreover, the integration process was conceived pragmatically rather than idealistic or dogmatic. Economic crises, which the two countries by now were used to tackling, would allow for exemptions and deviations from the stipulated integration process. Implementation of the programme was to be gradual and flexible. Sectoral negotiations did not have to produce economic specialisation, but rather cooperation. Building on its relative strength in this area, trade expansion remained key to the integration process but it was supposed to bring a balance between sectors and between productive segments. Technological modernisation and an effective resource allocation were aims to be achieved through harmonisation of economic policies and the preferential treatment of third country markets (Giardini 2011: 70-1). As such PICE represented a pragmatic liberalisation agenda both internally and externally.

In the realms of monetary integration and investment policies, the presidential summit in Bariloche and Viedma (the intended capital) in 1987 included serious consideration of the creation of a common monetary unit and a binational investment fund. Protocol 20 devised the *gaucho* to address stubborn bilateral trade imbalances penalising the possessor of the unit to encourage the purchase of goods from the other country. Yet, it was never adopted.

Yet, the motivations were far from purely economic as should be already obvious, but had a very strong political dimension. Above all, historical rivalry and political instability with the fresh memory of authoritarian regimes in the two countries made a formalisation of the previous tendencies towards sub-regionalisation highly significant. Tension between the two countries was longstanding and stabilisation of the relationship had been boosted with several security arrangements in the late 1970s and early 1980s. Stabilisation was both boosted and needing further support as Argentina left military rule behind in 1983 and Brazil received its first civilian President in 1985. This enhancement of political relations between the two countries provided the necessary foundations upon which economic integration could build. Giardini (2011: 71) quotes Silva in supporting this point: the two governments “adopted a socio-economic concept of national security, to replace the old geopolitical one.”

The PICE model of integration was however soon exhausted, yet its decline triggered initiatives for the revitalisation of the integration process. From the beginning, expectations on PICE had, despite unfavourable macroeconomic conditions nationally and internationally, been very high. Interpresidential conviction had sought to overcome the resulting challenges. As conditions improved in 1986-7 along with the enhanced legitimacy achieved by the regimes through the programme and democratisation, the integration process delivered positive results as stabilisation plans brought decreases in inflation, which in turn enabled economic growth. However, by 1988, conditions turned against the supportive political coalitions as economic and social problems came to the surface. Poor economic records for both countries affected both investment rates and integration processes negatively with growing difficulties to service debt repayments. The flexible and gradual sectoral approach had smoothed the initial phase, but became subjected to heavy lobbying for exemptions from business interests serving to undermine the legitimacy of the programme (Giardini 2011: 79).

As the two countries approached elections in 1988, the integration process was under threat. With PICE heavily reliant upon interpresidentialism, electoral outcomes could very well determine its future. To defend the integration process, Presidents Alfonsín and Sarney signed the Treaty of Integration, Cooperation, and Development (ICD), in November 1988, to consolidate the process

through a commitment towards the creation of a common economic space and the aspiration for a future common market. A two-stage process was envisaged: firstly, trade liberalisation and policy harmonisation to make trade liberalisation effective; and, secondly, further harmonisation in corollary areas required for a common market (ibid.: 81). In other words, the ICD treaty outlined a free trade to be followed by a common market. With the ICD Treaty, a liberal regional integration process in the Southern Cone started in all earnest. However, it was a cautious and flexible process in acknowledgement of the challenging domestic, regional and international political economic context of integration. Indeed, as one commentator involved in the process put it (in ibid.: 82): the drafting of the ICD Treaty was “cautious, much more cautious than the [drafting of the] Mercosur Treaty”.

Indeed, elections brought, contrary to pre-election fears, heads of state who appeared to be at least as interested in regional integration as their predecessors. Argentine President Menem and Brazilian President Collor de Mello embraced the idea of a common market in the Southern Cone in the Buenos Aires Act of 1990. They accelerated the process by systemically outlining the concessions made by the two countries to each other since LAFTA in the Economic Complementarity Agreement of November 1990 and halved the stipulated time to achieve a common market to be accomplished by 1994. With the only formal condition for enlargement was membership of LAIA, they also invited the other Southern Cone economies and Paraguay and Uruguay agreed to join, while Chile declined the offer in the fear of the macroeconomic instability of the other economies as well as its acknowledgement of lower levels of tariffs would create imbalances in the customs union (Giardini 2011: 92-5).

While not empowered with an electoral mandate to pursue it, Menem and Collor de Mello shared a different outlook on the integration process from their predecessors, however. Their inspiration was drawn from neoliberal ideas centred on free-market policies often summarised by reference to the prevailing “Washington ‘Consensus’” policy mix of secure property rights, privatisation, tax reform, fiscal austerity, new public expenditure priorities, interest rate liberalisation, competitive exchange rates, deregulation of barriers to entry and exit of capital flows (see Williamson 1993). This was the supposed policy consensus for how to address a globalising context characterised by a fiercely competitive international trade system of freely circulating services, goods and capital. Regional integration should not any longer a defence strategy facing the challenges of this hostile environment, it was a strategy enabling peripheral economies to go on the offensive. According to Argentina’s Menem, regional integration strategies based on ISI had led to isolation and economic decay. Yet, an offensive strategy of regional integration was only plausible if support from the US could be secured to address debt levels on beneficial terms. This brought the Menem Administration to legislating convertibility between the Argentine Peso and the US Dollar leading to a(n excessively) strong Peso. This led to the encouragement of imports at the expense exports. Mercosul markets thus became crucial for the implementation of Menem’s economic policies.

Collor de Mello had not either been elected on a neoliberal platform, and embraced a similar policy approach to Menem, including an rapprochement with the US and a moderation, but not complete abandonment, of the developmentalist approach to domestic and international relations. Economic openness to attract credit and technology to support the restructuring of the domestic economy was central to the policy approach. Again, regional integration took centre stage as an aggressive strategy to achieve global competitiveness (Giardini 2011: 83-8). Foreign exchange policy played again a key role. Facing hyperinflation, the Real Plan (*Plano Real*) was intended to bring about price stability in two stages and was underpinned by a sustained offensive to promote the virtues of market reform to business and industry (Phillips 2004: 196). The Immediate Action Plan and the Economic Stabilisation Programme (the preliminary first stage) were initiated in 1993. They stipulated spending cuts and enhanced government control over the federal budget. The second stage involved

a significant shift in exchange rate policy through the introduction of a new currency, the *Real*, and its pegging to the US Dollar. While supported by two Brady Plan debt arrangements, it proved effective in reigning in inflation and bringing about a significant (over)appreciation of the currency (ibid.: 71). It was also effective in contributing to the reduction in power of the labour movement New Unionism (*Novo Sindicalismo*) as economic restructuring and unemployment undermined union power (ibid.: 162).

Menem and Collor de Mello's policy synergies were partly reflected in the foundational treaty of the Mercosul signed in Asuncion on March 26, 1991. In the Treaty, the countries committed to the formation of a Customs Union named Southern Common Market, or Mercosul/Mercosur. At the core of the Treaty were commitments made to the following principles and practices:

- The free movement of goods, services, and factors of production through the elimination of tariff and non-tariff barriers to trade;
- A Common External Tariff (CET) and a common trade policy underpinned by coordination of positions on economic and trade policies in regional and international forums;
- Macroeconomic policy coordination in the areas of: foreign trade, customs, foreign exchange and capital, industry, agriculture, fiscal and monetary issues, financial services, transport and communications.
- Harmonisation of legislation relevant to the integration process

Trade liberalisation was wideranging and deep. Yet, large volumes of exemptions were made with steep timetables drawn up with greater leniency shown towards the smaller members. Some further exemptions were made subjected to less stringent timetables. The subsequent formal step in the integration process was taken with the signing in December 1994 of the Protocol of Ouro Preto. The Protocol amended the Treaty of Asunción with regard to the economic bloc's institutional structures transforming Mercosul from a Free Trade Area into a Customs Union by January 1995. With trade liberalisation so rapid, the customs union was close to complete (Phillips 2004: 87).

Institutionally, Mercosul was constituted, by comparison with European integration, in a remarkably intergovernmental and minimalist manner based on relatively informal processes as opposed to rule-based and supranational. Facilitated by the relatively small number of member states, consensus was to be the mode of agreement. It created two bodies: the Common Market Council (CMC) and the Common Market Group (GMC). The CMC consists of foreign and (typically) economic ministers from each member state and provides political leadership for the integration process. As in the European Union, member state presidency of the CMC rotates every six months. The GMC is constituted by eight representatives from each member state, including representatives from the ministries of foreign and economic affairs. It is the executive body of the Mercosul and responsible for the implementation and its monitoring of the founding Treaty as well as the enforcement of the Council's decisions. It is also in charge of creating timetable for achieving the completion of the common market. The foreign ministries of the member states are central to this intergovernmental setup as they perform coordinating roles in the interaction between the two bodies. As the executive branch, the GMC provides the umbrella for a number of bodies of a more 'technical' nature. This includes the third core institution of the Mercosul: the Trade Commission (CCM) created by the 1994 Ouro Preto Protocol. The Trade Commission is constituted by ten technical committees and is in charge of the implementation and development of the region's trade policies. A less significant role was afforded to the Joint Parliamentary Commission (CPC) with its membership of 64

representatives (16 per member state) from national parliaments of both chambers of congress and across political parties. It is assigned monitoring, consultative and advisory roles in the integration process. It prepares groundwork for legislative harmonisation, facilitates the domestic implementation of regional directives and reports to national congresses on progress. The Mercosul Administrative Secretariat (SAM) is responsible for administrative and operational support to the other bodies as well as the dissemination of documentation and information. The Consultative Forum on Economic and Social Issues (FCES) provides a forum for the economic and social sectors, including labour and business groups, and thus channels these actors' input into the integration process. Finally, and of central importance to this report is a range of working groups and special meetings (SGTs), including SWG4. These working sub-groups deal with structural and technical issues pertaining to Mercosul negotiations internally and externally. SWG4 received its specific mandate and long term working programme in the Montevideo Protocol of 1997.

SWG4 was tasked already in 1990 with preparing for the launch of Mercosul. This was in recognition of the strong crisis-tendencies emerging out of the phenomenon that is financial globalization. While this was a poorly understood concept and process at the time, the Southern Cone economies' experience with financial crises rendered them particularly sensitive to this issue. Yet, SWG4 was not to be given a stronger brief until the financial liberalization process launched with the Montevideo Protocol of 1997 (especially part III, Action Plan for the Strengthening of the Liberalization Program of Services Trade, from here on the Liberalization in Services Action Plan, LSAP), set up under this neoliberal period. The Preamble reaffirms the Treaty of Asuncion's commitment to the free circulation of financial services within the Mercosul stating the significance of liberalization in this area for economic development, for the enhancement of the Customs Union and for the creation of the common market (Preamble Montevideo Protocol). It also emphasises norms and principles of mutual recognition and caution reflected in terms such as transparency, balance and gradual liberalisation. Its adherence to the World Trade Organization's General Agreement on Trade in Services was also made clear. Notable, of course, is that this initiative predates Europe's Financial Services Action Plan (see Section 4). Still, the ratification of the Montevideo Protocol had to wait until 2005. The LSAP was an ambitious plan to create a free trade area in financial services with an ambitious deadline. It was given ten years for its completion (by 2015).

In line with the region's sensitivity to financial crises and its intergovernmentalism, the Protocol provided a number of clauses allowing for caution and scope for national sensitivities to be heeded and recognised with regard financial market integration. Financial integration was not taken lightly. While the European Financial Services Action Plan (FSAP), as we will see in Section 4, involved a 'Europhoric' and private-led embrace of liberalization with regulation and supervision appearing as a tag-on, LSAP was more public-led with regulation and supervision constituting an equal dimension to liberalization. Liberalisation was to happen with a clear degree of precaution taken. Reminders of this necessity were provided with the crises in the region around the turn of the Millennium, as we will briefly return to in the conclusion of this section. As such, the concern for systemic impacts of economic crises transmitted through the financial system took on significance in the Protocol as well as the subsequent work of the SWG4 in the 2000s. Regulators took on clear responsibilities to interpret the complexities of financial markets and prevent their translation into crises.

3.8 The Maastricht Treaty and the Creation of European Economic and Monetary Union

Against the backdrop of the economic and financial stability witnessed during the second half of the 1980s, albeit with Eurosclerotic growth figures very much still in place, the Maastricht Treaty of European Union was intended to take European integration into an even rosier future. It was

supposed to turn an economic community into a European Union, or at least stipulated this development. This was to be a political, social and economic and monetary union. It was also expanding, including Austria, Finland and Sweden and now also the transition economies in Central and Eastern Europe knocking on the door for accession. Instead, it quite arguably institutionalised a set of neoliberal policies providing the recipe for a vicious circle of negative integration without a dimension of positive integration (Scharpf 2000). In other words, the Maastricht Treaty provided an institutional framework for the liberalisation of the European economy while precluding European common action for productivity growth. In short, it entrenched the Eurosclerosis it was intended to cure (Cafruny and Ryner 2007: 30-32).

Intended to tackle the longstanding criticism against European integration as suffering from a democratic deficit (e.g. Williams 1991: 155) believed to contribute to a persisting lack of a European sense of community and shared identity (e.g. Duchesne and Forgnier 1995), the Maastricht Treaty assigned greater powers to the European Parliament (as well as introducing a Parliamentary Ombudsman and a 'Committee of the Regions'). The European Parliament was now able to veto legislative proposals at a new third reading in what was termed the Codecision Procedure (e.g. Majone 2005: 14).

Economic union involved the completion of the single market for goods, capital, services and people. However, the process of liberalisation and re-regulation that economic union involved is not understandable without the role to be played by monetary union, which was designed to support these processes. Indeed, there was a strong longterm will behind the creation of a monetary union with its transactional and supposedly macroeconomically integrative positive effects. Building on the German Bundesbank model of monetarist policy, a European Central Bank (ECB) was created with responsibility for a new currency: the Euro. The ECB was granted supreme independence with a firm commitment to price stability. Its assigned policy tool was to be the setting of Eurozone-wide interest rates, the primary mechanism through which monetary policy was to be transmitted. Together with the participating member state central banks, it comprised the Eurosystem.

To ensure macroeconomic policy coordination in preparation for the launch of the European Monetary Union, the Maastricht Treaty included convergence criteria. Budget deficits were not allowed to exceed 3% and public indebtedness 60%. The criteria were also intended to perform an eligibility function for membership. Adhering to the criteria for a set period of time testified to macroeconomic convergence. The convergence criteria were further institutionalised by the Growth and Stability Pact (GSP). The GSP was designed "to preclude attempts by individual member states to 'free ride on the policy credibility' of other member states and the EMU as a whole" (Cafruny and Ryner 2007: 32). Free-riding was here understood as the pursuit of expansionary fiscal policies while avoiding the risk of a proportional rise of interest rates on the currency. Complementing this further in the area of social and labour market policy while seeking to get around the Treaty of Rome's acknowledgement of member state sovereignty in this policy area, a new 'soft' policy tool was introduced with the Joint Coordination of National Employment Policies at the extraordinary Luxembourg Summit of 1997. This policy tool came to be known as the 'open method of coordination' (OMC) which involved information-sharing, best practice formation and shaming procedures on the normative basis of rules for flexible employment and streamlined social policy. Low inflation complemented by flexible labour markets and cheaper welfare states were believed to bring credibility in financial markets and thus low interest rates. Low interest rates, in turn,

supposedly enabled higher investment rates. ECB monetary policy thus functioned as the cornerstone of an implicit policy regime in the fields of fiscal, wage, labor-market, and social policy and translating into less flexibility on national or European levels to intervene in the economy to boost employment or provide substantial investments. In other words, it undermined positive integration and, as such, one potential source of a sense of European collective identity (Scharpf 2000: 115). Indeed, policies seen to be contrary to the ECB conception of price stability, indirectly including policies to enhance productivity, were construed as entailing a higher risk of inflation. The price to pay would be higher interest rates. Thus, if anything, EMU contributed to the disintegration of collective identity at the European level as any policy deviation would draw collective punishment. Alternatively, this is conceivable as the construction of a collective identity around fiscal austerity. We will return to this point shortly.

Returning to the fundamentals in the construction of the EMU, the will to bring it about overlooked fundamental asymmetries and, in recognition of the Treaty of Rome, failed to create the effective policy tools for macroeconomic policy convergence as the current Euro crisis testifies to (see section 5). While the OMC conceded too much autonomy to member states in bringing about macroeconomic policy convergence, it also failed to recognise the stubbornness of economic asymmetries between for instance the competitive austerity strategy of Germany around which the EMU was designed and the traditional competitive devaluation strategy of the Southern economies. It thus chose to ignore sceptical comments from policy-makers and scholars pointing out with reference to the Optimal Currency Area thesis that the European Union did not fit the bill (e.g. Eichengreen 2011), nor did it, like the US with its federal fiscal framework, provide the institutional framework for compensating for the consequences of such asymmetries. There were no meaningful funds set aside in the EU budget nor was there a transfer payment system provided to sustain an EU-wide fiscal federalism. Indeed there was an inbuilt asymmetry “between a highly cohesive and supranational monetary policy and intergovernmental fiscal policy”, which shone with its absence apart from the Common Agricultural Policy (CAP) and regional policy funds with only a very limited aggregate fiscal effect (Cafruny and Ryner 2007: 32). To consolidate these matters, the ECB was forbidden from lending directly to EU institutions or member states. Some of this neglect derived from the confidence generated by the preceding period of stability. It was reinforced by a combination of envy of the boom of the US ‘knowledge-based economy’ and the partial success of Europe in copying this growth model (e.g. Grahl 2009). The Maastricht Treaty with the EMU at its core institutionalised a clearly neoliberally inspired growth strategy.

This, but also its weaknesses, could be clearly seen in the social dimension of the European Union, as the EMU came to profoundly determine its fundamental nature and undermining the so-called European Social Model (ESM). As has never been disproven, there is no correlation between declines in real wages and investment rates. Indeed, while profit rates have grown significantly, investment rates have declined. Indeed, if anything the predominance of shareholder value in the anglo-american economies have led to disinvestment strategies. The idea that this would have done away with unemployment seems to have already been disproven by 20 years of pursuit of this policy (e.g. Cafruny and Ryner 2007: 33).

All in all, the framework institutionalised with the Maastricht Treaty has entrenched the eurosclerosis phenomenon by introducing as Cafruny and Ryner (2007: 32) “a vicious circle of restrictive monetary policies, rising unemployment and a decrease of actual and potential growth

without opportunities to provide growth enhancing measures". Indeed, the Maastricht Treaty's promotion of negative integration appeared to have pre-empted positive integration within European integration. Still, before the turn of the Millennium, European spirits were high. The EMU was seen as working with macroeconomic convergence and low interest rates across the board. While growth rates remained low, there was plenty of optimism in Europe. This optimism set the stage for financial integration through the Financial Services Action Plan to be made the centrepiece of the Lisbon Strategy of the 2000s. Indeed, the economic and monetary union was believed to demand the completion of a single market for financial services as transaction costs and exchange rate risk had become mere history.

3.9 Conclusion: Booms and Crises

This section has provided a long historical perspective contextualising and discussing early financial integration in the European Union and the Mercosul. The two respective histories are clearly very different and European integration advanced well ahead of the Mercosul. Yet the two integration processes have their touching points through their intersertion in the global political economy. The Bretton Woods system provided the policy context for very early integration. The two regions shared in the difficulties of the 1970s and early 1980s as a result of the decline of US hegemony. The 1980s saw upswings in the optimism of the integration process. Argentina and Brazil sought closer integration on the back of democratisation and their mixed experiences with Latin American integration. Europe emerged more stable economically and financially. Europe embarked on the creation of a single market while the Southern Cone economies, bar Chile, sought a free trade area and a customs union as first steps towards fuller integration. The neoliberal turns in both regions in the 1990s, however, saw at the artificial cutting off point of the Millennium two very different outlooks. In the Mercosul, Argentina suffered great pains as the Convertibility Plan hit its limits and an inevitable devaluation and subsequent (in 2001) debt default. Brazil, similarly, faced the negative consequences of close currency alignment with the stronger Dollar bringing a sizeable devaluation of the Real. Yet, commitment to Mercosul integration remained intact with financial integration receiving its marching orders with the 1997 Montevideo Protocol. In Europe, on the other hand, Europhoria and decent growth reigned as it had overcome German unification, monetary integration and had set its sights firmly on financial integration.

The report next turns to the 2000s and the deepening of financial integration in both areas.

4) 2000-2007/8 – Accelerating Financial Market Integration

- 4.1 Introduction and the Lisbon Strategy
- 4.2 The Lisbon Strategy
- 4.3 Giovannini Barriers
- 4.4 Financial Services Action Plan
- 4.5 The Lamfalussy Process
- 4.6 Basel II and the Capital Requirements Directive(s)
- 4.7 Mercosul
- 4.8 Conclusion

4.1 Introduction

The period from the turn of the Millennium to the onset of the financial and economic crisis was a period of waning optimism in Europe, from the heady heights around the Millennium to the uncertainty generated by the crisis. It was also a period of significant acceleration of financial market integration. While financial integration had progressed significantly in wholesale services, retail services remained highly segmented principally along national lines. The Cardiff Council meeting in 1998 had called for a Financial Services Action Plan (FSAP) to remove the final barriers to the completion of the single financial market. FSAP took centre stage in the Lisbon Strategy and was granted a special procedure to accelerate its implementation, famously named after the chairman of the committee Alexandre Lamfalussy. The Lamfalussy report also called for the creation of new network-based committees of local supervisors for law-making and supervisory co-ordination: CESR (securities markets), CEBS (banking), and CEIOPS (insurance and occupational pensions). FSAP was given a sharp deadline of 2005. The Commission adopted a new legislative definition of financial integration (Baele et al. 2004), broadly in line with the idea that formal integration would lead to the rule of “the law of one price”. The period sees a shift in the direction of governance towards a private-public orientation with the Commission increasingly delegating preparatory and advisory work to market actors perceived to have the relevant expertise. The Commission was increasingly accepting the orthodoxy of Financial Economics with an emphasis on micro-economic theory, according to which markets are near capable of self-regulation (e.g. Muegge 2011; Dorn 2012). However, the climate amongst member states was more mixed with a clear divide emerging between a Northern and a Southern coalition, with final convergence around the preferences of the Northern coalition (Quaglia 2010).

In the Mercosul, on the other hand, the economic outlook grew in optimism from the lows of the Brazilian and Argentine crisis around the Millennium. Brazil became “a BRIC” in the global economy and Argentina recovered. In the context of Venezuelan accession, Paraguay asserted itself to push for the creation of the structural convergence fund FOCEM. However, the key development in the region was the leftwing shift in much of the whole of South America and the relative decoupling from US influence. These developments clearly took place in the Mercosul too. The flexibility of the intergovernmentalist integration process in the Mercosul enabled a shift away from the neoliberal characteristics of the integration process in the 1990s and towards a Social Democratic process with limited redistribution (e.g. FOCEM). In the work of SWG4, largely determined by the ambitious Montevideo Protocol’s Liberalization Action Plan of 1997, this translated into an added dose of caution. The question at the end of the period, however, was whether the cautious liberalization of the SWG4 was congruous with the rest of the integration process.

This section will outline the FSAP and its implementation through the high-speed legislative process set out by the Lamfalussy Report. It will also contextualise these developments by means of looking at the developments in the international context. This will bring the section to an account of developments in the Mercosul. In conclusion, the section argues that developments in the financial integration processes of the two regions were characterised by a similar liberalization agenda. Yet, the overarching regional integration processes were moving in somewhat opposite directions, which resulted in different outcomes in the context of the coming global financial and economic crisis.

4.2 The Lisbon Strategy

Introduction

At the Millennium, the European project of integration was on a high. Optimism derived from the successful rebirth of the integration project with the signing and operationalisation of the Maastricht Treaty, including Monetary Union, Germany's successful tackling of the early challenges of unification and an economy perceived as macroeconomically sound characterised by disinflation, public finance stabilisation and low interest rates. Europe committed to becoming the most competitive and dynamic knowledge-based economy in the world sustained by the liberal integration of the world's largest financial market. This sub-section will outline this strategy, known as the Lisbon Strategy.

Description

At the 2000 Lisbon Summit, the European Commission (2000) confidently set out the objectives for the 2000s. Europe was, despite relatively high unemployment and weak productivity growth, in a uniquely strong position to catch up with and even surpass its main competitor in the global economy, the US. Enviously looking at the US tech-stock boom, the key was information-technological development combined with the full exploitation of the largest single market in the world and a supportive social dimension. Indeed, the lag in technological development was said to be the cause of weak output dynamism and relatively high unemployment figures, but if addressed would catapult Europe to global leadership (Grahl, 2009). It thus set out in its Lisbon Strategy "to become 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" by 2010 (Presidency conclusions, Lisbon European Council, 23 and 24 March 2000).

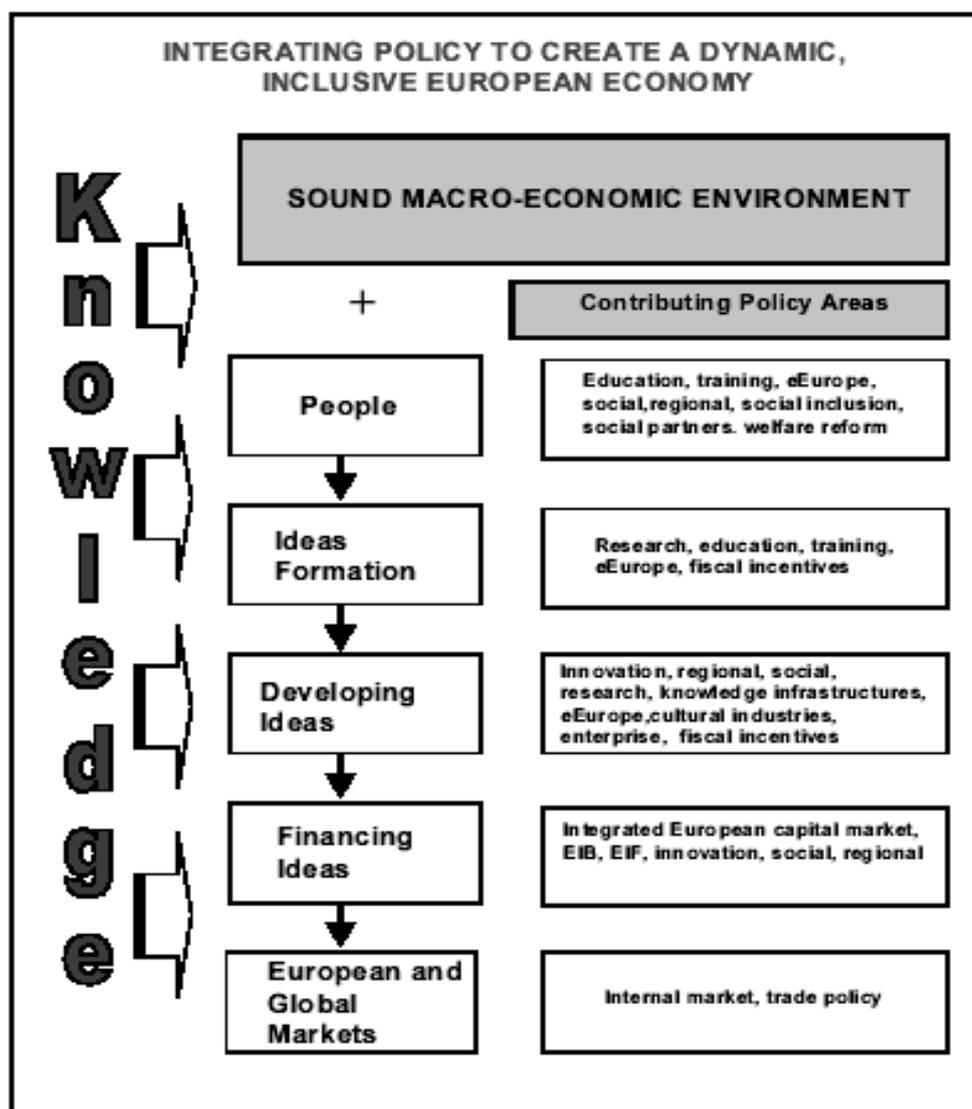
Knowledge was to be the driver for productivity and economic growth in this "new economy", in which innovation derived from knowledge-infused "human capital". Europe's "knowledge-based economy" was designed, as opposed to the new economy in the US, to have a strong social dimension. Reformed welfare states were to be transformed into "social investment states" capable of "preparing" labour, and "activating" pacified benefit recipients, for participation in a flexible and dynamic knowledge-based economy (e.g. Morel et al. 2011). Its strong social dimension was presented as a European strength, not a drain, although significant reform was needed.

The Commission (2000) identified financial integration as a fundamental premise for this knowledge-based economy. An efficient single market for financial services with "an integrated capital market and a dynamic financial services industry" was to provide the fuel for the acceleration of innovation and the source of discipline for corporate governance and member states. This was inspired by US financial economists believing in the market's superiority over that of organisations with regards

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efficient allocation of resources, in accordance with the 'efficient market hypothesis' (Fama 1970). Managers should be deprived of corporate control with the latter turned into a tradeable commodity (shares). Managers were to be disciplined in their decisions to reinvest or distribute profits. In case managers cannot deliver shareholder value by allocating resources efficiently, the 'free cash flow' should be distributed to shareholders who can reinvest in a more efficient manner. Shareholders were principals and managers their agents (Jensen and Meckling 1976; Fama and Jensen 1983). If shareholder value paradigm is followed, everyone will be better off (pareto optimal): managers, workers, consumers, suppliers and distributors. Indeed, the European economy as a whole would benefit. The financial options for enterprises would be widened and the costs of capital lowered. A takeover market was to be introduced through the Takeover Directive to connect the FSAP with corporate governance in the real economy. Low capitalisation of European equity markets and their fragmentation were to be overcome by removing administrative and legal obstacles. Investment capital was to be significantly boosted by attracting pension savings managed by institutional investors through the removal of portfolio restrictions. Thus, the Financial Services Action Plan discussed and devised in the preceding Council meetings were to take centre stage in the successful operationalisation of the Lisbon Strategy.



Conclusion

Europe's Lisbon Strategy appears in hindsight strikingly misconceived. Firstly, recent research has pointed out the now obvious. As Petit has recently argued, the Lisbon Strategy appears in hindsight distinctly outdated. It endeavours to create a European "new economy" in order to overtake its main competitor. Of course, the US had already implemented strategies to create this economy for over a decade. While it could be argued that the infrastructure and the cultural readiness were not there for its sustained success in the 1990s with cost recovery models clearly underdeveloped in the US, as proven by the bursting of the tech-stock bubble (2012), the same can be said for Europe in the 2000s. Secondly, little consideration was given to the possibility that unemployment and technological lag were due to the strict monetary and fiscal stabilisation measures imposed on the economy in order to launch the Euro, or the shift to the distribute and downsize model encouraged by the shareholder value paradigm (Boyer 2001). Quite arguably, this served to subdue the productivity growth so urgently sought (e.g. Cafruny and Ryner 2007; Grahl 2009). Finally, while European global competitiveness may require large and liquid security markets, there was no acknowledgement of that the evidence of the superiority of US-style financial structures was weak. Financial integration in Europe could have taken on different characteristics than those sought, and thus sustaining the continental bank-based system for the provision of investment capital. This point will be developed further in the overall Conclusion of this report. Next, the section turns to the barriers identified as preventing the creation of the world's largest single market for financial services.

4.3 Giovannini Barriers

Introduction

This sub-section outlines the Giovannini barriers, after the chairman of the committee identifying the remaining obstacles to financial integration. These Giovannini Report(s) lay the foundation for the Financial Services Action Plan, at the heart of the Lisbon Strategy.

Description

The 1988 Cecchini Report had set out the remaining barriers to the European Single Market in the so-called "1992 Programme" designed to materialise the 1986 Single Act. It had also estimated the benefits to be gained from their removal as permanent and high. The 1992 programme took significant steps in achieving this (e.g. Pelkmann 1994). However, while barriers to the exchange of financial services were very much part of this calculation (Cecchini et al. 1988, ch. 6), these were not substantially addressed by the 1992 programme. The Investment Services Directive of 1993 (ISD) had aimed at providing the legislative framework for the full harmonisation of the European market. The ISD had set minimum standards for national securities regulations. Investment firms were to be operating with a "single passport" according to the principle of "mutual recognition", authorised and supervised according to the principle of home country control. Integration of wholesale markets had progressed significantly further than in retail services (e.g. Financial Services Authority, 2003). However, technological developments and the emergence of alternative trading systems demonstrated the need to revise this framework to include a wider range of market actors. With the common currency anticipated to provide a major boost to financial market integration and the

operationalisation of the Monetary Union in stage three, the Commission set out to take the steps needed for the completion of the single market for financial services in the new Millennium. Keen on seeking advice from, indeed wishing to concede the lead on financial market integration to, financial market participants themselves, the Commission called upon banker Alberto Giovannini to undertake a series of studies of the remaining barriers to the completion of a single market for financial services, and how to remove them (Commission, 1997). Focusing in particular on cross-Border Clearing and Settlement Arrangements in the European Union, fifteen “Giovannini barriers” were identified, as well as the body to address them and the sequencing of their removal:

Giovannini Barriers			
No.	Barrier	Suggested Reform	Body
1	National differences in information technology and interfaces	Harmonisation of information technology and interfaces used by clearing and settlement providers across border via an EU-wide protocol.	SWIFT and the Securities Market Practice Group (SMPG) to provide protocol. Coordination provided by ESCB.
2	National clearing and settlement restrictions that require the use of multiple systems	Enable market-led integration of EU clearing and settlement arrangements by removing national restrictions on the location of clearing and settlement and on that of securities.	National Governments to remove barriers, possibly in context of the new Investment Services Directive.
3	Differences in national rules relating to corporate actions, beneficial ownership and custody	Harmonisation of national rules relating to corporate actions processing.	Local agent banks, European Credit Sector Associations and ECSDA to coordinate private-sector proposals. National governments to respond via the relevant EU Council.
4	Absence of intra-day settlement finality	Ensure intra-day settlement finality in all links between settlement systems.	ECSDA to coordinate in consultation with the ESCB/CESR Joint Working Group.
5	Practical impediments to remote access to national clearing and settlement systems	To ensure a level playing field, the removal of any practical barriers to remote access to national clearing and settlement systems.	National governments to draw up the conditions upon which EU-wide access can be guaranteed. ESCB and CESR to set requirements.
6	National differences in settlement periods	Harmonisation of settlement periods for all equity markets. Yet, choice of appropriate settlement period is still open. Further study was deemed to be necessary.	Commission to commission further studies on the issue.
7	National differences in operating hours/settlement deadlines	Harmonising operating hours and settlement deadlines using TARGET system as benchmark. Top priority.	ECSDA and ESCB
8	National differences in securities issuance practice	Harmonisation of securities issuance practice, in particular in relation to allocation of ISINS.	The International Primary Market Association (IPMA) and the Association of National Numbering

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			Agencies (ANNA) to draw up proposals
9	National restrictions on the location of securities	See 2	See 2
10	National restrictions on the activity of primary dealers and market makers	Removing any outstanding restrictions on the activity of primary dealers and market makers	National governments. Coordination by relevant EU Council
11	Domestic withholding tax regulations serving to disadvantage foreign intermediaries	Ensuring a level playing field for financial intermediaries, whether local or foreign, in offering withholding agent services in all Member States.	National governments. Coordination by relevant EU Council.
12	Transaction taxes collected through a functionality integrated into a local settlement system	Ensuring a level playing field for domestic and foreign investors through the removal of any provisions requiring that taxes on securities transactions be collected via local systems.	National governments. Coordination by relevant EU Council.
13	The absence of an EU-wide framework for the treatment of interests in securities	Implementation of the EU Collateral Directive to remove much of legal uncertainty relating to netting and the uneven application of conflict of laws by the scheduled date of 27 December 2003. Also, provision of EU-wide legal framework to establish, when using intermediaries, intermediary ownership of securities. An EU Securities Account Certainty project to be set up to this end in order to draft required reform and set aside adequate resources.	Implementation of Directive and setting up of Project to be addressed by national governments.
14	National differences in the legal treatment of bilateral netting for financial transactions	See 13	See 13
15	Uneven application of national conflict of law rules	See 13	See 13

- First Sequence (within 2 years)
- Second Sequence (within 2 years + 3 months)
- Final Sequence (within 2 years + 1 year)

Conclusion

The Giovannini reports' on Cross-Border Clearing and Settlement Arrangements (2001; 2003) identified significant barriers remaining to integrated financial markets in the European Union. Some

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of these remained despite the reforms undertaken under the Investment Services Directive of 1993, but new barriers had arisen as a result of technological developments and the emergence of alternative trading systems. New market actors were not sufficiently addressed by existing legislation, which had been drawn up on the basis of the principle of minimum harmonisation. Segmentation required more intensive harmonisation. As such, they focused on liberalising regulation in the form of more detailed harmonisation, and less on supervision of this new marketplace. Noteworthy is the turning to financial market actors themselves in drawing up this list. This signals the Commission's shift away from the previous period's emphasis on publically led financial market regulation and towards private-led regulation by giving large financial firms the lead in regulation in drawing up this list (e.g. Dorn 2012). Unsurprisingly, the Giovannini reports (2001; 2003) urge, to the greatest extent possible, that financial firms should lead the process identifying their needs in the functioning of a European single market for financial services. The language of financial market integration in Europe is technical with the effect of depoliticising the issues at stake.

4.4 The Financial Services Action Plan

Introduction

While financial integration had progressed significantly in wholesale services, retail services remained highly segmented principally along national lines. The Cardiff Council meeting in 1998 had called for a Financial Services Action Plan (FSAP) to remove the final barriers to the completion of the single financial market. This was acted upon by the Commission for the Vienna Council meeting later in the year and actioned in the 1999 Cologne meeting. FSAP took centre stage in the Lisbon Strategy and was granted a special procedure (the "Lamfalussy Process") to accelerate its implementation. New network-based committees of local supervisors were created for law-making and supervisory co-ordination: CESR (securities markets), CEBS (banking), and CEIOPS (insurance and occupational pensions). FSAP was given a sharp deadline of 2005. This section outlines the FSAP, the Lamfalussy Process, the work of the new network-based committees before giving greater attention to key pieces of legislation, including the Market Abuse Directive (MAD), the Prospectus Directive, the Transparency Directive and MiFID. Particular attention here will be given to MiFID.

Description

A market-driven modernisation of EU securities and derivatives markets was considered to have been catalysed by the introduction of the Euro. In completing the single financial market, FSAP sets indicative priorities and a timetable for achieving three strategic objectives: establishing "a single market in wholesale financial services, making retail markets open and secure and strengthening the rules on prudential supervision" (Summary of Commission Communication COM(1999) 232). In the area of retail markets, the Commission noted with confidence that the legal framework to protect against institutional failure and systemic risk was in place. Remaining to be addressed were legal obstacles for the provision of retail services and cross-border purchasing (e.g. single bank account, mortgage credit). Additional work was envisaged in the area of prudential structures and taxation. A total of 42 legislative measures were designed to be implemented by 2005.

The FSAP identifies that a response to the introduction of the Euro was already visible in the organisation of financial marketplaces. The Plan understood fundamental changes in financial markets to be driven principally by wholesale services. Six areas were targeted for reform.

1. Integrated securities and derivatives markets need a common legal framework. This was to be achieved by significantly updating the Investment Services Directive through the introduction of the Markets in Financial Instruments Directive (MiFID) and the Markets Abuse Directive (MAD)(see below).
2. Barriers remaining to raising capital EU-wide were to be removed by updating Directives on public offer prospectuses and reporting requirements. Two new directives were thus introduced: the Prospectus Directive and the Transparency Directive (see below).
3. Listed companies should issue a single set of financial statements. This was to be achieved on the basis of international standards, notably the International Accounting Standards (IAS) and the International Standards on Auditing (ISA).
4. In response to the liberalisation of pension provision, especially in the area of supplementary pensions, and the idea of attracting substantial pension funds, a coherent legal framework regulating supplementary pension funds was necessary. A Directive on the prudential supervision of pension funds was to be introduced to this end.
5. To facilitate cross-border securities trading, legal uncertainties in relation to the mutual acceptance, use and enforceability of cross-border collateral were to be removed through a new Directive in this area.
6. Perceived as key to introducing greater discipline in the area of corporate governance was the creation of a transparent and secure European space for corporate cross-border restructuring. The Directive on Takeover bids and the European Company Statute were to be adopted to this end (see below).

Substantial barriers were also identified in relation to retail markets:

1. To facilitate cross-border investments for savers, transparency, security and the provision of information pertaining to the cross-border provision of retail financial services had to be enhanced.
2. To strengthen trust in cross-border transactions, redress procedures had to be strengthened. Out-of-court facilities were to be provided.
3. Consumer protection rules across the EU had to be better understood in order to balance their application EU-wide.
4. Critical to the functionality of the knowledge-based economy, trust in electronic commerce had to be strengthened through the adoption of Directives for their safe functioning.
5. National rules on insurance intermediaries required harmonisation as their unevenness were perceived as hampering the freedom to provide services.
6. Punishing charges for cross-border payments had to be reduced in order to provide a level playing field for domestic and cross-border retail payments.

Barriers were also identified in terms of prudential structures, tax barriers and other related distortions. Systemic and institutional risks were understood as potentially emerging out of the creation of new sources of financial risk. Regulatory safeguards were to keep up with the changing risk landscape and new realities in the integrated single market. State-of-the-art supervisory practices were to be adopted across the EU (e.g. solvency margins for insurance companies and capital adequacy rules). Tax coordination across financial markets, and particularly relating to the effective taxation of cross-border savings income, had to be completed as it rendered the creation of a single market for financial services politically challenging.

This raft of legislative measures clearly testifies to the centrality of financial integration assigned by the Commission. Considering the political, legal and technical challenges involved in their negotiation and implementation, it is rather extraordinary that 93% of these measures were adopted by mid-2004. Towards the end of this outline of the FSAP, we will analyse this achievement. Further illustrative of the ambitious nature of regulatory work in the area of EU financial integration is that during the work on the implementation of the FSAP, the Commission lengthened the list of required measures to be addressed upon the completion of the Plan. This list included further work on money laundering, capital adequacy and cross-border mergers. Yet, this achievement would not have been possible without the careful consideration of the prioritising and sequencing of legislation as well as the very legislative procedure through which significant parts of the FSAP was to be implemented. We turn to these considerations next, as discussed by the Lamfalussy Report.

4.5 The Lamfalussy Process

Introduction

To meet the challenging 2005 deadline of the FSAP, the EU's Economic and Finance Ministers (ECOFIN) commissioned a report from a Committee of Wise Men in 2000, formed under the leadership of Alexandre Lamfalussy. The remit given was the evaluation of the priorities of the FSAP and assessing further needs to ensure greater convergence of the markets.

Description

The Committee produced a report, popularly known as the Lamfalussy Report, in early 2001. It is significant for three reasons: firstly, it set the priorities for the implementation of the FSAP. In 2003, priority was to be granted to:

- the Prospectus Directive to include a system for mandatory shelf registration;
- the modernisation of securities listing requirements;
- the generalization of the principle of mutual recognition for wholesale markets, including a clear definition of the professional investor;
- the modernisation and expansion of investment rules for investment funds (UCITS) and pension funds;
- the adoption of International Accounting Standards; and,
- the adoption of the single passport for recognised stock markets (on the basis of the principle of mutual recognition).

Notably, it also acknowledged the regulatory and supervisory weaknesses in the financial system, especially with regards micro-/macro-prudential supervision and cross-border financial conglomerates. It promoted encouragement of convergence in this area. However, this was not given top priority.

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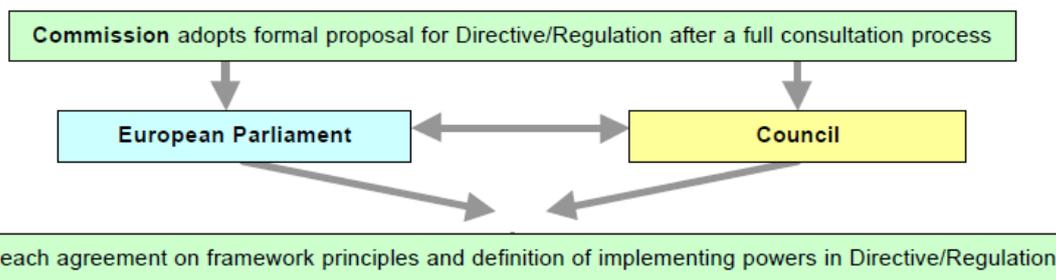
Secondly, the Lamfalussy Report also called for the creation of new network-based committees of local supervisors for law-making and supervisory co-ordination: CESR (securities markets), CEBS (banking), and CEIOPS (insurance and occupational pensions)(the so-called “Level 3 Committees”). These committees were to play a significant role in the design of the FSAP legislation. Thirdly, and perhaps of the greatest significance in terms of accelerating the implementation of the FSAP, the Lamfalussy Report advocated a special legislative procedure for the fast-tracking of the raft of legislative measures. This came to be known as the Lamfalussy Process and was implemented in legislation pertaining to substantial reform area of securities under the FSAP (see flowchart immediately below). It has, following the signing of the Lisbon Treaty in 2007, subsequently been rolled out to be implemented in banking, insurance and occupational pensions.

The Lamfalussy Process involves a legislative four-level approach, which has served to speed up the legislative process significantly as it reduces the co-legislators’ (the Parliament and the Council) involvement with regards the provision of what is considered to be technical detail. It delegates significant powers to the Committees, populated by national regulators. At the first level, the co-legislators engages in “political” co-decision-making and relating to framework principles. The Commission, acting on the second level adopts so-called “delegated” or “implementing” acts. The Commission will typically seek the advice from the Committees on the technical details to be included in legislation at this level. The Committees can also pre-empt Commission legislative work by providing draft regulatory or implementing technical standards that may subsequently be adopted by the Commission (although this may be objected to by either Council or Parliament in the case of regulatory standards). At the third level, the Committees seek convergence in regulatory practices through the organisation of peer-review, as well as issuing recommendations and guidelines and compares regulatory practice, to secure harmonised implementation and application of level 1 and 2 rules. The Commission, finally, supervises member state compliance with EU legislation with the power to take legal action if non-compliance is found.

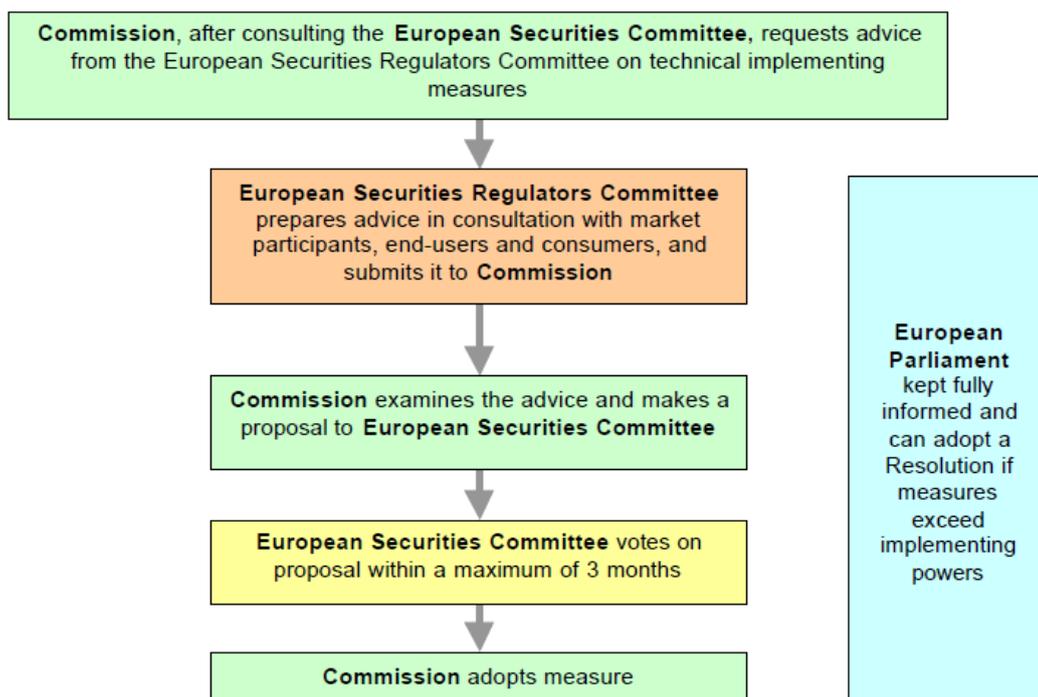
The Lamfalussy recommendations were adopted with only minor alterations.

THE FOUR-LEVEL APPROACH RECOMMENDED BY THE COMMITTEE

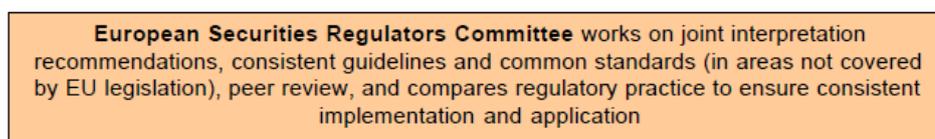
LEVEL 1



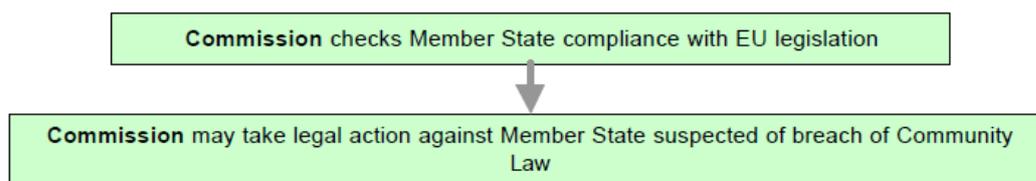
LEVEL 2



LEVEL 3



LEVEL 4



Taken from the Committee of Wise Men Report (2001: 6).

Emerging out of the Giovannini and Lamfalussy reports was the Eurosystem's definition of financial integration, which is distinctly 'legal' (Baele et al. 2004: 6):

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The market for a given set of financial instruments and/or services is fully integrated if all potential market participants with the same relevant characteristics (1) face a single set of rules when they decide to deal with those financial instruments and/or services; (2) have equal access to the above-mentioned set of financial instruments and/or services; and (3) are treated equally when they are active in the market.

With law harmonised, agents face a single set of rules. Yet, financial integration does not have to follow as discrepancies in non-legal enforcement (norms and trust) can persist. Of course, while legal in character, there is a link to ‘the law of one price’. Gertrude Tumpel-Gugerell, member of the ECB executive Board develops this in a 2006 speech (Tumpel-Gugerell, 2006):

there is a strong conceptual link between financial efficiency, financial integration, financial development and economic efficiency. The performance of a financial system, and notably its efficiency, is influenced by its fundamental features in conjunction with the processes of integration and financial development. The fundamental features of a financial system include i) the legal system, financial regulation and corporate governance, ii) the financial structure – the balance between markets and intermediaries iii) market infrastructure (payment, clearing and settlement systems) and iv) other conditioning features, such as social norms, religion and political systems.

Without empirical underpinning, she warns, the link between financial and economic efficiency seizes to have direct policy relevance. Reassuringly, she references research making that link, although, given the number of variables involved (e.g Guiso et al. 2005), this research can hardly be seen as conclusive (e.g. Cafruny and Ryner 2007).

The Lamfalussy constituted a major innovation with regards the legislative process. It was testpiloted in the substantial area of securities legislation, and thus served to accelerate the implementation of the FSAP. The process outlined was clearly private-led with questions arising with regards its soundness in terms of regulation. The sub-section continues with a consideration of a select number of key and related Directives in the area of Securities.

Effective in 2005, the Prospectus Directive harmonises the format for prospectuses across Europe. It updates, replaces and consolidates a number of older Directives. Firms can submit the same prospectus for admission of the trading of their securities to trading to their local regulator as to any other European regulator for access to other European markets according to the principle of mutual recognition. Not having to re-apply to the local regulator in this process will serve to cut costs to companies by avoiding delays and costs inherent in the re-application process. Investors are also supposed to benefit from the Directive by enjoying standardised and consistent information when choosing between different securities on offer. As such, a key information-related obstacle to trading on European markets is removed, enabling greater diversification of portfolios and thus supposedly more effective risk management strategies.

Adopted in 2004 and updating and replacing the “Consolidated Admissions and Reporting Directive” (CARD), the Transparency Directive (TD) is based on the principle of mutual recognition and minimum harmonisation in that the rules of the security issuer’s home member state will apply no matter to which regulated market in a member state the securities are admitted. It creates a common basis for the periodic provision of information, notifications of major shareholding and storage of regulated information. The TD thus ensures greater quantity and quality of information facilitating cross-border securities issuance and trading. This in turn is to support the effective working of the price mechanism.

The Markets Abuse Directive (MAD) was implemented in 2005 designed to strengthen confidence in the integrity of the European single market for financial services and enhanced crossborder cooperation in a context of growing cross-border trade. It addresses all individuals and firms operating in regulated markets. The pre-existing Insider Dealing Directive was considered out of date and incomplete by not addressing market manipulation. As such, MAD is a key legislative measure within FSAP. MAD was intended to harmonise diverse member state regimes in tackling market abuse, a diversity which had brought increasing uncertainty in financial markets as new products and technologies had been developed. MAD defines and addresses insider information and market manipulation. It stipulates extensive reporting requirements to ensure that market abuse and manipulation are pre-empted or identifiable.

The perhaps most extensive and significant directive related above all to the infrastructure in securities markets: The Markets in Financial Instruments Directive (MiFID). MiFID is a cornerstone piece of legislation of the FSAP and enjoyed fast-tracking legislation thanks to the Lamfalussy Process. It came into effect in 2007 replacing the outdated Directive on Investor Services (ISD). It is interesting for its relationship to the two Directives introduced above as constitutive of a significant core of the FSAP. MiFID represented a shift towards a much more intensive regulatory approach aiming at full harmonisation and the creation of a single rulebook for the European single market for financial services, as opposed to mutual recognition or minimal harmonisation. However, MiFID was already called up for extensive review in 2010 as the crisis revealed weaknesses in its regulatory provision. MiFID had provided the loopholes for the expansion of “the dark side of trading” demonstrating its limitations in providing effective (FinanceWatch 2012).

Developed on the basis of the single passport principle of mutual recognition, MiFID enables investment firms, multilateral trading facilities (MTFs) and regulated markets to operate throughout the EU on the authority of the home country. It extends the coverage of the ISD setting new and more elaborate requirements for firms to adapt, especially with regards to business conduct and internal organisation. The range of firms addressed by MiFID includes stockbrokers and broker-dealers, portfolio managers, investment banks, corporate finance firms, some commodities firms and many futures and options firms. Perhaps the main objective of MiFID is the harmonisation of investor protection. It also contains, at level 3, guidelines for market participants to ensure consistency of implementation and coordination of supervisory practices.

While the ISD allowed the monopolising concentration rule, which required investment firms to route orders through stock exchanges only, MiFID prohibits this rule. Instead, it allows for the competing principle of “dark trading”, e.g. through the operations of systematic internalisers. The purpose is to create a market for markets, or competition between typically privatised markets allowed to take a range of forms (“fragmentation”). Competition between markets is supposed to lower costs of finance and thus promote reliance on market-based funding for investment. Ultimately, the resulting fragmentation of the European marketplace is to give way through competition to a consolidating monopolisation across Europe. This was a hotly contested topic though between advocates of the concentration rule (typically Continental Europeans with a sustained tradition of stock exchange monopolies) and the fragmentation camp represented by a Northern coalition of fragmented securities markets led by the City of London (following the early 1980s “Big Bang”). The concentration advocates argued that the fragmentation principle significantly weakened the price mechanism by obscuring orders and prices and undermining supervision through discretionary practices. The fragmentation camp claimed that it represented the needs of modern financial markets and embracing intermarket competition. The fragmentation camp won

the day, although “best execution rules” requiring firms to post order and price lists (albeit with significant time lag) were introduced to enhance the price mechanism.

Quite possibly, ‘the wrong team won’, as argued by FinanceWatch (2012). Feeding into the MiFID review starting in 2010, the watchdog convincingly argues that MiFID’s embrace of fragmentation at the expense of the concentration rule has supported speculative behaviour stretching the intentions of MiFID well beyond its initial provisions in providing dangerous loopholes to be exploited by “the dark side of trading”. The report points to the examples of Over-The-Counter (OTC) trading and dark pools trading, including Broker-Crossing Networks, the use of which, in their opinion, has significantly exceeded their designs. With the design of these poorly regulated marketspaces intended for transactions with ‘no market impact’ to protect their use has gone well beyond the latter function and effect. With regard to OTC trading, this was intended to enable exceptional trades of particular complexity and size, for instance hostile takeovers, that made these transactions unfit for exchange trading. Today, OTC trading constitutes around 40% of total volumes on European equity markets. What is more peculiar is that the typical size of these transactions is actually smaller than the typical market transaction and that this tendency is growing stronger. With such a large proportion of equity trading taking place immediately beyond that which informs the price formation mechanism, MiFID is clearly sponsoring market practices that it was not designed to sponsor and which are likely to render financial markets inefficient in their basic functions. Furthermore, FinanceWatch argues that a common motivation for avoiding “lit markets” is to conduct high frequency trading (HFT). “Dark Pools” have come to particularly attract this type of ultraquick, algorithmic trade. While, again, the initial purpose of dark pools was to enable the posting of large block orders to render them non-transparent and thus limit their market impact, the non-transparent conditions of dark pools enables the arbitrage opportunities for huge volumes of small HFT transactions. As such, the swelling of dark pools further testifies to the growing volumes of trades that do not contribute to the price formation mechanism. Finally, a new, meekly regulated and rapidly popularising new type of dark platform has emerged, ‘brokercrossing networks’, thanks to the imprecision of MiFID in its definition of trading platforms. Sizeable broker-dealers sponsor dark ‘trading clubs’ that combine multilateral (matching of client orders with each other) and bilateral (trading against the client on own account) trading. This development contributes to the growth in the dark side of trading as a consequence of MiFID’s limitations, and with that the growing dysfunctionality of European financial markets.

In the final analysis of MiFID, FinanceWatch identifies significant growth in HFT as facilitated by the rapid expansion of dark trading platforms, and attributes a loss of confidence in European financial markets to this development. The report’s conclusion is that dark trading should be strictly confined to large block orders. Loopholes in MiFID should thus be closed to enhance market transparency, protect investors and empower regulators.

Conclusion

The Financial Services Action Plan was intended to build on the introduction of a common currency to bring a strong disciplinary dimension to support the construction of a European knowledge-based economy. Especially in the area of securities regulation, benefiting from the Lamfalussy Process, a generally “permissive consensus” favouring “regulatory liberalism” seems to have enabled impressive progress (Gamble 2009; Muegge 2012). The implementation of the FSAP was supposed to have been reinforced through the introduction of the Takeover Directive. This strategy was inspired by developments in the US both theoretically (Financial Economics) and practically (‘new economy’). However, the success of the FSAP has proven uneven and struggles over the Takeover Directive have not only continued but have magnified with the crisis. The Commission’s ambitions to develop the most competitive knowledge-based economy in the world by 2010 failed miserably, a

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development that was firmly consolidated by the onset of the Euro Crisis (see Section 7). As Muegge (2012: 4) argues, however, “[t]he operation of pre-crisis governance depended on the reproduction of beliefs about the inner workings of financial markets and, flowing from that, the desirability of cross-border market integration and regulatory liberalism.” These beliefs have been shaken, but it is questionable whether the shock has resulted in a paradigmatic shift. Section 7 considers this to a greater extent, although to draw any firm conclusions on this would be premature at this point.

4.6 Basel II and the Capital Requirements Directive(s)

Introduction

The Euro crisis has spelt a striking failure of the capital requirements regime not only in Europe but also internationally. Translating from the Basel II accords of the Bank of International Settlements, the European requirements regime, the Capital Requirements Directive(s)(CRD), replaced directives relating to the 1988 Basel I Accords that had set out shared capital adequacy standards for international banks in response to the 1980s debt crisis and the lax banking standards that had applied in many advanced market economies. Basel II was designed as state-of-the-art with both greater risk-sensitivity, flexibility and a distinct pan-European supervisory body to monitor the adherence of credit institutions (here including banks) to the Directives. Still, the crisis revealed the flaws of the CRD, especially with regards its private nature through its reliance upon the ratings of credit rating agencies and its self-regulatory character. Basel II are currently being revised with new Basel III accords negotiated.

Description

In 2007, the EU internalised the Bank of International Settlements Basel II accords. It contains two directives on credit institutions and investment firms with a particular focus on capital adequacy levels. It replaces a series of directives related to the 1988 Basel I Accord. The new directive(s) were designed to be more risk-sensitive, but also more flexible for market users. The Basel Accords emerged in a period of regulators working intensively to create and strengthen prudential standards capable of withstanding shocks deriving from global financial crises.

CRD consists of three pillars:

- Larger credit institutions could choose from a menu of types of risk weighting standards (standard, foundation and advanced) applying different kinds of measurements to fit the credit, market and operational risk profile of credit institutions. For smaller credit institutions, risk weighting measures were provided by credit rating agencies (CRAs);
- a supervisory review process notably founded on an internal assessment by the credit institutions themselves. Firms and supervisors are required to establish whether additional capital should be held and act upon such assessments; and,
- a public disclosure rule allowing for market discipline through the market judgement of the risk worthiness of credit institutions on the basis of the disclosure of information pertaining to risks, risk management and capital held.

The single market passport principle applied in so far as credit institutions were allowed to operate across the EU once their own national regulatory bodies had approved their adherence to the CRD (mutual recognition). Nevertheless, the new Committee of Banking Supervisors (CEBS) had been assigned to monitor cross-border issues and to harmonise national supervision of credit institutions.

Conclusion

Basel II and CRD typified trends in banking regulation after the East Asian financial crisis. Private market actors were given a considerable role in monitoring credit institutions through public disclosure and self-assessment. For smaller credit institutions, CRAs were given a significant role in assessing risk-weightings. However, with the issuer-pays remuneration model, CRAs were perversely incentivised to provide positive assessments. For larger credit institutions, banks did not only design risk-weighting assessment methods themselves but also played a role in monitoring their adherence to the capital adequacy regime. To see how this formula leads to pro-cyclicality is, at least in hindsight, not so challenging (e.g. Chwiero 2011; Hlleiner 2011).

4.7 Mercosul

Introduction

This part of the section shifts attention to the Mercosul ahead of the comparative conclusions to be made at the end of the section. It discusses Mercosul emergence out of the late 1990s shaken by the Brazilian economic crisis of 1998 and the Argentine collapse in 2001. Out of these crises, social democratic governments rose with a desire to seek greater autonomy from US influence. This part explores how this contributed to a shift in regional integration from an emphasis on democracy to a focus on participative and social dimensions. Yet, the smaller member states played a key role. Indeed, Paraguay's intervention resulted in the creation of a Structural Convergence Fund Mercosul (FOCEM). Integration remained slow due to strong intergovernmentalism, Venezuela's accession and sustained divergences within the region. The strong intergovernmentalism in Mercosul allowed for the shift in direction, yet has hamstrung progress in the development of deliberative institutions, which are important to legitimating financial integration. Structural divergences persisted to contribute to a sensible degree of caution. Mercosul also welcomed Venezuela into the region. The section outlines the work of SWG4 in this context, which is striking for its persistence in pursuing its Montevideo remit. This part provides less technical detail and more historical narrative.

Mercosul Developments

Mercosul emerged out of the late 1990s shaken by crises in the two big member states. This set the context for regional integration in the 2000s, including, of course, financial integration. Affected by the East Asian crisis, the Brazilian economy entered into crisis in 1998. Argentina was less susceptible at that point, but fell victim to its strong dollar peg in 2001 as its lower productivity to the US led to balance of payment problems. At the same time, the economies of the Southern Cone were getting

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ready to seek greater independence in the historical relationship to the hemispheric influence of the US. The Washington Consensus had failed to generate the promised results and US political influence in the region was waning. This provided scope for Mercosul to develop more independent economic thinking.

While Paraguay and Uruguay played significant roles in the Mercosul in the 2000s, the driving axis of the organisation remains Brazil and Argentina (Giardini 2011: 191). In this context, it is no secret that Brazil came to seek a regional leadership role especially under President Lula, albeit a solidaristic and consensual such, to establish a global position on the basis of its growing economic power. Mercosul served a central purpose to this end (e.g. Giardini 2011). Under President Lula, Brazil saw a social democratic shift forged on the basis of “a consensus regarding the goals of high economic growth with mild redistribution” (Schmalz and Ebenau 2012). In Argentina, seeing Mercosul as “an instrument of economic development” with Brazil being its first business partner, the election of President Kirchner struck a general political chord with Brazilian political developments. The left-wing shift in “the big two” resonated in Paraguay with President Duarte’s accession in 2003. This left-wing shift clashed with Mercosul’s liberal constitution to bring about caution. Still, the interpresidentialism of the Mercosul enabled the flexibility to generate a left-wing momentum in Mercosul integration with a shift of emphasis from democracy towards participation and social dimensions (in terms of poverty reduction, social inclusion and equality)(Giardini 2011: 193).

In terms of trade, while the 1990s had seen patterns of trade and investment diversify within the region towards trade in industrial goods, the 2000s saw rapid growth in trade with Asia, especially Brazil’s trade with China. While this rapprochement with China may have served the purpose of delinking from the US, the growth in Sino-Brazilian trade has encouraged a degree of de-industrialisation in Brazil as China has primarily been interested in importing primary goods and exporting low and medium level manufactures. Argentina remained focused on agricultural exports to Brazil and internationally. Paraguay and Uruguay kept relying on their larger neighbours for trade. Intraregional trade has grown. Yet, the differences in size, productivity growth, trade relations, etc. remained great in the region. Europe’s new-gained confidence generated significant flows of foreign direct investment into the region, especially Brazil. Attempts to strike a EU-Mercosul trade agreement were initiated, but ultimately resulted in little.

In terms of financial and monetary integration, the 2000s was a period of internal caution, but growing external confidence as coordination of the position in international negotiations continued under the growing global profile of the region. With regards monetary union, the Treaty of Asuncion clearly mentions the ambition to co-ordinate financial and monetary matters. In the 1990s thus Brazil started to explore the idea of becoming the central banker for South America (Arestis & de Paula, 2008). European monetary integration clearly had a significant impact. The Argentine crisis however put an end to that initiative at that point, underlining pre-existing concerns about workability of a common currency as asymmetries in the region remained large. Moreover, despite Brazil’s growth, there is no central bank with a reputation matching that of the Bundesbank able to provide the credibility for a shared currency (Ugarteche, 2012). Yet, as Otero (2013: 3-4) argues: “the creation of the euro...had an important ideational impact and...its symbolic effects...stimulated monetary cooperation in emerging markets, acting as a blueprint for prospective regional institutional change.” This dates back to the 1960s when the European Payments Union was created providing a source of inspiration for the South American regional payments system with multilateral settlement. However, the creation and perceived success of the Euro added further impetus. This is acknowledged by Maria Celina Arraes, former deputy governor for international affairs at the Central Bank of Brazil: “The rise of the euro is a unique, outstanding event and is an unparalleled

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model for Latin American countries’ monetary integration ambitions” (2009:162-3). Indeed, until the onset of the Euro crisis, it was no great secret that Mercosul policy-makers harbours the idea of one day having a common currency (e.g. Otero 2012: 131). And, indeed, initiatives were taken in this period to bring about structural convergence which could potentially enable such a future.

For instance, driven by Paraguay in the context of Venezuelan accession to the Mercosul and the smaller member states’ concern about big state dominance in the region, the region established the Mercosul structural convergence fund (FOCEM). FOCEM came into operation in 2006 with the aim of reducing regional asymmetries, promoting structural convergence, developing competitiveness and promote social cohesion particularly benefitting the smaller member states (Mercosul Report 15: 85). The focus of the first four year programme was infrastructure in the border regions. While small in size (having distributed \$1.1bn by 2012), it appears a meaningful step in the strengthening of the Mercosul institutional structure and the integration process more generally. FOCEM strikes a chord with other public investment funds created in South American regionalism during the 2000s and can be seen as aligned with the left-leaning political economy in South America since the turn of the Millenium.

In the area of financial market integration, Working Sub-Group 4 concerned with Financial Affairs (SWG4) continued the work it had started in 1990 in preparation for the launch of the Mercosul. SWG4 had been given a clear brief of liberalization by the Montevideo Protocol of 1997 (especially part III, Action Plan for the Strengthening of the Liberalization Program of Services Trade, from here on the Liberalization in Services Action Plan, LSAP), set up under the neoliberal period of the 1990s, but ratified in 2005. Yet, the Protocol also provided a number of clauses allowing for caution to be heeded with regards financial market integration. The difficult experiences in South America, and in the Southern Cone in particular, of financial crises warned against taking financial integration lightly. Instead, the specificities of the financial realm urge special attention and precaution. The concern for systemic impacts of economic crises transmitted through the financial system was made clear in the Protocol and the work of the SWG4 in the 2000s. Regulators were given clear responsibilities to interpret the complexities of financial markets and prevent their translation into crises.

The LSAP is an ambitious plan to create a free trade area in financial services with an ambitious deadline. By 2015, it was supposed to have been created. However, by 2013 it had not yet been achieved, and it is uncertain whether the deadline will be met especially with regards regulatory harmonisation and supervisory homogeneity (personal communication with the BCB, 2013). Notable developments and accomplishments were in this period 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. The table below summarises some of the achievements of the already established subcommittees during the period.

Capital Markets	Financial Statements	Financial System	Technical Commission on Insurance
Framework Agreement on clearing and settlement systems	Provision of reference model and harmonization of applied	Basel II compliance	Annual statistical updates on the regional insurance market

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	accounting procedures		
reports on the prerequisites for the creation of a regional capital market	Impact assessment of NIC39 relating to credit operations (forecast), portfolio transfer, insurance, derivatives	Coordination of common interests for international negotiations	Framework Agreement on the basic conditions for insurance companies and their branches
rendering transparent of asymmetries in regulation of financial services through comparative table	Impact assessment of implementation of Pillar III of Basel II	Banking system harmonisation	Developing framework agreement for reinsurance market
		Harmonisation activities in the reinsurance sector	
		Harmonisation of financial services	

In addition, the national coordinators monitored the integration progress as stipulated by the Montevideo Protocol in order to strengthen international negotiation process. The coordinators address exchange rate issues and provided a comparative table of asymmetries. Of non-negligible significance, too, was the setting up of the website for information-sharing also to the public.

Conclusion

Clearly progress was made in relation to the Montevideo protocol. Coordination of a “cautious liberalisation” was pursued. However, while the college of regulators is relative to Europe’s small and communication strong (Pasin, 2012), national sovereignty remains considerable. Without a strong and relatively independent bureaucracy like the European Commission at the heart of the process, the ambitious LSAP could have petered out. Yet, with the Mercosul integration process in some other realms seemingly moving in a more social democratic or Developmentalist directions, the question was at this point (and maybe still is?) whether the integrationist effort is congruous, cohesive and realistic. As former Argentine diplomat Andrés Cisneros (2004) put it: “integrarse o amucharse” (integrate or pile up)...

4.8 Conclusion

This section has covered eventful periods in the integration processes in the Mercosul and the European Union. European integration with its more longterm and supranational characteristics was able to move quickly towards the operationalisation of the single market, not least including the single market for financial services. The FSAP sought to remove a long list of barriers to the single market for financial services to support the push towards the development of the most competitive knowledge-based economy in the global economy. It did so in response to the perceived “spillovers” created by monetary integration in the 1990s and on the back of considerable optimism generated by the perceived success of this decade. Mercosul developments were less “linear” in the context of a shift from a neoliberal decade to a more social democratic-developmental period under Brazilian and Argentine leadership. In relation to financial integration, the SWG4 was caught between the liberalisation agenda of the Montevideo Protocol (LSAP) and these political developments. The outcome was a process of cautious liberalisation of financial services accompanied by a move

towards the creation of regional investment funds for structural convergence and poverty reduction, benefitting the smaller member states. Monetary integration had for long been a vision, but was put on hold following the Argentine crisis. Yet, the vision did not die in this period. In the subsequent section, in the account of the period since the onset of global financial and economic crisis, however, we will see how the inspiration that was European monetary integration turned from vision to a source of learning.

5) 2008- Crises Responses

- 5.1 Introduction: G20, Bailout and Eurocrisis
- 5.2 TARGET II
- 5.3 TARGETIISECURITIES
- 5.4 Economic Policy Governance and the European Stability Mechanism
- 5.5 European Systemic Risk Board
- 5.6 European Banking Authority and the European Banking Union
- 5.7 European Securities and Markets Authority
- 5.8 European Insurance and Occupational Authority
- 5.9 Mercosul
- 5.10 Conclusion

5.1 Introduction

The crisis that has come to be known as the ‘Euro crisis’ was long coming. Scholarship in Europe and beyond had foreseen it already in the inception of the European Economic and Monetary Union (EMU), although notably not by mainstream European integration scholars (Eichengreen 2012). Nevertheless, it took European regulators by surprise. Europe believed itself to be largely immune to the US “Sub-Prime Crisis”. It clearly was not. Markets became illiquid as financial institutions (FIs) quickly turned to hoarding cash in distrust of the ability of other FIs to honour their debts. This chapter explores the substantial European response to the Euro crisis. A swathe of Directives and Regulations has been rushed through the European institutions. The institutional landscape has changed dramatically as a consequence, including how pre-existing institutions interact. A sea of technical standards, recommendations and guidelines have been created and issued. Europe is desperately responding to a dramatic decline in legitimacy, and is negotiating the evasion of further losses in so doing. Yet, the extent to which there has been a shift back towards a publically led regulatory and legislative process is questionable. While this can be seen to have occurred in some areas, notably in the area of credit rating agency regulation, private actors appear to retain a firm grip on developments. While Commission, Council and Parliament appear to have been responsive to political pressures for regulatory reform, the Commission and Parliament have been under tremendous pressure from financial market lobbyists to soften regulatory impulses. Divisions have re-emerged in the Council between the Southern and Northern Coalitions. While trying to cut the unfortunate link between sovereign debt and financial markets, Europe endeavours to address economic imbalances, the size of which were previously underestimated and now appearing close to unmanageable.

The 2000-7 global upswing was the temporary success of the finance-led growth regime centring on the US economy, but to which other national and regional economies were connected, albeit in varying ways and extents. A credit boom, which was engineered by predatory lending practices and feeding consumer opportunism, was firmly supported by low interest rates, lax regulation and widespread speculation on sustained price rises. It proved unsustainable as downward speculation finally hit. The resulting “Sub-Prime Crisis” hit core institutions in the US first with Bear Stearns failing to meet its financial obligations in 2007. Shock waves soon hit the shores of other economies, including European such, as bank balance sheets with “sub-prime” assets started to look overly leveraged. A creeping sense of fear turned into widespread panic as bank after bank fell over. To prevent a global collapse, an unprecedented injection of liquidity was coordinated by the ad hoc assembly of the G20. Still, Europe believed itself to be able to weather the storm and evade major contagion.

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However, the rapid financial integration that had taken place on the back of monetary integration, especially since the launch of the Lisbon Agenda, the Lamfalussy Approach and the Financial Services Action Plan, had, without adequate cross-border regulation and supervision, made Europe and financial markets highly susceptible to exogenous shocks. Indeed, lopsided financial market integration exposed the EURO zone to the institutional and socio-economic weaknesses of the Eurosystem. It demonstrated that the convergence in interest rates and prices brought about since the Millennium had not been the outcome of structural factors (ECB - Praet 2012), but by belief systems, market opportunism and herding behaviour. Without an effective Growth and Stability Pact to provide fiscal discipline, fiscal integration, a more substantial redistributive system, or an ECB mandate to intervene more aggressively (e.g. through a Eurobond market), the Eurosystem was not institutionally equipped to handle the revealing of substantial economic imbalances in the Eurozone. Instead, the system came under intense speculative pressure as bond markets targeted several peripheral economies in the Eurozone bringing interest rates to unsustainable levels leading to IMF-led bailouts of Ireland and Greece. European responses proved ineffective as they failed to tackle the underlying problems in the Eurozone, largely throwing money after problem banks.

The difficult and lengthy negotiations revealed also the problematic absence of a political union. Financial market integration in the Eurosystem marred by its flawed construction thus became the hotbed for speculation against not only the weaker peripheral economies, but also the Eurosystem as a whole. Credit ratings for the core economy of France soon dropped too. In 2012, also the German growth engine ground to a halt. While ECB president Draghi's confidence boosting Outright Monetary Transaction intervention in 2012 has calmed the worst jitters on financial markets, this promises to be another moment of calm before yet another storm unless reforms are undertaken rapidly. With the costs of bailouts absorbed initially by governments, and subsequently distributed through painful austerity programmes, growth in the Eurozone is not on the cards for some time; the Europe2020 growth strategy appears to be sidelined for now. Moreover, ambitious further efforts towards political and financial integration have been undermined by disagreements over their direction and depth. Still, the initiatives in the area of financial market integration since the time of the onset of the crisis (whether in immediate response to the crisis or launched in its midst) should be of interest to the Mercosul.

Focusing on the new regulatory bodies, the chapter provides a snapshot of the rapidly emerging European Framework for Financial Market Stability intended to reduce the scale and scope of future financial crises. In sum, it argues that the European response to the Euro crisis has been substantial, and that it contains many lessons to learn about regional financial integration. Still, there is clear continuity between pre- and post-crisis regulation. Whether the response will be sufficient to quell popular dissent to bailouts and the austerity regime and thus strengthen low levels of legitimacy or not remains to be seen. This amounts to a political high wire act of considerable proportions. The section also compares European developments with those taking place in the Mercosul.

Mercosul has clearly ridden the storm of the global financial and economic crisis out well. This has been enabled by an intergovernmental, obviously political regional organisation, but also the lessons picked up from the number of difficult crises experienced in the recent Mercosul past. Partly enabled by a continuing commodity boom and East Asian demand for Mercosul commodities, Mercosul has protected and stimulated domestic markets through Keynesian-style countercyclical expansionary policy. This process appears to point Mercosul in a more integrated direction whereas recent trade trends have pointed to a degree of deregionalisation of trade flows, not to mention trade conflict within the region and beyond.

Still, financial integration is moving ahead broadly as stipulated by the Montevideo Protocol although the crisis has clearly been a preoccupation.

This section proceeds by looking at significant developments in the area of payments systems in Europe.

5.2 TARGET2

Introduction

This sub-section explores a major innovation in the wholesale market infrastructure: Target 2. The system of payments for participants of the Euro inter-bank wholesale market was substantially updated in 2007, albeit not in direct response to the crisis. An unstable TARGET system was replaced by the TARGET2 system. It is intended to provide a more reliable and efficient infrastructure for large-value settlements in “real-time” and thus constitute a core infrastructure for the envisaged Single Euro Payments Area (SEPA). It is also supposed to support Eurosystem monetary policy. However, it has also served to build up major imbalances within the Eurozone, which are at the core of the Euro crisis.

Description

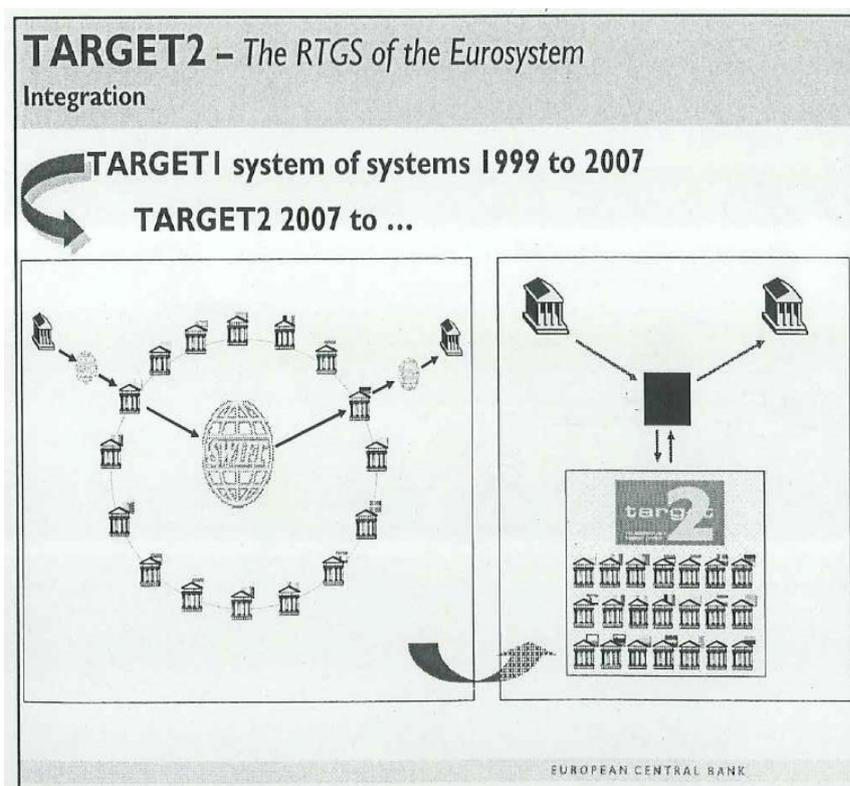
The TARGET system introduced in 1999 was an interlinking system bringing together existing national payment systems under one shared calendar, harmonised format and technical language, and with the ECB as clearing house.⁵ While a major innovation from the previous bilateral systems and thus contributing meaningfully to serve the integration process, its design resulted in mini-crises, or “incidents” (service interruptions), requiring frequent “firefighting” and the creation of ad hoc contingency procedures. The system was not perfectly stable. TARGET2 emerged out of this system. It came into operation in November 2007. TARGET2 services large-value transfers. The system (primarily) settles EURO money market and EMU monetary policy operations to the daily average value of €2,477 billion (in 2012). As of 2012, there are 999 direct participants, 3,386 indirect participants and 13,313 correspondents enjoying the services provided. Moreover, the system settles the cash positions of 82 ancillary systems.⁶ It is founded on the principles of: harmonisation, single price structure for core services, cost effectiveness and no intra-system competition. Its main objectives are to:

- supply a reliable, safe, highly resilient and efficient infrastructure for settlements in “real-time” gross of intra-European payments;
- constitute a core infrastructure for the envisaged Single Euro Payments Area (SEPA); and last, but not least,
- support Eurosystem monetary policy.

⁵ For further information about the TARGET system, see <http://www.ecb.eu/paym/t2/target/html/index.en.html>.

⁶ A full list of TARGET2 participants is available on the ECB homepage: <http://www.ecb.eu/paym/t2/html/index.en.html>.

TARGET2 is founded on the concept of having a shared technical infrastructure, or a single shared platform (SSP), between the German, French and Italian Central Banks operating the system. It enjoys a harmonised set of rules with a shared calendar, opening times and nominal fees set for transactions, which together enable this integrated system to function. With a commitment to providing a state-of-the-art technological infrastructure, the technical availability of the SSP is near perfect (99.99% one year after the launch). It dramatically reduces the time (close to “real-time”) required for transactions. The transactions of payments are settled one by one continuously and with immediate finality. Financial messaging provision is supplied through the SWIFT network. The running of the system is based on regular exchange of information (e.g. activities to bring about convergence of technical knowledge, through sharing and production of static data, bi-daily TCs) which works as a “glue” for the system. Common practices and a common language have thus been developed, around which an epistemic community develops with a common spirit/identity of central bankers.



Target I and Target II Compared. Source: Patrick Papsdorf (European Central Bank), 2011.

While national monetary autonomy has been sacrificed under the EMU, all participating national central banks (NCBs) retain a degree of control. The system is “client-based” with central banks responsible for business relations with national participants (credit institutions and ancillary systems), fulfilling administrative and monitoring requirements of the system. This continued delegation of tasks to the national level results from considerations of both seeking to benefit from longterm trust established with client participants and the national-level credibility of the system. Central Banks ensure the smooth migration of banking communities to TARGET2 (see chapter 10 Migration and test procedures, for more information). Yet, a level playing field is assured within the system with uniform services provided no matter particularities of central banks or their historical banking communities. Yet, a range of features like reservation facilities and the use of limits have been designed so as to give flexibility to participating banks or banking communities in deciding on which features to subscribe to. Central banks must be both directly addressable so as to be able to

receive payments from other participants *and* able to submit payments on behalf of its customers or on its own.

Tasks of National Central Banks	
Administrative	Operational
Communication with and support to participants	Inclusion and exclusion of participants
	Monitoring activities of participants
	Providing the intraday liquidity required to smooth the running of the system
	Payment initiation on behalf of participants or of their own
	Billing participants
	Handling local contingencies

Interview with Patrick Papsdorf and Lorenzo DalBianco, European Central Bank, 2012)

The TARGET2 system is housed and guaranteed by the ECB, yet is ostensibly a private good and not available to public sector organisations. It is in (indirect) competition with a set of other payment systems (e.g. Centre Counterparty systems (CCPs) and the EURO1 system), and thus needs to be competitive in terms of pricing to retain legitimacy. In the large-value transfer market, Yet, in the large-value market, TARGET2 has a monopoly. The following transactions with their size require settlements to go through TARGET2:

- (a) payment orders directly resulting from or made in connection with Eurosystem monetary policy operations;
- (b) settlement of the euro leg of foreign exchange operations involving the Eurosystem;
- (c) settlement of euro transfers resulting from transactions in cross-border large-value netting systems;
- (d) settlement of euro transfers resulting from transactions in euro retail payment systems of systemic importance; and
- (e) any other payment orders in euro addressed to TARGET2 participants.⁷

As such, it is designed so as to remove competition among its component parts. As a result, 92% in value terms (58% in volume term) of the total large-value EURO payment system traffic was settled through TARGET2. The system's main users (for core services) are provided with a single price structure and standard interface for settlements of ancillary systems. There are no restrictions on the value of the payments settled.

Yet, to ensure legitimacy (as opposed to demand), cost effectiveness is a key principle of the system, which, of course, is directly linked to the risks associated with the system. With the ECB as ultimate guarantor and all transactions in central bank money, risk is perceived to be low, and serves to

⁷ TARGET2 Guidelines in Official Journal of the European Union, http://www.ecb.eu/ecb/legal/pdf/l_03020130130en00010093.pdf, 30.01.2013.

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justify the monopoly position in the interbank market. The system is also designed to provide highly modern and flexible liquidity management. Yet, the ECB does not provide overnight credit. This is partly due to the objective of promoting the movement of liquidity between banks. This is intended to mitigate against tendencies towards liquidity crunch within the system. Prices are thus set in accordance with a cost recovery model based on minimisation of risk, continuity in business relations and “real-time” speed of transaction settlements. However, with the crisis, trust levels amongst participating banks in the system has waned with the consequence that volumes of transactions, and thus the revenue generated by the system, have declined. This loss of demand, in turn, has brought about higher prices for using the system with consequences for its credibility (Interview with Papsdorf and DalBianco, 2012).

TARGET2 functions as a transmission belt for ECB monetary policy. It seeks to ensure liquidity in the interbank system and thus to contribute to the ECB’s overall policy aim: price stability. Yet, while supporting ECB monetary policy, TARGET2 is quick to emphasise that tasks such as collateral management, monetary policy execution and reserve management and standing facilities are not part of TARGET2, but remain the responsibility of central banks. It concentrates above all on payments processing (Interview with Papsdorf and DalBianco, 2012). We will return to issues arising from this in the analysis below.

Despite the increasing prices on services as a result of the crisis, TARGET2 is a much more robust system than the previous TARGET system. Albeit in hindsight attractive, moving from the earlier bilateral systems to TARGET2 immediately would have involved potentially insurmountable challenges, both financially and politically. Apart from facing likely opposition and uncertainty (e.g. there was plenty of such with regards who was to join the EURO from the outset), going to TARGET2 immediately would also incur huge startup costs (Interview with Papsdorf and DalBianco, 2012).

TARGET2 facts

In 2012:

- TARGET2 had 999 direct participants, 3,386 indirect participants and 13,313 correspondents;
- TARGET2 settled the cash positions of 82 ancillary systems;
- TARGET2 processed a daily average of 354,185 payments, representing a daily average value of €2,477 billion;
- the average value of a TARGET2 transaction was €7,1 million;
- two-thirds of all TARGET2 payments (i.e. 68%) had a value of less than €50,000 each; 11% of all payments had value of over 1 EUR million each;
- the peak in volume turnover was 29 June 2012 with 536,524 transactions and peak value turnover was on 1 March 2012 with €3,718 billion;
- TARGET2’s share in total large-value payment system traffic in euro was 92% in value terms and 58% in volume terms;
- the SSP technical availability was 100%;
- 99.98% of TARGET2 payments were processed in less than five minutes.

Source: TARGET2 Website, 2013

Conclusion

TARGET2 face a number of challenges to ensure future success. One challenge consists of providing a meaningful service not only to big institutions and ancillary systems in relation to large-value transfers, but also in relation to the smaller-value transfers of smaller banks. Expanding the geographical reach of operations is also a considerable challenge. Connecting non-EURO EU members to the system presents a substantial challenge in terms of legislation, coordination and

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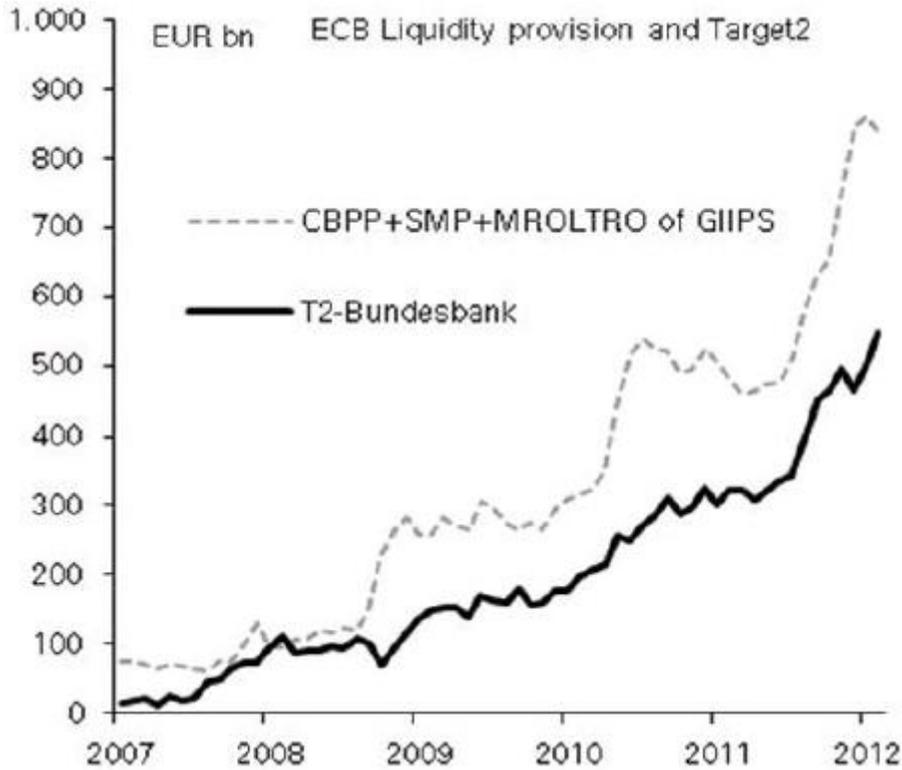
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harmonisation. Moreover, with a payment system being constructed specifically for transfers relating to securities (TARGET2S), compatibility between the two systems needs to be ensured (Papsdorf, 2011).

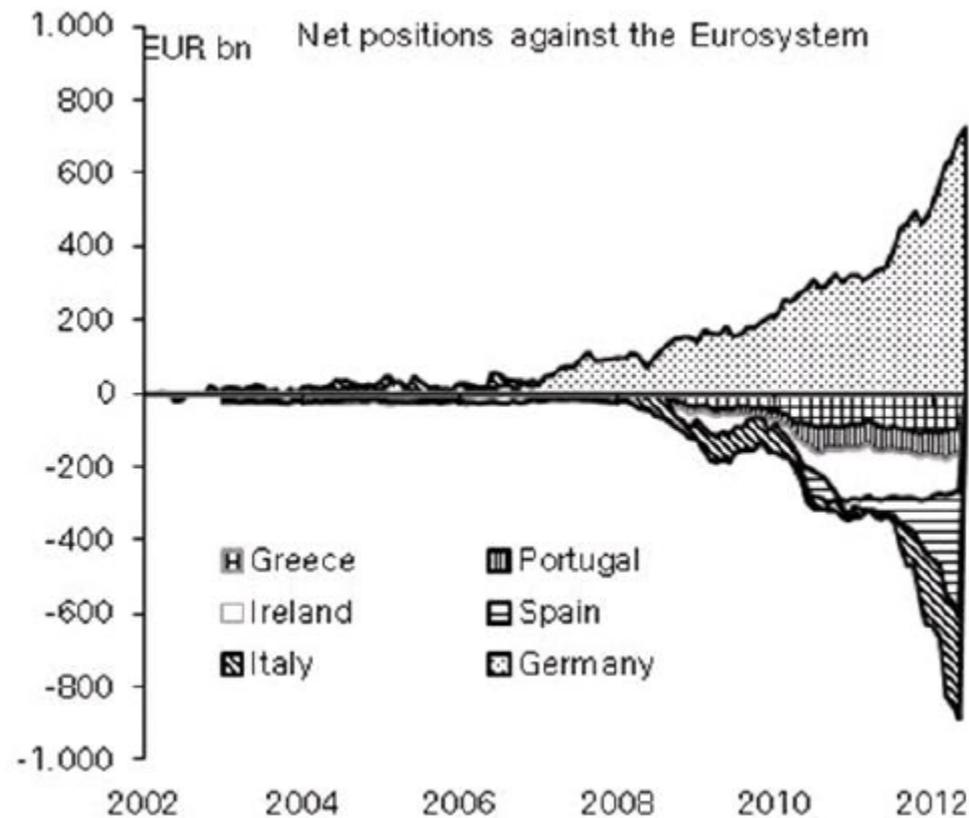
The final and greatest challenge involves sustaining the legitimacy and, ultimately, the financial stability of the system in the context of the crisis. With the Euro crisis, price levels have gone up as volumes of transactions and thus income generated have dipped. Addressing this challenge is inextricably linked to the redesign of the Eurosystem as a whole. Yet, the TARGET2 team itself discusses this as a matter of supply and demand relating to whether it can continue to comply with the cost recovery model that assimilates the running of the TARGET2 payment system to a service provided on a competitive basis (Interview with Papsdorf and DalBianco, 2012). In other words, the ECB represents this challenge as a matter of market performance and legitimacy.

Another position is represented by Thomas Mayer (2011; 2012: 117-137). He claims that the quick, continuous and reliable transfers within and beyond the Eurozone that TARGET2 has enabled have been far from altogether positive. Rather, lurking below the surface of the Eurozone's banking crises and public debt, and "caused by the misalignment of internal real exchange rates", is a balance-of-payments crisis growing (2011: 8). Indeed, he claims that TARGET2 has been playing, and continues to play, a role in the build-up of the huge imbalances that lie at the foundation of the Euro crisis. TARGET2 has provided the infrastructure for transfers between banks in "deficit" and "surplus" member states. He points out that each national central bank has a net balance of payment position within TARGET2. The net position can bring a liability (balance-of-payments deficit) or a claim (balance-of-payments surplus) against the ECB at the heart of the system. Without the fiscal measures to rebalance net positions, TARGET2 has not only helped to sustain, but has also magnified these divergences. The payments system has facilitated transfers of goods from the core economies, with higher productivity rates (esp. Germany), to the periphery with lower productivity rates, as well as the transfers of private capital flows in the opposite direction, underwritten by the perception of low real interest rates also in the peripheral economies. The balance of payments for individual member states remained close to zero therefore.

With markets' becoming risk averse due to the crisis and private capital flows to the periphery drying up, the cracks in the EMU started to be identified. Investment risks suddenly varied significantly between the peripheral economies and the core economies as the probability of the formers' debt default was considered to be on the rise. Yet, TARGET2 automatically provides unlimited funding to national central banks and their client banks with a negative net position and thus an overvalued internal real exchange rate. To assure solvency, deficit national central banks, acting on behalf of the ECB, provide credit to client banks. In this manner, ECB reserve money flow to fund the payment outflows created by the balance of payment deficits. This results in the following scenario, as Mayer illustrates (2011: 3): "banks in the country with the overvalued internal real exchange rate rely primarily on their national central bank and the ECB for funding of their balance sheets, [while] banks in the country with the undervalued exchange rate...receiv[ing] the[se] payments have plenty of liquidity and therefore do not need ECB funds." At subsidised prices, goods, services and assets are thus transferred from creditor to debtor countries, with the claims and liabilities vis-a-vis the ECB the measure of the subsidy. Without repayment obligation, these imbalances can of course keep on rising constituting a "hidden" resource transfer. Currently, he argues that TARGET2 provides huge volumes of quasi-loans at prime rates to deficit balance-of-payment countries of close to €600bn in 2012 (Mayer and Schelkle 2012).



Source: Mayer and Schelkle 2012



Source: Mayer and Schelkle 2012

In the Eurozone, there is no strong official institutionalised mechanism for rebalancing the net positions of national central banks in TARGET2. There are a number of weaker or ad hoc measures beyond TARGET2, but not within the system. The fact that it remains a largely “hidden” resource

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transfer suggests that its revelation will require a resolution, which is likely to be politicised. Mayer outlines four options to policy-makers:

1. Internal devaluation in debtor countries
2. Legitimation of public transfer payments to turn deficits into surpluses and the other way around
3. Abandonment of low inflation policy of the ECB, and the enabling of inflationary policy of goods, services and asset prices in creditor countries
4. TARGET2-led inflation in creditor countries

The first option is already underway through a range of economic adjustment programmes (see subsection 5.5), although not officially related to the TARGET2 imbalances. Whether these will be sufficient to reverse the current situation is questionable. Mayer is sceptical about the political feasibility of the second option of seeking to legitimate the absorption of TARGET2 imbalances onto creditor country balance sheets. Considering the volumes involved, and the lack of a strong sense of European solidarity, Mayer is probably right to be sceptical. Option 3 involves the ECB to abandon its low inflation monetary policy and thus sponsor the overheating of core economies. This appears also politically unpalatable given e.g. German resistance to take any further hits to the taxbase. Option 4 appears as a more plausible option, but the austerity regime appears too deflationary for this option to be effective. Considering that internal devaluation is the preferred policy thus far, this may very well be the option pursued in relation to TARGET2 imbalances. As such, the consequences of individual member state break outs, or worse EMU collapse, is a great threat to the legitimacy of TARGET2. The chances of success of this option, nevertheless, appears small, given that it may be introduced on top of current efforts to address periphery public debt. As Mayer (2012: 135) argues:

The optimal policy mix would be achieved when the centrifugal political forces, unleashed by inflation and fiscal transfers in the surplus countries and by deflation in the deficit countries, do not exceed the political will in both country groups to keep EMU together. Of course, achieving and sustaining this policy mix until EMU is again on safe ground is tantamount to the most daring political high wire act, requiring unprecedented political skill in all the relevant decision makers.

Yet, in such a case, TARGET2 is only one of several issues to be addressed by the EURO zone and beyond. And, this does not even start to consider the fairness of implementing this option. Indeed, would German recovery from unification during the decade prior to the Euro crisis been as impressive had not TARGET2 facilitated the export of goods to the periphery? Granted, Greece undertook creative accounting in their public figures. However, to say that Greeks deserve austerity policies suggests a national laziness is not supported by figures on working hours with Greeks working far more than for instance Germans. The success of Spain and Ireland related in part to construction booms, which were badly affected by the global financial and economic crisis, which in turn translated into a fiscal crisis as unemployment shot up and banks struggled.

In sum, in this discussion of TARGET2, we have seen that the integration of European interbank payment systems through TARGET2 provides fertile ground for balance-of-payment imbalances to develop thanks to the productivity imbalances and lack of fiscal integration (both discipline and redistribution) of the Eurosystem as a whole. This is due to contribute to the highly challenging set of problems Europe is finding itself in at the moment with no politically palatable way out. We will next turn to the payment and settlement system being designed for securities trade, a system very much based on the designs of TARGET2.

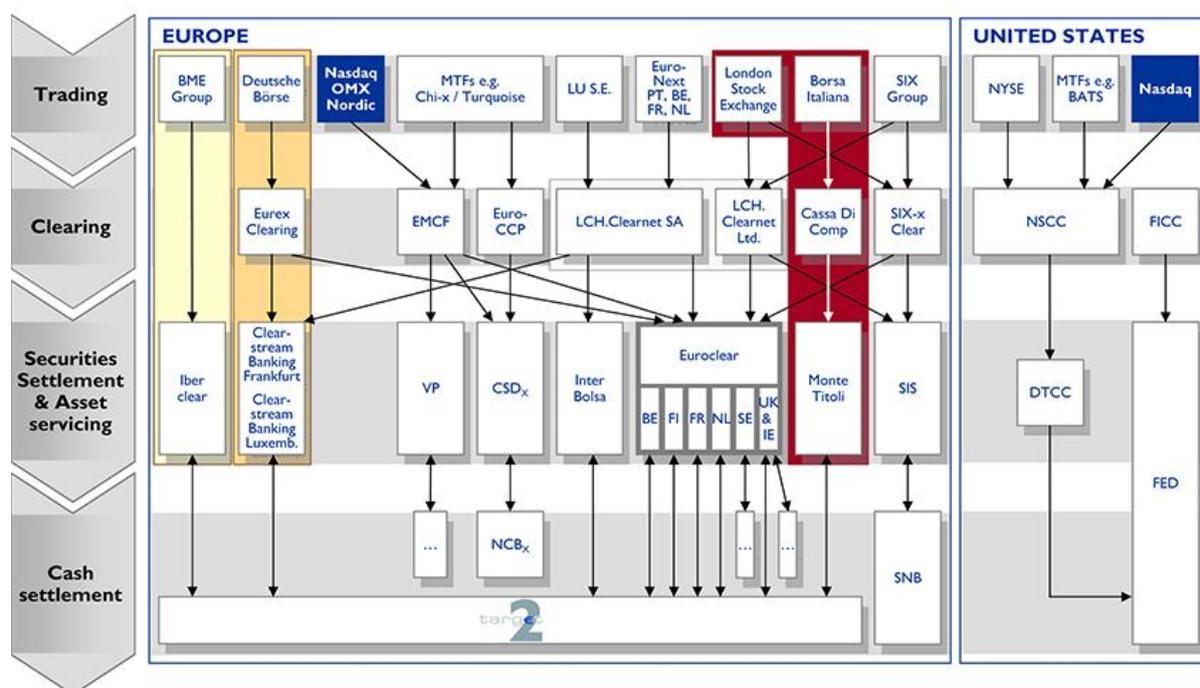
5.3 TARGET2SECURITIES

Introduction

As pointed out by the Giovannini Reports (2001; 2003) and identified as objectives by the Lisbon Agenda, considerable post-trading sector fragmentation in European financial markets contradicts the idea of a single competitive European market for financial services, not least within the Eurozone. The introduction of TARGET2SECURITIES (T2S) is intended to contribute to overcoming this problem. The expected launch date is June 2015. The below description is thus based on the expected design of the system.⁸

Description

The current costs of cross-border settlement in Europe are high because the value chain is long and complex involving several Central Securities Depositories (CSDs) and frequently one or several custodian banks. Furthermore, the settlement services are provided by national monopolies. For a sense of its relative complexity, a comparison with the US is instructive. The below graphic illustrates the differences in the trading landscape between the two economies.



Adjusted from ECB T2S website, the European post-trade landscape compared with that of the USA.

The result is that cross-border settlement is much more costly than domestic settlement, which disincentivises market-led European integration of financial services. Moreover, the procedures for settlement are complex, lacking in legal, technical and fiscal harmonisation, which translates into high levels of risk.

T2S is being designed so as to reduce fragmentation in European financial retail markets. While Out of the Giovannini reports' 15 barriers, the introduction of the system is intended to address six (T2S Website):

⁸ See e.g. Guideline of the European Central Bank of 18 July, 2012, in the Official Journal of the European Union: http://www.ecb.int/ecb/legal/pdf/l_21520120811en00190029.pdf

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1. National differences in information technology and interfaces
2. National clearing and settlement restrictions that require the use of multiple systems
3. Differences in national rules relating to corporate actions, beneficial ownership and custody
4. Absence of intra-day settlement finality
5. Practical impediments to remote access to national clearing and settlement systems...
7. National differences in operating hours/settlement deadlines

The ECB initiated its explorations of what was to be called T2S in 2006 together with the central securities depositories (CSDs). The T2S Framework Agreement was signed in 2012 by 24 CSDs (of which a significant few are based in non-EURO economies). It shares many of the features with the TARGET2 system and is envisaged to substantially benefit the European post-trading sector by being able to operate a single pan-European platform for the settlement of securities, a centralised delivery-versus-payment (DvP) settlement service, in central bank money. This is no coincidence as it is based on the same platform as TARGET2. It is designed on a not-for-profit, cost-recovery basis to be operated by the Eurosystem, or more specifically a specialised T2S team within the ECB.

T2S is intended to address the abovementioned six barriers by eliminating discrepancies between domestic and cross-border settlement, and by bringing settlement costs to very low levels by global comparison through the creation of unprecedented economies of scale. The key to these achievements is the use of, like for TARGET2, a single shared IT platform, harmonisation of standards into one single set as well as one operational framework under the full ownership of the Eurosystem. CSDs and custodian banks will thus be able to rationalise internal processing and systems.

As it will share platform with TARGET2, settlement services will be provided in “real-time” gross, which is envisaged to eliminate counterparty risk by making sure that obligations are fulfilled. The buyer will only receive the securities once the cash has reached the seller as both the securities and cash legs of the transaction are settled according to the DvP mechanism. Transactions should thus be final and secure. Indeed, sharing platform is supposed to bring positive synergies in the form of enhanced mechanisms of liquidity management, enhanced ability to exploit benefits from pre-existing operational structures and support organisation, ensured business continuity and arrangements for disaster recovery.

T2S is not intended as another CSD. Rather, it is presented as a technical solution with only a supporting role in monitoring, regulation and supervision at the national level. Accordingly, the opening, maintaining and closing of the securities accounts of CSD customers will remain the legal responsibility (according to national laws) of CSDs and the cash accounts of national central bank customers will still be ascribed to national central banks. Settlements’ “finality” will be determined only in relation to the accounts of T2S; it is only the securities account balances in T2S that will change. The completion of legal transfers are determined according to the relevant national laws (see Settlement Finality Directive), or, if a non-EEA country, according to the national laws pertaining to the location of the CSD.

An interesting feature of T2S, because of its single set of rules, standards and prices, is that it promises to be able to provide its services beyond the Eurozone, to all transactions in Europe, also involving other currencies, as long as eligibility conditions for the currencies are fulfilled and central banks have adapted to a harmonised, standardised interface. It renders cross-border settlements indistinguishable from domestic settlements, and is thus neutral to all transactions no matter country, market infrastructure, CSD and market participant business models. In this manner the current infrastructural complexity will be replaced by simplicity resulting in much lower fees. T2S could thus make European securities markets vastly more cost-effective and thus attractive to investors.

For Europe, then, the introduction of T2S is claimed to become a mechanism that accelerates harmonisation. By eliminating inefficiencies and barriers, it is intended to contribute to the creation of “a single, sound and competitive financial market in Europe” (T2S website). By only dealing with central bank money and committing to the highest standards of availability, security, resiliency and business continuity, as well as promoting the sharing and diversification of risk, it is also believed to bring financial stability to a currently unstable regional economy. In addition, it is envisaged that the system will allow banks to optimise liquidity levels and management of collateral. In combination, new business opportunities should open up, bringing competition to the benefit of European investors and issuers. Thus T2S could impact positively on economic growth in Europe.

Conclusion

The idea that financial market integration in the area of securities brings about stability thanks to the greater liquidity generated and greater risk-sharing is influential but also dangerous, especially if not carefully qualified. While presented as merely a technical solution to another market imperfection, the introduction of TARGET2S may provide distribution channels for unhealthy dynamics similar to those emerging in the TARGET2 system. Without adequate fiscal and political integration as well as a thorough regulatory framework providing the right incentives to financial market participants, integrated securities markets will bring further dangerous exposure of European economies to financial globalisation. The global financial and economic crisis has demonstrated that financial integration renders larger cross-border markets more vulnerable to contagion and systemic risk, as it enables animal spirited behaviour (herding behaviour and overshooting). Indeed, it is wholly envisageable that sectoral, national or sub-regional bubbles will become more sizeable and frequent under the enormous securities markets to be created through T2S. At the very least, it puts an onus on regulators and supervisors to prevent but if need be identify, at an early stage, systemic risks. While the European Systemic Risk Board (ESRB)(see below) has been created to identify emerging systemic risks, it is a concern that the conception of risk has not changed substantially in the language of European regulatory bodies and that the notion of systemic risk remains relatively unexplored (see below). Rather than being primarily aimed at the creation of maximum liquidity, well-designed systems have, in the analogy with electric systems, circuit-breakers (Stiglitz 2010), appropriate incentive structures to the intended purpose of financial services (Kay 2011) and constraints on the build up of systemic risk (e.g. Buiters 2009). Yet, such systems have to be flexible and updated as financial innovation and inevitable regulatory evolve. The integration of payment systems for securities should not be an unqualified given, but must be done cautiously and have powerful circuit-breakers built in and be appropriately regulated. Above all, regulation must be structured by legitimate purposes.

The point however is that most of the new financial infrastructure being laid is seeking to prevent future Euro crises, not necessarily dealing with the current one. The report next turns to a new set of policies and institutions, which very much deal with the situation at hand, the raft of initiatives endeavouring to address the instability generated by the flaws in the Eurosystem.

5.4 Economic Policy Governance and the European Stability Mechanism (ESM)

Efforts to stabilise the Eurozone since the onset of the crisis has been and remains slow and painful. As argued above, the stabilisation process is a political wire act at a high level. This section briefly outlines the economic policy measures taken, with a special focus on the European Stability Mechanism (ESM) intended to provide a monetary firewall. The Euro crisis intensifies before it calms

down and then intensifies again. After a short calm, the Cypriot bank crisis has now incited fears of contagion to other small “deposit economies”.

Description

The Growth and Stability Pact introduced with the European Economic and Monetary Union (see Sections 3 and 4) failed to provide the framework required to prevent imbalances to develop within the Eurozone. Important part of its flawed design was the emphasis put on fiscal imbalances while turning a blind eye to economic imbalances more generally and systemic risks in the financial system more specifically. As bubbles, of varying kind (see 7.1 above), finally burst, leveraged bank balance sheets collapsed with this outcome translating into⁹ fiscal deficits of governments in a series of peripheral Eurozone economies: “Financial problems created...fiscal imbalances, rather than...fiscal imbalances creating financial problems as was assumed by the architects of the Stability and Growth Pact” (Eichengreen, 2012: 128), and as, indeed, have largely continued to be the assumption with only Greece being the appropriate case in point.

Emphasis in the crisis response has been put on fiscal consolidation and structural reforms in the member states. A raft of partly overlapping initiatives has been taken to ensure fiscal discipline: the strengthened Stability and Growth Pact (the “Six Pack”), the “Two Pack” (adding force to the “Six Pack”, the Treaty on Stability, Coordination and Governance in the EMU (TSCG or the “Fiscal Compact”), the “European Semester” and the Euro Plus Pact. In combination, these initiatives will provide budgetary transparency, peer pressure, policy reform impetus in the direction of the “austerity policy regime” and the Commission with powers to penalise member states failing to achieve fiscal consolidation and/or to live up to budget objectives, given that these are not resisted by a majority of member states. Through the European Semester and the Euro Plus Pact, this will extend beyond the Eurozone, albeit voluntarily (in the case of the TSCG and the Euro Plus Pact). These initiatives are clearly more forceful than the original Stability and Growth Pact and the Open Method of Coordination initiated to bring about policy convergence. For instance, convergence towards a structural deficit of 0.5% for member states with a debt ratio around or over the 60% level of the original SGP, and 1.0% for those with a debt ratio significantly below this level, is enforced within the Eurozone and beyond, if signed up to the Fiscal Compact. Indeed, fiscal and political integration has here progressed substantially, albeit insufficiently.

This high wire political act of fiscal consolidation and convergence is taking place with limited interest in growth and the “European Social Model”. Alongside these initiatives, the European strategy to boost growth and jobs, Europe2020, appears marginalised, if not altogether counteracted. As has been seen in the Mediterranean economies, fiscal consolidation has thwarted growth with the result that debt repayment, not to mention general well-being, is rendered seemingly impossible. As one MEP put it: “Whoever wants to survive the crisis, must also learn to grow out of it. The necessary fiscal consolidation can only work when it is coupled with new initiatives for growth” (<http://static.euractiv.com/de/node/507898>, accessed on 24/2/2013).

Efforts to construct more effective economic governance structures have been made in parallel with efforts to fight fires in sovereign debt markets by setting up temporary and now permanent bailout funds. As a financial backstop for any financing needs of an EMU member, the ESM was introduced in 2011 as a permanent replacement of the European Financial Stability Facility (EFSF) through an amendment of the Lisbon Treaty. On behalf of its Board of Governors, the Troika (ECB, Commission and IMF) issues financial assistance to member states in case of risk to the financial stability of the

⁹ The outcome of the recent EFTA court case against Iceland’s refusal to bail banks out over cross-border activities suggests that there is no legal necessity behind governments’ decision to bail out bondholders.

Eurozone and unsustainable public debt. In the assessment, the ESM identifies the temporality in the debt positions: is the position unsustainable and requiring restructuring, or is it a matter of delayed adjustment requiring assistance on a temporary basis? In the latter case, a bridge loan will be provided. Strict conditionality is attached to the assistance provided (through a Memorandum of Understanding signed between the Troika and the member state).¹⁰ Constituting ESM's funds, there is, firstly, paid-in capital of €80bn, secondly, money market instruments and, thirdly, medium and longterm debt maturing over a period of up to 30 years, issued by the ESM. Member states are obliged to contribute to the authorised capital stock (€700bn) in accordance with the ESM treaty.

Does the establishment of the permanent ESM genuinely support financial market integration, or is it merely a firefighting, albeit permanent, device? It appears as if the answer is a bit of both. The ESM is set up in acknowledgment of that the ECB must be relieved of the firefighter role as the "policy-maker of last resort" that it has played during the first two years of the crisis (Eichengreen 2012: 131). In other words, it institutionalises firefighting as the development of unsustainable sovereign debt is inevitable within the Eurozone. On the other hand, it is devised to send a powerful message to calm jittery financial markets that the Eurozone's commitment to providing a backstop to developing problematic sovereign debt is permanent and forceful. Yet, of course, when considering the size of the ESM relative to the size of public debt (and let us here include the quasi-loans accumulated through TARGET2) for Spain, or further down the line France, it is easy to see how this message is not felt to be powerful enough, thus failing to provide a platform from which integration can proceed without major interruption. Suggestions of a mutualisation of debt through the creation of Eurobonds and a Eurobond market, to mirror the US Treasury bill market, would send a more powerful message. Yet, it is feared by some (especially the Germans), that the creation of such a low-risk instrument to be traded on a deep and liquid market would create yet another mechanism (cf. TARGET2) through which, in their eyes, unhealthy imbalances could build up yet again. A range of different types of Eurobonds have, however, been discussed (e.g. Delpla and von Weizsäcker, 2010).

Conclusion

Clearly, political commitment to enforce particular rules and mechanisms in the sphere of economic policy has become much stronger. This commitment is however geared in the particular direction of fiscal consolidation with little concern with growth and investment, putting onus on individual member states to adhere to the approach. Two related questions arise: is it meaningful for all member states to adhere to this low-inflation approach, and is it meaningful for Europe as a whole to adhere to it? We'll return to these questions later. A somewhat different approach is suggested by the idea of mutualising debt through some version of Eurobonds, preferred by France and some of the peripheral economies in the Eurozone. The redistributive system thus created could, if the right enforcement transform Europe, but this is not in the interest of all. Moreover, this could imply the rise of the Euro in the pecking order of international reserve currencies.

The report turns next to a range of new regulatory and supervisory bodies endeavouring to provide a more sturdy response to micro- *and* macroprudential risks.

5.5 European Systemic Risk Board (ESRB)

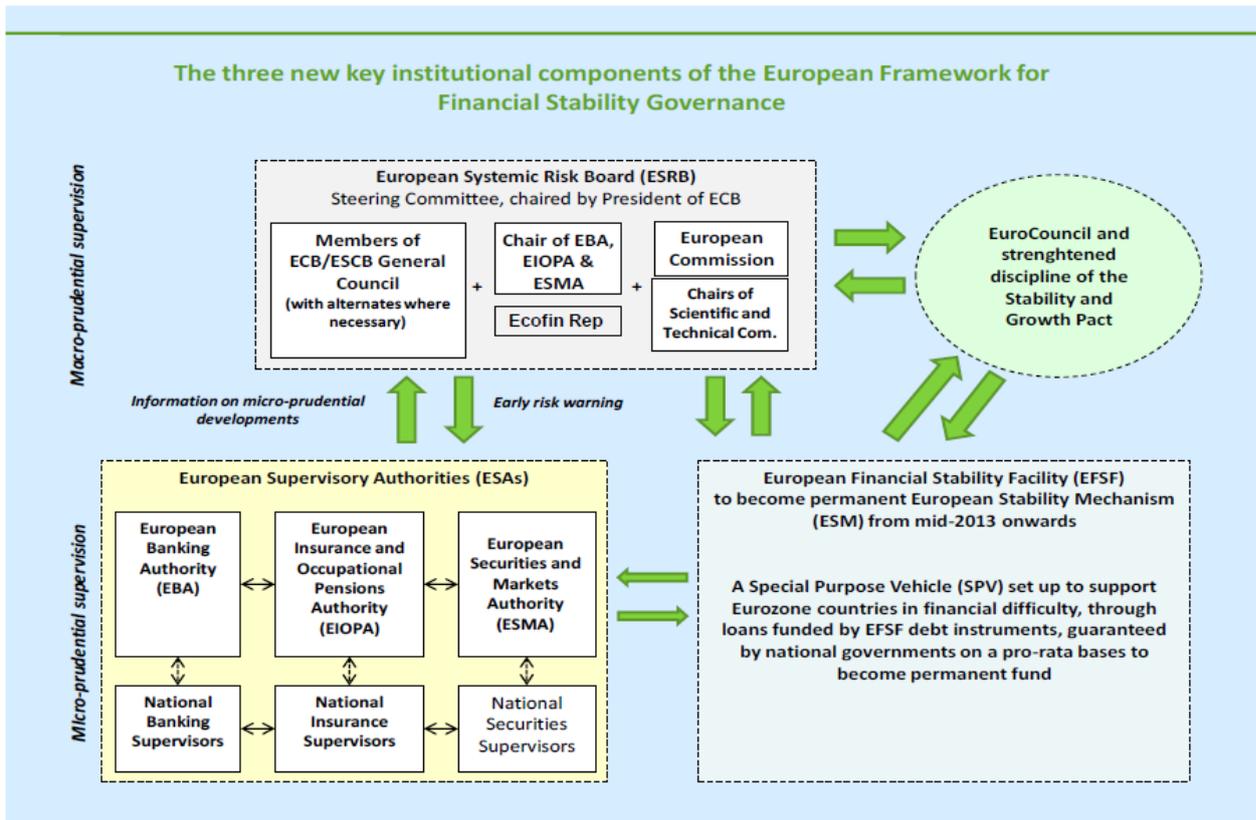
Introduction

¹⁰ In February 2013, Spain became the first member state to sign a MoU and draw on the funds of the ESM.

In an interesting piece dating back to the discussions about the role of the European Central Bank in the Economic and Monetary Union, Folkerts-Landau and Garber (1992) considered whether the ECB would be merely the embodiment of the monetary rule of ensuring low and stable inflation or a policy-maker of last resort, including providing liquidity in emergencies, payment system provider and supervisor. They argued that the former would only be possible given that Europe could agree on repressing the financial system, especially securities markets. This prediction has of course turned out correct, especially following the crisis, with the ECB playing a growing role in European financial markets by designing innovative mechanisms for the provision of emergency assistance to governments suffering financial distress. This is not least thanks to developments in securities markets, which during the 2000s became so central to the banking sector following the popularisation of the process of securitization. Relatedly, and as we have seen in the discussion of TARGET2, the ECB has also become the main source of emergency liquidity to the banking and payments systems. The ECB thus is now far more than the embodiment of a monetary rule, but also both supervisor and regulator.

Since the crisis, the EU has been impressively busy in erecting a new supervisory architecture to oversee further financial integration and to supervise financial firms and institutions in both the Eurozone and the EU at large, in order to prevent the eruption of financial crises in the future. Little did they then know that the Euro crisis was around the corner. Still, the crisis in 2007-8 had exposed significant shortcomings in the supervision of the European financial system with national supervisory models outdated and insufficient for grasping the complexity of interconnectedness that has followed financial globalisation. Much of the direction of this activity was spurred by the recommendations provided in the so-called De Larosiere Report (2009). The report recommended the strengthening of a European level supervisory framework in order to decrease the risk and depth of future crises. A European framework for financial stability governance was to be created, including three European Supervisory Authorities (ESAs) to provide microprudential oversight. It further identified the ECB to play a role in macro-prudential oversight, but for a long series of reasons not micro-prudential such (incl. conflict of interests, political independence, Treaty obstacles, etc.). It is out of these recommendations that the European Systemic Risk Board (ESRB) emerged in 2010.

Depending on which organigramme chosen to illustrate this new architecture, macroprudential and microprudential risk governance is positioned at different levels. This is not altogether surprising as the Euro crisis has forced a profound rethink of their respective meanings and interrelationship. This is reflected in the organisation of this architecture.



The New Supervisory Architecture for the EU. Taken from Lannoo (2011: 8).

Undeniably, the Euro crisis has constituted a wake-up call for European regulation and supervision by revealing the insufficient resilience of the financial system as a whole. The creation of the ESRB, located in Frankfurt along with the ECB, is in many ways the best piece of evidence for this. Chaired by the President of the ECB and with members from all three new ESAs, Ecofin, the Commission and the chairs of Scientific and Technical Committees, this body is intended to amass a holistic understanding.

The notion of systemic risk, with which the ESRB is arguably fundamentally concerned, remains vague in their publications: “Systemic risk can be defined as the risk that financial instability becomes so widespread that it impairs the functioning of a financial system to the point where economic growth and welfare suffer materially.” Problematically, “the system” itself remains undefined, which becomes a problem when the risks in and of it are to be defined and regulated. Indeed, the EU is exploring a new territory of systemic governance. The “macroprudential approach”, with which it concerns itself, is referred to as having a rather brief history dating back to the origins of the debt crisis in the 1970s with research on it still in its infancy; in other words, there is no fully developed conceptual framework for macro-prudential supervision. The meaning of key terms in such an approach like “financial stability”, “systemic risk” and “macroprudential supervision” are thus to be further developed (see also Brady and Markeloff, 2013). In a speech in 2010, former ECB President Trichet stated the following:

First, many standard macroeconomic models do not have well developed financial sectors and are mostly linear in nature. Therefore, they cannot easily capture widespread financial instability. As a consequence, they were not able to predict the drastic downward revision of growth figures we experienced during the crisis. Second, a greater understanding is needed of how financial regulations

act at the aggregate level, both in containing systemic risk and in affecting the growth potential of economies. This would allow a more precise “calibration” of policy recommendations that would have to [be] made in the ESRB context, for example. Third, the systemic importance of non-bank financial intermediaries is not explored as well as systemic banking risk. But we do need to include the roles of large and complex insurance corporations or highly leveraged financial players and their interactions with banks in our overall judgements about relevant system-wide interactions. For example, the impact of a large pool of “hyperliquid funds” that can shift allocation in global markets in real time is not yet fully understood, and it would be valuable to see it captured in financial models.

The ESRB has set itself the arguably ambitious task of developing these understandings and to become more aware of systemic risks, and in so doing learning where gaps in the regulatory framework for a cross-border financial system are and how to fill them. This is set to include shadow banking, for which data is not always available, stress testing, for which conceptualisation is complex. Moreover, the interconnectedness of the financial system must be addressed, and here the monetary dimension adds a layer of complexity.

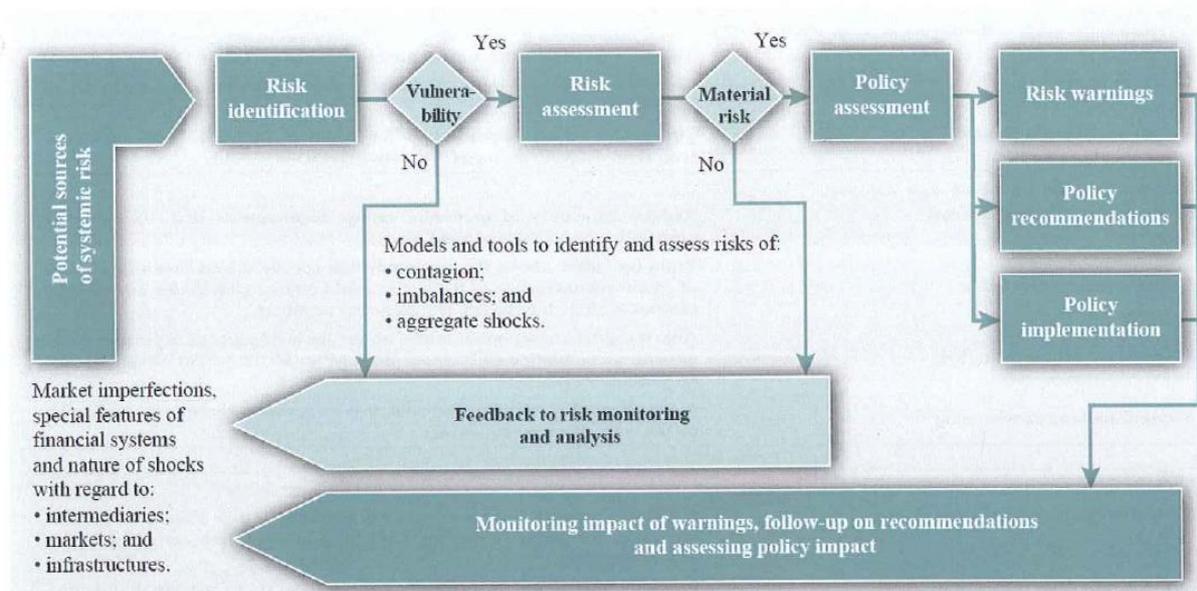
Moreover, it concerns itself with the micro-constitution of systemic risks, how macro- and micro-risks are related, and thus how micro- and macroprudential perspectives compare (see below).

Macro- and micro-prudential perspectives compared		
	Macroprudential	Microprudential
Objective	Risk prevention: reduce probability of systemic events	Limit distress of individual institutions
	Risk mitigation: reduce impact of systemic risks by strengthening financial system’s resilience	Protect depositors (and taxpayers)
	Avoid output costs	
Focus	Risks across financial institutions, markets, infrastructure	On individual financial institution’s capital and liquidity

Taken from BCB Dossier (2012).

In its work, it has three sets of core tasks. Firstly, “input gathering and analysis” involves the collection and analysis of wide-ranging information, using and testing a range of analytical models and concepts (see below).

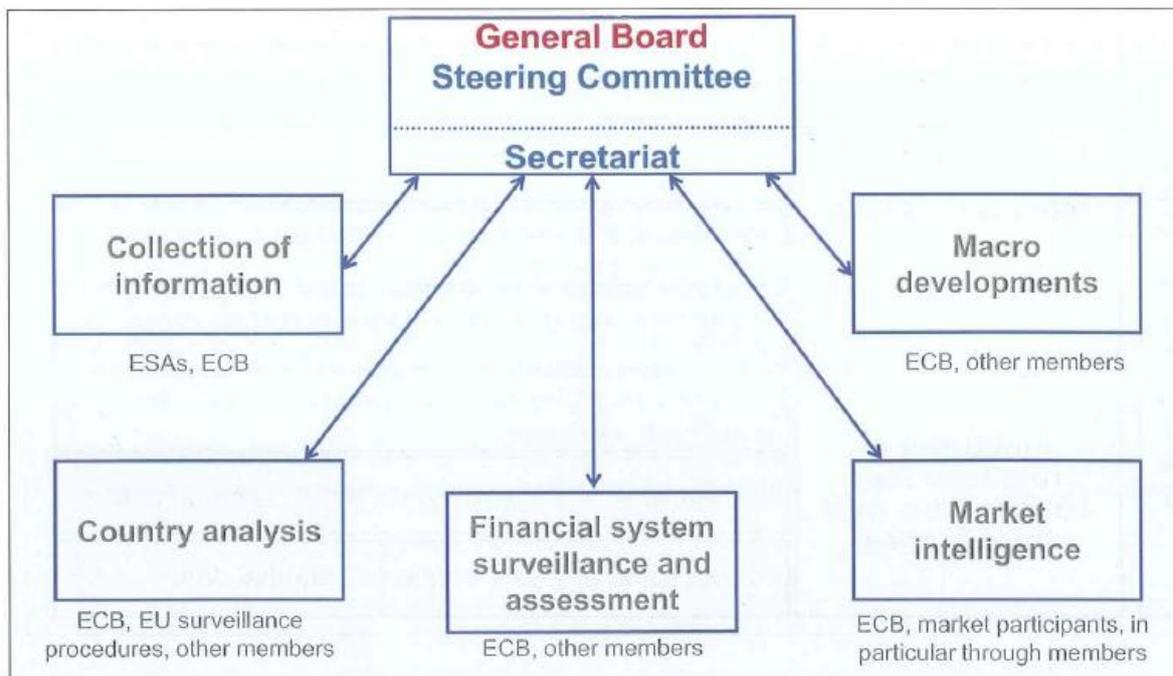
Role of analytical tools and models



Taken from BCB dossier (2012).

Secondly, “assessment” implies the identification, assessment and prioritisation of risks. Finally, it develops “policy responses” in the form of “warnings” and “recommendations”. To accomplish this, it draws on a rich network of support (see below), the members of which are represented on the Board.

Network of support



Taken from BCB dossier (2012).

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Warnings and Recommendations are non-binding, taking the form of “comply or explain”. Yet, while non-binding, the process through which these are issued and must be responded to may bring significant harm to member states by being made public.

Conclusion

In sum, the value added by the ESRB is intended to be:

- a) provision of EU level assessments of the stability of the whole financial sector;
- b) strengthening the quality of such assessments
- c) production of high quality risk warnings and recommendations

Yet, the ESRB face very substantial challenges in its work. It is quite conceivable that in the case of future financial crises, the ESRB will appear like more of a talking shop than effective supervisor/regulator. The same problem could emerge with its possible failure to prevent crises given the non-binding nature of its recommendations and warnings. In this context, the division of labour between the ESRB, other supervisory authorities and central banks needs development. We next turn to the new European Supervisory Agencies, primarily concerned with microprudential analysis and governance, but also tasked with contributing to macroprudential such.

5.6 European Banking Authority (EBA) and the European Banking Union

Introduction

The European Banking Authority came into existence on 1 January 2011 as one of three new European Supervisory Authorities concerned with microprudential oversight. It took over the tasks and responsibilities of the former Committee of European Banking Supervisors (CEBS). It adds to this portfolio, the task of “stress-testing” banks across the EU. While the CEBS’s standing in the central banking community was relatively weak proven by its failure to get central banks to attend to the cross-border impact of weak national regulatory frameworks on banking, the London-based EBA has, like the other two ESAs, both formal supervisory and legislative roles. Indeed, in relation to the traditional agency model within the EU, the EBA, along with the other ESAs, is rather vaguely referred to as an independent ‘union’ body with legal personality. However, its real powers, as we shall see, in contributing to micro-prudential oversight in the banking sector are carefully circumscribed by member state and financial market interests.

Description

As Eichengreen argues (2012: 129), where externalities deriving from cross-jurisdiction are considerable, the standard policy recommendation is “to assign responsibility for policy to a centralized authority whose domain encompasses all the relevant jurisdictions and which therefore has an incentive to internalize the spillovers in question”. Yet, with regards banking regulation, such considerations appear circumscribed by member state and financial market interests (especially of those based in the UK, but also in Sweden and Denmark). In legislative terms, the EBA has been given the tasks of strengthening supervisory co-ordination among national agencies, promoting supervisory harmonization and preventing regulatory arbitrage. Key means to carrying these tasks out are supposed to be the development of level 3 and 4 legislation, in the form of technical binding

standards (TBS) and guidelines. TBSs are difficult to categorise as they sit somewhere between rules and operational guidance. Yet, the issuance of this lower level legislation requires the endorsement of the Commission, which can also change or reject it. With regards specific regulatory forms of TBSs, the co-legislators (Parliament and Council) have veto powers. In supervisory terms, it carries out “stress-tests” in the banking sector and is supposed to compel information-sharing between banks. Initial questions about the EBA’s ability to play these roles effectively in the banking sector have so far received a mixed response. They require a high degree of legitimacy amongst central banks and banks alike.

In this context, the early response to the introduction of the EBA is of interest. Born in the midst of an almighty power struggle over the future of European banking, in which, on the one hand, banks were blamed for the crisis by many, and, on the other hand, a few countries led by the UK were concerned about the delegation of power to the EBA amidst fears of that the authority would undermine competitive advantages in banking services, the European Parliament’s ratification of the EBA’s first chair (as with the other ESAs’ chairs) was painful. For what was perceived as a hugely important role in tackling a banking sector reluctant to change its ways, competence and influence were key. The candidate was considered to have neither in sufficient amounts.

Moreover, the first set of “stress-tests” in 2011 failed the encouragingly low number of eight banks with the limited total capital shortfall of €2.5bn. However, while the volumes and depths of bank data provided by the EBA suggested that banks were willing to open their books up to scrutiny, the criteria by which that scrutiny took place were so relaxed that the conducting of a “stress test” seemed misplaced. The key criterion of the banks being able to withstand another recession (measured at a 15% decline in the stock market and 0.5% negative growth in the Eurozone) effectively bracketed the possibility of sovereign debt default. Indeed, the risk of sovereign debt default (especially in the case of Greece) to heavily exposed German and French banks was not fully considered (based on a low 5% pass mark), despite the fact that markets were in full anticipation of this event. If Greek default would have been accounted for, capital shortfall would have been much higher. Secondly, the few that failed were primarily Spanish, for which problems were since long known. The immediate impact on markets was close to nil with markets having already priced most of the likely (yet by the EBA ignored) future developments. Worryingly, because of the lax criteria, the stress tests did little to boost confidence in the banks that passed the tests. On the other hand, the detailed data provided was such that markets may discover new risks and opportunities, especially with regards credit exposure at risk and sovereign risk. In this early phase, the position of the EBA thus appears to be weak. This weakness relative to national regulators and banks promises to render its relationship to the Commission, to which it answers and in relation to which it hopes to exercise influence, potentially frustrating.

Quite arguably in response to the EBA’s inadequacies, and especially with regards its incapacity to short-circuit the negative dynamics between problem banks and indebted governments (clearly made acute by the aggravating situation in Spain), forceful steps towards Eurozone banking union were taken during the second half of 2012. A political decision was taken at the December Brussels summit on that blueprints for the union consisting of a single banking supervisor, a single fund for the resolving of banks and a common deposit-guarantee scheme in order to enable the winding down of problem banks, were to be drawn up, ratified and implemented during 2014. It would fall under the auspices of the ECB, making the ECB supervisor of all Eurozone banks with powers to police, penalise and wind problem banks up. Yet, the liquidity of banks would come under the direct scrutiny of the ECB, which would demand higher levels of capital reserves in place to render recapitalisation less probable. With the new body in place, the European Stability Mechanism could also be brought in to recapitalise banks under routine-like procedures. Bank resolution is devised to be funded through contributions from the financial sector itself and including arrangements for

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appropriate and effective publicly funded backstops. In the medium term, public backstops are to be rendered fiscally neutral by imposing post facto charges on the financial sector.

Conclusion

While Germany voiced concerns, in relation to its landesbanker and London, again, concerned about its status as the core financial node in the European financial landscape, the details remain unfinalised. Nevertheless, it appears certain that the banking union (in roughly this form) will relieve the EBA of its duties in the Eurozone, and weaken the latter's purpose in relation to the rest of the EU further. Moreover, it will break the separation of macro- and micro-prudential oversight with the ECB taking on roles in relation to both, and thus again giving the ECB policy-making and supervisory roles and the pressures that come with that. While potentially problematic in this way, the initiative does spell further integration of the financial architecture.

The next European Supervisory Agency that the report takes a look at is the European Securities and Markets Authority (ESMA). While there is clear overlap between EBA and ESMA, the next subsection will seek to distinguish their remits.

5.7 European Securities and Markets Authority (ESMA)

Introduction

In response to the De Larosiere Report and to the G20 discussions, and made operational in January 2011 along with the other institutions in the new supervisory framework, ESMA replaced the rather informal network of advisors that was the Council of European Securities Regulators (CESR). A crisis of the European project of integration, like many before, has again given integration powerful momentum, and the creation, remit and work of ESMA may shape financial integration for years to come. As Moloney (2011: 45) puts it: "the potential for, and the desirability of, a single EU regulator (in terms of rulemaking and/or supervision) for EU financial markets has been a hardy perennial of the scholarly debate for years, but political support has been limited....[In the crisis,] severe weaknesses were revealed in the EU's rule-book and in pan-EU supervisory coordination; the fiscal risks to Member States from poor coordination and management of cross-border risk transmission in an integrated market were laid bare". It is designed to play a major role in the drawing of a single rule-book for European financial markets. In accordance with the Lamfalussy Process, it is granted quasi-rule-making powers to speed this process up. While, on the one hand, this may appear a radical development and impossible to envisage without the impetus created by the crisis, there is strong continuity with European ambitions to produce a single rule-book ESMA dating back to before the FSAP.

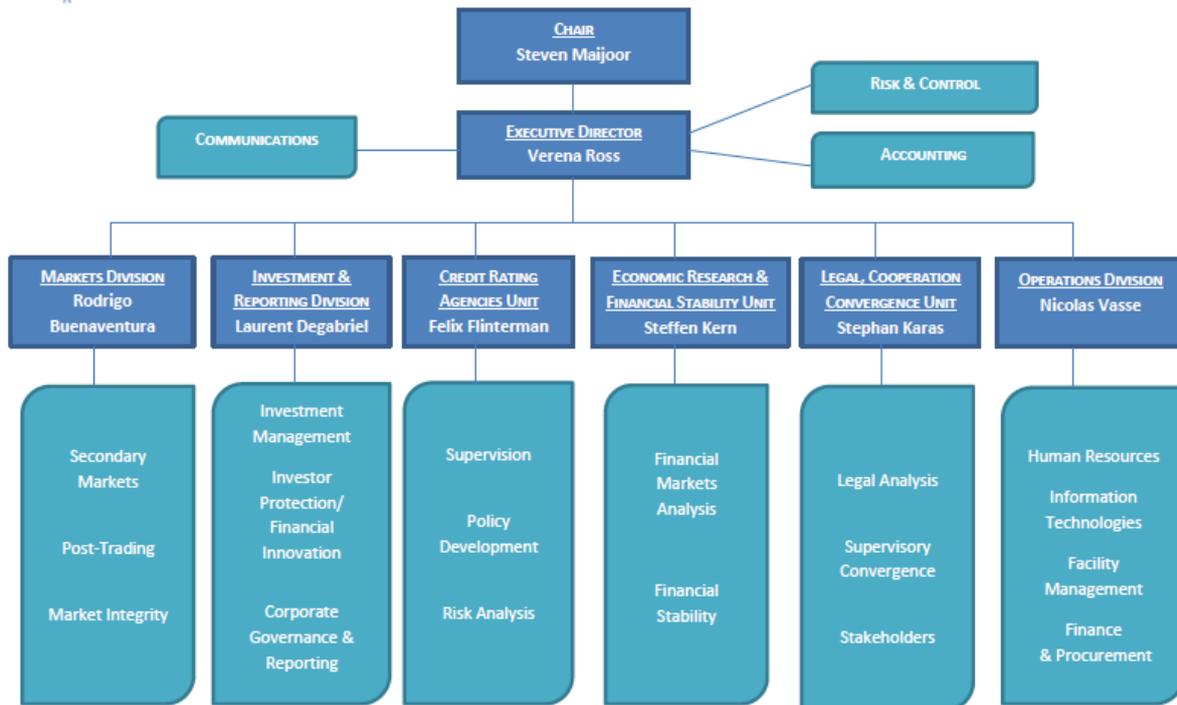
ESMA has in addition been invested with supervisory powers. This development of supervisory powers, on the other hand, is rather dramatic. The asymmetries between increasingly integrated European financial markets and supervision taking place on national level have clearly contributed to easily exploited weaknesses in the supervisory framework rendered apparent by the crisis. It has been argued that ESMA is insufficiently powerful with regards rule-making and too powerful in supervision for its own legitimacy's sake (Moloney 2011; 2012). What is clear, either way, is that ESMA is a new European body with an ambitious remit. In conjunction with an institutional analysis of ESMA's powers, this section will briefly list the raft of policy areas in which ESMA has already been called on to provide technical standards and guidelines for, before focusing on the Registration and Supervision of Credit Rating Agencies (here RSCRA).

Like the EBA, ESMA is a ‘union authority’ with a degree of independence, setting it apart from the traditional agency model within Europe. It is intended to contribute, especially in the technical realm, to the prevention of instability of the financial system of the EU by securing “the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection” (ESMA website, 2013). Indeed, as Moloney (2011: 65) testifies to the ambition, “while the likelihood of EU intervention will increase, so too should the technical quality of legislative rule-making”. A central activity is the fostering of supervisory harmonisation amongst regulators of security markets themselves and across financial sectors. It is supposed to work closely with the other two ESAs to achieve this end. The status of ESMA as an independent ‘union’ body with legal personality promises to shape the evolution of its work.

Firstly, ESMA takes over the role of the CESR as expert technical adviser to the Commission with regards adoption of delegated rules. While this appears insignificant, in light of its added powers (see below), ESMA’s technical input promises to be significant. Secondly, stating a more apparent institutional change, ESMA’s information-gathering and assessment powers will give it an influential role in the adoption of legislative measures, and thus the legislative process as a whole. Thirdly, its right to issue opinions to EU institutions at its own initiative may provide a further opportunity to establish its voice in the legislative process. Fourthly and more importantly, however, are ESMA’s powers on the third and fourth levels of legislation. Here, its third-level powers to propose ‘binding technical standards’ (BTs)(ESMA Articles 10-15)¹¹ is a highly significant development representing the ambition to harmonise decision-making amongst supervisors. This ‘regime’ is currently endorsed by the European Parliament in relation to controversial issues, as discussion can be pitched at a technical level (e.g. the OTC Derivatives Proposal). ESMA’s capacity to propose BTs is a form of delegation from the Commission, of the latter’s powers to pass delegated rules. They sit somewhat ambiguously between rules and operational guidance. On the fourth level of legislation, ESMA can exercise norm-setting powers by issuing, indeed imposing, guidelines and recommendations to the competent authorities or directly to financial market participants.

While its CESR precursor developed vast swathes of soft law, ESMA’s legal powers, also of course reinforced more generally by the post-crisis political environment, are much stronger, which should render its influence much greater. For instance, national supervisors and market participants must ‘make every effort’ to comply with the issued guidelines. If failing to do so, there is now a mechanism of ‘comply or explain’ (in detail) as well as the publication of non-compliance. ESMA’s annual report will also contain a ‘list of shame’ stating which authorities have failed to comply with ESMA guidelines and how. This will be accompanied by an ESMA statement of intent of how to make compliance happen. Finally, ESMA can impose binding decisions on third parties. In sum, the creation of ESMA is a statement of intent in relation to Europe-wide harmonisation of supervisory practices (See Moloney 2011). The question outstanding is the extent to which ESMA will manage to establish its autonomy in relation to the Commission, which is increasingly seen, by financial market participants, as at the forefront of a regulatory onslaught. This will have implications for its legitimacy and influence.

¹¹ BTs take two legal forms: ‘regulatory technical standards’ represent a delegation of quasi-rule-making powers from the EU institutions; ‘implementing technical standards’ represent a delegation of implementing powers from the member states. Both forms are subjected to Commission oversight. The Commission can endorse, change or reject standards (but must communicate with ESMA in the process). Implementing standards are also subject to veto powers of the European Parliament and Council. In fact, the co-legislators can revoke delegation altogether.



01-07-2012

ESMA organigramme taken from ESMA website.

ESMA has so far attended (or is in the process of attending) to provide technical advice, binding technical standards and guidelines in relation to a vast swathe of regulations and directives. The report will here give some insight into the work of ESMA's Market Division as well as the supervisory powers of the Credit Rating Agencies Unit.

The Market Division divides its work into that focusing on Secondary Markets, Post-Trading and Market Integrity. ESMA's Secondary Markets Standing Committee undertakes work on issues pertaining to the impact of market structural change on the transparency and efficiency of trading in financial instruments. This involves trading platforms and Over-The-Counter markets. It concerns transparency requirements for the trading in shares, non-equity instruments and commodity markets. These relate to the MiFID directive (Markets in Financial Instruments Directive)¹² (see Section 4). Another key task of this Committee is the fostering of supervisory harmonisation among relevant national authorities. It further provides advice to the Commission, as well as BTSs and guidelines and recommendations pertaining to MiFID provisions for regulated markets, Multilateral Trading Facilities (MTFs), systematic internalisers, other organised trading platforms and pre- as well as post-trade transparency.

With regard to, work on Market Integrity, a standing committee of significance is the ESMA-Pol committee which focuses on issues dealing with facilitation of cooperation of national authorities,

¹² With MiFID in operation by 2007, following the level 2 technical advice provided by ESMA's precursor CESR to the Commission, ESMA continues work to provide Binding Technical Standards (level 3) to ensuring supervisory harmonisation. This is intended to allow smooth pan-European operations of regulated markets, MTFs and financial firms through home member state authorisation ('single passport'). Investor protection is here thus also harmonised.

exchange of information in market abuse investigations, market surveillance and enforcement of securities laws. With regards market surveillance, the committee undertakes work to enhance the efficiency and effectiveness of national authorities' activities in relation to market surveillance. In terms of cooperation, it focuses on cross-border cases working to ensure efficiency and timeliness. It also supports information-sharing activities. In line with this approach, it also provides a forum for national authorities in which these can exchange experiences of market surveillance and enforcement. In relation to BTSs and guidelines and recommendations, it provides advice to the Commission on issues pertaining to market integrity, for instance in relation to market abuse (the Market Abuse Directive, or MAD) and short selling.

Work on commodities derivatives markets is led by its own task force. The implementation and elaboration of recent and ongoing level 1 and 2 legislation such as MiFID, MAD and EMIR (European Markets Infrastructure Regulation (OTC derivatives, central counterparties (CCPs) and trade repositories (TRs) (see below)) affect the area of commodity derivatives. On the basis of monitoring and analysis of all relevant regulatory and sectoral developments, the task force provides technical advice to the Commission, drafts TBSs and additional advice to the European institutions.

With regards the area of post-trading, ESMA's work is led by the Post-Trading Standing Committee. It has especially focused on the infrastructures required for the safe, reliable and efficient completion of trades. Here, it works in three key areas: a) on new key regulations, especially EMIR (see below) and the Central Securities Depositories (CSD) regulation; b) on ensuring coordination in supervisory activities in areas such as Settlement Discipline and TARGET2-Securities; and c) on carrying out its responsibilities with regards the Settlement Finality Directive (SFD).

This standing committee have created three task forces to develop the BTSs and recommendations and guidelines required under EMIR: the Central Counterparty Requirements Task Force, the Trade Repositories (TRs) Task Force and the OTC Derivatives Task Force. The CCP Requirements Task Force is tasked with developing TBSs on CCP organisational requirements, the keeping of records, margins, liquidity risk controls, default fund, default waterfall, collateral requirements, stress testing and back testing, investment policy, reviewing of models and business continuity. The TRs Task Force develops BTSs stipulating the details and type of reports required for different classes of derivatives, and the details required for inclusion in the application for registration with ESMA as well as in the information (and frequency of such) to be given to particular authorities, including ESMA, CCP supervisors, relevant ESCB Members, and last but not least the public. The OTC Derivatives Task Force, in line with the EMIR draft proposal, is tasked with the development of BTSs for the specification of the provisions pertaining to clearing obligation assessments (including exemptions in the detail), what to be included in the public register and detailing the techniques for risk mitigation to be applied if OTC derivative contracts are not cleared by the CCP.

With regards the Central Securities Depositories (CSD) Regulation (adopted in 2012) pertaining to the amelioration of securities settlement and the operations of CSDs including the harmonisation of settlement periods, discipline measures and rules, ESMA is to deliver TBSs and guidelines. Concerned with the rise in settlement fails, ESMA has set up a Task Force on CSDs and Settlement Discipline. Here, ESMA's is testing the working hypothesis that it is the lack of harmonisation in settlement discipline regimes that is contributing to this rise. ESMA has also been involved in preparatory work on securities settlements and CSDs in relation to the construction of the TARGET2Securities payment system.

ESMA has also been involved in the development of the Regulation on Short Selling and Certain Aspects of Credit Default Swaps.¹³

As a result of the political momentum gathered by the crisis, ESMA has also been granted significant supervisory powers. Although the EU has taken increasing control over the rule-book of financial markets, supervision and enforcement have remained national competences. To an extent, this remains the case even with ESMA's new powers, but ESMA's new roles in relation to both competences promises to transform the supervisory architecture in Europe. CESR had adopted a soft supervisory harmonisation model centring on voluntary participation in practices of peer review, best practice sharing, institutional support of cross-border cooperation with regards market abuse, mediation, support of delegation, and the enforcement of financial reporting. The crisis revealed the flaws in this approach (Moloney, 2010). Micro-prudential oversight was clearly lacking. Arguably, nowhere was this more apparent than in the case of Credit Rating Agencies.

Following continued unease with CRAs despite the adoption of two regulations in response to the crisis, the Commission launched a public consultation in 2010 (available on http://ec.europa.eu/internal_market/consultations/2010/cra_en.htm). Six broad problem areas were identified:

1. Unsound credit rating methodologies;
2. CRA independence potentially undermined by the conflicts of interest arising from the 'issuer-pays' model, length of tenure (of the same CRA) and ownership structures of CRAs;
3. Insufficient competition in the credit rating market with monopolistic effects;
4. Ratings users suffering losses due to inaccurate ratings infringing upon CRA regulation do not have sufficient opportunities for redress;
5. Capital markets suffering from 'cliff effects from the overreliance on external credit ratings; and,
6. Changes in sovereign debt ratings resulted in both 'cliff' and contagion effects.

Following some dilution of a third resulting proposal (especially with regards problem areas 2 and 3), CRA III was adopted. The crisis response to the failures of the CRA industry has been forceful. ESMA is to play a central role in its regulation and supervision. The report will here focus on its supervision, to give a flavour of the powers invested into ESMA in the new financial market supervisory architecture. Although, ESMA's supervisory powers in relation to CRAs is not typical of ESMA's supervisory powers, it points to a plausible future trajectory of cross-border supervision in Europe. Of course, this may very well be due to that CRAs represent a small, albeit now highly controversial section of the financial markets, are intensively cross-border in their operations and impact, and they do not bring immediate material fiscal risks for member states, making the exceptional empowerment of ESMA less risky, at least in the short run. In the medium- to long-term, an operational model supporting extensive transfers of direct power has been designed and may serve as a prototype for future transfers of power in the financial market integration process (Moloney 2012: 204-5).

To start with, it is worth noting that distinguishing between operation supervision and coordination in the EU is not an easy task. The boundaries tend to blur. Nevertheless, operational supervision has tended to remain a national competence with coordination and harmonisation activities taking place on an EU level. Yet, with ESMA's role in relation to CRAs, this separation is less apparent.

With regards its activities in bringing about supervisory harmonisation, ESMA largely follows the pattern of the other ESAs, including its relative autonomy from the Commission. One particular task

¹³ The text of the Regulation together with the relevant technical standards and delegated act are available at http://ec.europa.eu/internal_market/securities/short_selling_en.htm

is prominent, which is in the case of financial crisis. ESMA, working closely with the ESRB, is supposed to promote and facilitate a coordinated EU response through information exchange. Yet, it is in the realm of daily operational matters that it stands out.

Firstly, ESMA has exclusive competence over the registration of CRAs. It also charges a fee for their registration, although. This brings CRAs into the supervisory fold of ESMA, who has exclusive competence over their supervision as well. Yet, competent authorities in the member states are still responsible for the supervision of the use of ratings.

Secondly, ESMA authorises national competent authorities to carry out direct supervision on its behalf, including the delegation of specific tasks (including on-site inspections and investigations). Indeed, national authorities must accede to such requests subject only to some prior consultation. However, delegation of tasks which may undermine ESMA's authority are not to take place, thus excluding supervisory responsibilities such as final assessments, decisions on registration and (follow-up) decisions concerning infringements. Moreover, national authorities are obliged to notify ESMA if convinced that the Regulation has been breached, whether within the national jurisdiction or in another member state. To underline ESMA's powers, ESMA is typically not obliged to follow national authorities' requests, although it may normally do so. This refers to requests to attend to: ostensible breaches of regulation; the examination of CRA reasons for the withdrawal of registration; suspend, in exceptional circumstances, the use of ratings for regulatory purposes. However, it does have to provide the full reasons for why requests have not been attended to. Similarly, with regards on-site inspection, ESMA is carefully empowered to be the pre-eminent actor according to a detailed regime outlining the roles of ESMA and the local competent authority respectively. Moreover, in relation to local courts, ESMA has a degree of autonomy and the lawfulness of ESMA decisions are to be determined by the European Court of Justice, not local courts. ESMA is clearly the pre-eminent actor in supervision, although it clearly depends on the work of local supervisors to carry supervision out.

On the ground, ESMA's supervisory powers are considerable. They even include the right to access, examine and duplicate any relevant records or material, summon to its offices, hear and interview relevant persons, acquire records of telephone and data traffic. In terms of enforcement, it can take an array of direct actions, including the issuing of public notices, fining, withdrawing CRA registrations, temporarily suspending the use of ratings for regulatory purposes and (temporarily) prohibiting the issuance of ratings. The procedure of enforcement in national courts is somewhat unspecified. ESMA, however, has legal personality enjoying 'the most extensive legal capacity accorded to legal persons under national law' and able to be a party to legal proceedings (Regulation on CRAs, Article 5). While ESMA should refer criminal prosecutions to the relevant national authorities, it has administrative sanctioning powers, which it can exercise directly.

In sum, it is clear that ESMA has been granted considerable supervisory powers in relation to the Regulation of CRAs, although partly institutionally circumscribed by its particular relationship to the Commission. It is also clear that the granting of such, for now, exceptional powers in the supervisory area was politically motivated as a response to the crisis as well as facilitated by the limited fiscal implications intervening in this area promises to have for member states. Still, it can potentially set a precedent for the activities by the European Supervisory Authorities.

Conclusion

The creation of ESMA promises to be a much-needed contribution to the improvement of supervision of financial markets in Europe. ESMA has considerable harmonisation powers through

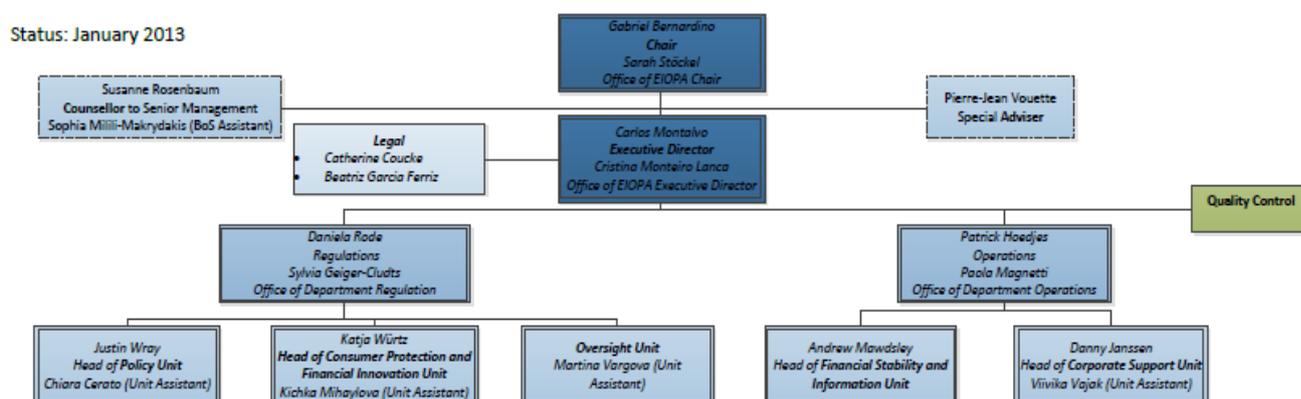
the role it plays in providing technical advice in the level 2 legislative process, and in designing and disseminating BTSs and in the issuing of guidelines and recommendations to national competent authorities. Its supervisory powers, albeit of uneven strength across regulatory issues, are by European standards intrusive. How ESMA handles these powers, not least in relation to national competent authorities will be crucial for its legitimacy and efficiency.

The final European Supervisory Authority is the European Insurance and Occupational Authority (EIOPA), the so far most low profile of the three.

5.8 European Insurance and Occupational Authority (EIOPA)

Introduction

EIOPA came into being along with the other two ESAs in January 2011. Its precursor was CEIOPS. EIOPA is quite arguably the least high-profile of the three ESAs. While also tasked with supporting the stability of the financial system, this could in part be explained by that insurance and reinsurance companies as well as pension funds, constituting the main market actors that EIOPA is concerned with, have with a few exceptions escaped the limelight in the same manner as the constituents of the other two ESAs. As such, EIOPA's role in the new Financial Market Supervisory Architecture appears less current. The remaining constituents of EIOPA, consumers, have, despite efforts made by EIOPA to attract their attention, only recently started to find their way to EIOPA. Quite arguably, in the 'turf wars' between the new ESAs anticipated at the outset, EIOPA has played a waiting game. Still, EIOPA, like the other ESAs, is tasked with the duty to produce BTSs, recommendations and guidelines, albeit without some of the supervisory powers of ESMA. Moreover, while ESMA has had to address a raft of regulations and directives, EIOPA has had to respond to relatively few. Yet, in addition to outlining EIOPA's areas of responsibility, this section will focus in on one major directive: Solvency II.



EIOPA organigramme, taken from EIOPA website, 2013.

Considering the attention predatory lending practices, fraudulent insurance schemes, dissatisfying pension schemes and speculative forms of financial innovation has received since the onset of the crisis, it is only recently that EIOPA has started to attract the wherewithal of consumers. EIOPA is tasked with take the driver's seat in the promotion of transparency, fairness and simplicity in the retail markets for financial products and services. EIOPA's tasks in this area include:

- Adopting guidelines and recommendations to promote safety and soundness of markets and convergence of regulatory practice;
- Contributing to the development of common disclosure rules;
- Issuing warnings in case a financial activity poses a serious threat to EIOPA's core objectives;
- Within specific parameters, temporarily prohibiting or restricting certain types of financial activities that threaten the orderly functioning of financial markets or the stability of the whole or part of the EU's financial system;
- Developing training standards for the industry;
- Collecting, analysing and reporting on consumer trends; and,
- Reviewing and coordinating financial literacy and education initiatives by competent authorities.

To lead this work, EIOPA has set up the Committee on Consumer Protection and Financial Innovation (CCPFI).

In the area of occupational pensions, EIOPA has been given the duty of contributing to a sound, consistent and effective level of regulation and supervision of institutions for occupational retirement provision to ensure that risks are appropriately addressed. This work has contributed directly to the Directive on the activities and supervision of Institutions for Occupational Retirement provision (the IORP Directive), including the development of BTSs on the reporting of prudential legislation. EIOPA is also undertaking work pertaining to the quality of information provided to members of defined contribution (DC) pension schemes.

EIOPA develops BTSs and issues guidelines and recommendations in the area of insurance. It also provides opinions to the co-legislators and the Commission on issues related to this area. Work is at the moment primarily geared towards the creation of a new supervisory regime for insurance and reinsurance (the EU Directive on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)).

Building on work dating back to 2004, the Solvency II project reviews the prudential regime for insurance and reinsurance undertakings in the EU. While, adopted by the co-legislators in 2009, the technical work is extensive in the area of insurance and are currently expected to be concluded in 2014.

Technical standards and guidelines will cover the following:

- Technical provisions, internal models, solvency capital requirements, own funds, and valuation of assets and liabilities;
- Governance of the own risk and Solvency assessment regime;
- The supervisory review process, capital add-ons, special purpose vehicles, repackaged loan investments, extension of recovery period ("Pillar 2 dampener") and finite reinsurance;
- Supervisory reporting and disclosure, transparency and accountability; and,
- The supervision of insurance groups

Solvency II should come into force in 2015.

EIOPA is tasked with playing a key role, along with the other two ESAs tasked with micro-prudential oversight and EBSR tasked with macro-prudential oversight, in the development of a crisis prevention, management and resolution plan. One reason for EIOPA not being in greater public focus is the particular relationship between insurance and the financial system more generally, not least due to the specificities of the former. Not least as a consequence of the scale of the current

crisis, EIOPA has taken its time to evaluate risk, especially systemic such, in its area of supervision in order to contribute meaningfully to this plan. EIOPA is still endeavouring to find answers to key questions: “Is the purpose to minimise upset to the stability of the financial system? Or is the purpose to minimise the economic costs to policyholders and the broader economy of a significant insurance failure?” (EIOPA website, 2013) These questions of systemic stability and risk versus policy holder welfare may reveal a fundamental tension in EIOPA’s mandate. Unsurprisingly, EIOPA has not found fully satisfying answers to these questions yet.

More practically, however, the recovery and resolution of large and complex insurance companies and groups of insurance companies are acknowledged by EIOPA to be very challenging potential tasks. It is however considering measures to facilitate the execution of these tasks, if need be. Crisis in the insurance sector, EIOPA claims, is a different prospect than in most other parts of the financial sector. Crisis prevention is thus essential, and EIOPA is collecting data in order to be able to identify cross-border patterns emerging at an early stage. Promoting crisis prevention, EIOPA involves national competent authorities in information-sharing on how to address adverse developments. With national authorities retaining their supervisory powers, EIOPA identifies close working relationships with these authorities as central to the successful coordination of supervisory practices and procedures. Resolution remains too a national competence and there is only limited scope, according to EIOPA, for coordination here. Work in this area has been geared towards the theoretical and practical underpinnings. Parallel work is ongoing in several international forums. Meanwhile, the Commission is considering a proposal for a framework for recovery and resolution of non-bank financial institutions. EIOPA coordinates responses from insurers in this process. Should schemes already developed for the recovery and resolution of banking also be extended to other financial institutions, including insurance.

Conclusion

EIOPA’s constituency of insurers and pension funds are firmly rooted in national supervisory frameworks and the crisis has not been sufficient to disembed the latter. EIOPA is therefore clearly treading carefully in responding to the crisis. Yet, while a qualitatively different business than say banking, insurance and pensions are increasingly central to European financial markets. EIOPA is considering these relationships, while undertaking its technical work in response to directives such as Solvency II. In response to policy holders and consumers more generally, EIOPA is becoming more responsive.

In the Mercosul, watching European developments from afar has been bewildering. In the next sub-section, the report turns to developments in the Mercosul since the onset of the global financial and economic crisis and an analysis of the current outlook in the Mercosul with a particular focus on financial integration.

5.9 Mercosul

Introduction

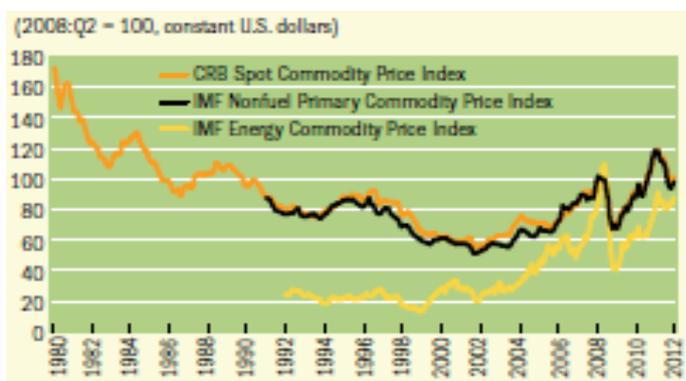
This sub-section provides a historical overview and an analytical account of the Mercosul response to the crisis. This provides the context for a brief summary of the work of SWG 4 and its short term work programme. The sub-section argues that Mercosul’s intergovernmental mode of integration, the lessons 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. In a global context, its gradual decoupling from the US, including distancing from prevailing economic thought and relatively lax regulatory regime, has given the region the freedom to respond in this more effective manner to the crisis. Yet, very important for its ability to stave off crisis has also been the continued commodity boom, partly generated by regional stimulation packages, but primarily thanks to continued Chinese demand for Mercosul commodities. Yet, Mercosul financial integration has reached an impasse with current policy preference divergences and significant differences between 'old' and 'new' members with this moment bringing up a series of interrelated questions. How can Mercosul financial integration move further given this situation? Perhaps more fundamentally, how much further does Mercosul want to go in liberalising and integrating, however cautiously, regional financial markets? Finally, what would be required for a single Mercosul financial market without a common currency to function with minimal systemic risk? Asking such questions will set the report up for proposing a number of recommendations in the Report's overall conclusion.

Mercosul Developments

With the eruption of the global financial and economic crisis in the US (as the "subprime crisis"), it sent shockwaves through the global political economy as credit crunched towards the end of 2008 and first quarter in 2009. The rapid G20 bailout, agreed upon at the April 2009 London Summit, staved off the worst effects and the coordination of re-regulation to prevent future crisis provided a degree of reassurance in the subsequent stage. However, without also the global coordination of growth stimulation, governments and regions face a challenging and uncertain scenario. Wherefrom is growth in the global economy supposed to come? Choirs of voices pointed to the growth dynamic, but also leadership, of the so-called 'emerging BRIC economies' (e.g. Subacchi 2008).

Brazil along with the other Mercosul member states have indeed handled the crisis well following the initial negative consequences on growth and employment. Both Argentina and Brazil contributed through their membership in the G20 to constructing a mass global bailout, which brought an initial inflationary period in the global crisis, and contributed to an expansionary phase in the Mercosul. However, as this initial expansion tailed off towards the end of 2008, recessionary trends appeared. Global trade contracted, commodity prices rose and investor confidence and credit crunched. Exports and private investments thus saw a sharp decline. Activity levels and employment dropped considerably. The simple average unemployment rate in the Mercosul economies, excluding Paraguay, shot up from a 6.9% to 8.2% in the last quarter of 2008 to the first half of 2009, albeit less pronounced in Uruguay. Yet, as imports fell too as a consequence of falling exchange rates, particularly of the Brazilian *Real*, balance of payments crises could be avoided. With imports subdued, the moderate relative falls and subsequent quick recovery in exports of commodities to East Asia, especially to China thanks to the latter's mass fiscal expansion, contributed to this. Continued rises in commodity prices, no doubt, benefitted the Mercosul economies substantially (see commodity price developments over the last three decades in graph below).



Source: Helbling, 2012: 30.

In Uruguay, the pattern was rather different. Uruguay enjoyed a major influx of private financial capital at the beginning of the crisis and was able to accumulate substantial foreign currency reserves with only limited falls in these inflows during the contractionary period. Further exchange rate volatility was prevented by the accumulation of foreign currency reserves which served to reduce uncertainty and calming foreign exchange markets. Still, these trends were short-lived and by March 2009, the world economy was on the whole stabilising and Uruguay and the rest of the Mercosul started its recovery.

Regional crisis management has however been rather nominal in nature; member states have largely individually managed the crisis with some tensions arising as a result. A currency swap regime between Argentina and Brazil was discussed but has not been agreed upon. A Local Currency Payment System (*Sistema de Pagamentos em Moedas Locais - SML*) between Argentina and Brazil (discussions are ongoing with Uruguay) was implemented but the negotiations to amend the Common External Tariff failed. There were renewed trade negotiations with the EU, the successful removal of double levying on third country imports as well as the full implementation of FOCEM.

The SML (CMC Decision No. 25) became an instrument available to all member states in 2007 as voluntary bilateral agreements between central banks, with it first being implemented in October 2008 for trade transactions between Argentina and Brazil (according to CMN Res 3.608, September 11, 2008). It enables exporters and importers in both countries to use the local currencies for payments. The SML rate, a cross-rate between the Brazilian Ptax rate (BRL/USD) and the Argentinean Reference rate (ARS/USD), is set on a daily basis with the two countries' central banks as clearing houses. Financing is on offer for over a maximum of 360 days. and to reduce administrative and financial costs (by reducing hedging needs, not least with a currently volatile US Dollar). It is intended to facilitate cross-border transactions between small and medium-sized enterprises in particular. Today, the SML facilitates about 3% of total bilateral trade between the two members. The SML is also being negotiated between Brazil and Uruguay and Argentina and Uruguay. The SML was intended to remove reliance upon the US Dollar as the intermediary trade currency (e.g. Arraes 2009). Still, balances are liquidated in US Dollars. Yet, benefits are perceived as limited and financing insufficient for the system to attract greater transaction volumes (Institute for the Integration of Latin America and the Caribbean, 2009). Still, it is noteworthy that as Europe's project of monetary integration appears to be in decline, Mercosul takes steps, albeit perhaps rather small as of yet, towards monetary integration (Otero 2013).

FOCEM reached full level of operation in 2008. Created to reduce regional asymmetries and strengthen development in the region's smaller economies and border regions in particular. The programmes under the fund focus on the generation of structural convergence, competitiveness, social cohesion and institution-building. By mid-2011, FOCEM had provided \$1.1bn to 37 projects.

To consolidate progress towards customs union (CUCP) was approved at end of 2010 with the task schedule running until 2019 and thus to strengthen trade with third countries with which there are trade agreements. To this end, the so-called double levy on imports was successfully removed in 2009, although significant work remains for its full implementation. In relation to these developments in relation to trade liberalisation, the stalled negotiations with the EU of the early 2000s were restarted in 2010 and then received a much-needed boost by the visit of a large and willing European delegation in early 2013. In return for opening European markets up to Mercosul agricultural exports in particular, the trade in industrial goods and services are due to be liberalised. Also knowledge and research exchange programmes are part of the deal. The annual trade affected by the deal amounts to \$130bn (Euractiv 2013). Yet, sticking points remain. Within Mercosul, trade issues are arising. Despite substantial negotiations between Argentina and Brazil to amend the Common External Tariff on a range of goods, agreement could not be made. This has provided the foundation for some tension between the two countries subsequently. It has also led to tension between Brazil and Paraguay.

Although a dispute-settlement body and a small secretariat set up to address commercial conflicts in the region are by now in existence, trade-related tensions have arisen. Firstly, trade protection measures were introduced between Argentina and Brazil. Argentina also widened its non-automatic licensing, which frustrated not only Brazil but also Uruguay. Since early 2011, Argentina has increased the number of items (600) which are not automatically licensed for importation. Goods can now be detained for a maximum of 60 days. In combination with a number of other supposed non-tariff barriers, this has led exporters to complain to the WTO. The effect on Mercosul trade has been significant. In the first half of 2012 alone, Brazilian and Uruguayan exports to Argentina were down by 15% and 10% respectively from the same period in 2011. In return, Brazil has imposed some barriers on exports from Argentina. Capital controls were introduced in 2012 by Argentina leading to further tension.

The combined effects of these and other developments have over the last two decades led to a negative shift in the proportion of intraregional trade with all five member states showing significant reductions in the percentage of trade with other member states (see graph below). Moreover, trade liberalisation and the close trading relations developing with East Asia, including the latter's demand for Mercosul commodities against low- to medium level industrial and technological goods has reduced. This has led to disincentives to further industrialisation. Concerns arise from expectations that commodity prices are to come down, partly as a consequence of a shift in the Chinese strategic plan away from exports and a reduction in commodity imports in the building of a stronger domestic market (e.g. Helbling 2012 and Schmalz and Ebenau 2012).



Source: The Economist, 14/7/2012

In the work of SWG4, the crisis has of course been a preoccupation and appears to have focused minds to an (even) even greater extent on regulation and supervision. Indeed, the working programme has since the onset of the crisis 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. Yet, liberalisation and harmonization efforts have continued with a clear focus on regional systemic asymmetries in regulation and supervision. Reminded of the fragility of the global financial system but also the potential policy interpretations of its crisis, the Common Market Council Decisions 49/08 and 54/10 are also of significance to the work of SWG4. CMC decision 49/08 established the Action Plan for the Strengthening of the Liberalization Program of Services Trade in Mercosul reinforcing the commitment to meet the deadline of the Montevideo Protocol. CMC decision 54/10 involved the reassertion of the member states' commitment to liberalization of financial services in the region. Having established a degree of consensus on how to interpret the crisis and its regional impact, SWG4 continues to pursue the liberalisation programme initially set out by the Montevideo protocol.

Key discussion points in the short-term work programme are the following:

- Analysis of Mercosul asymmetries on Financial Services concerning National Treatment (NT) and the Market Access (MA).
- Analysis of hindrances to the progress of an effective Financial integration, possible alternatives and requisites for each of the identified problems
- Developing a Technical Cooperation plan in order to foster the financial integration.

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- Building up a template that address the financial regulators requirements to be used in all financial integration process or financial services negotiations involving Mercosul.
- A fully report about the use of Mercosul currencies on the other Mercosul countries.
- Presentation of a plan for full incorporation of SGT-4 regulations by Venezuela (incl. comparative tables).

However, the Paraguay suspension following constitutional altercations and the admission of Venezuela in 2012 have delayed the operationalisation of some of these plans. In the medium-term, the Mercosul agenda could include a payment and settlement platform focusing on the interconnection of the nationals payment systems, given that it can be designed so as to avoid and mitigate systemic risks.

The ‘technical’ work on identifying challenges in the financial integration process has been completed by SWG4. In the regulatory domain, therefore, SWG4 has reached a point at which further integration requires changes in the Constitution and the Civil Law. This in turn, of course, means that political, and as such legitimating, decisions have to be taken by the National Congresses of the member countries, if further integration is to be outlined by the working group. The question then arises: is this continued, albeit clearly cautious, liberalization process compatible with Mercosul integration more generally? Is a Mercosul of the future capable of combining liberalized financial markets with public investment funds of different kinds and a sustained political integration process? How can Mercosul financial integration move further given this situation? Perhaps more fundamentally, how much further does Mercosul want to go in liberalising and integrating, however cautiously, regional financial markets? Finally, what would be required for a single Mercosul financial market without a common currency to function with minimal systemic risk?

I will return to some tentative answers to this difficult question in the Report’s conclusion.

Conclusion

This sub-section has addressed the Mercosul response to the crisis and the current picture in relation to financial integration. Mercosul has clearly ridden the storm of the global financial and economic crisis out well. This has been enabled by an intergovernmental, obviously political regional organisation, but also the lessons picked up from the number of difficult crises experienced in the recent Mercosul past. Partly enabled by a continuing commodity boom and East Asian demand for Mercosul commodities, Mercosul has protected and stimulated domestic markets through Keynesian-style countercyclical expansionary policy. This process appears to point Mercosul in a more integrated direction whereas recent trade trends have pointed to a degree of deregionalisation of trade flows, not to mention trade conflict within the region and beyond. The complex historical relationship between Argentina and Brazil at the core of the Mercosul has re-emerged as both strength and weakness during the crisis. While allowing for flexibility in member states’ response to the crisis, it has also led to tension not only between Argentina and Brazil but also in relation to Paraguay. Since the crises around the Millennium, politically negotiated exceptions to the block’s rules have become the norm.

Moreover, while Europe is becoming conscious of its mistakes in monetary integration, Mercosul has benefitted from not having gone down that road. Yet, Mercosul has started to take small but potentially significant steps in this direction. These steps have several purposes, of which one is to

continue the region's decoupling from the US and its reliance upon the US Dollar in trade. The Mercosul "big two", Argentina and Brazil, have become more vociferous in the international fora emerging to address the global crisis and contributed to the G20's global mass bailout. However, in the absence of a global growth strategy, Mercosul is trying to find ways to create the stimulus programmes to ensure that growth persists in the region. If Mercosul is serious about intraregional trade supported by an integrated financial market, the collapse of one Mercosul economy, especially one of the two big ones (Venezuela is as of yet insufficiently economically integrated to constitute a problem in this sense), may have considerable consequences for the other. However, as there already is the Chiang Mai Initiative and the extended FLAR idea in UNASUR, maybe this is unnecessary as any of the above could be extended to include the Mercosul as a whole. We shall return to this question in the Report's overall conclusion.

While financial integration is moving ahead broadly as stipulated by the Montevideo Protocol, the crisis has clearly preoccupied considerations in this area. Yet, is the work of market liberalisation, albeit of a cautious nature, of the SWG4 bringing about the type of markets that are going to be compatible with a regional integration process that is politicised and currently left-leaning? This is a question worth asking at this point as further technical work by SWG4 requires political decisions by the national congresses. It appears that a much deepened financial liberalisation has contributed to the problems experienced in Europe. We will return to this question in the Conclusion of the Report.

5.10 Conclusion

While historically much more institutionalised and supranational in nature than Mercosul, European integration with its Community Method of focusing on economic integration to lead to political integration through spillovers appears to becoming true. Of course, this is a highly simplified reading of the process. Indeed, political integration is being accelerated by economic "spillover", however, it is hardly some kind of a natural, rational process, as sometimes suggested. Rather, monetary integration has led to highly problematic outcomes. The Euro crisis is forcefully demonstrating that artificially bracketing the political from the economic is artificial, indeed a political project in itself. Yet, politics is the best we have got in terms of designing economy and society in legitimate and sustainable ways. There is no need, indeed it is perhaps counterproductive, to ignore that fact. Yet, the process of making the European economy work, with financial integration as a key element, has become, due to the crisis, a political high wire act of great proportions and consequence. With financial re-regulation and sustained monetary union membership the carrots, the sticks of austerity imposed by the so-called Troika, the ECB, the EU, and the IMF, are running the risk of back-firing as social and political upheaval around Europe is testifying to with the common outcome of depoliticising technocratisation of government as we have seen in Greece and Italy. What should at the outset have been a deeply political, and hence legitimating, process of monetary and fiscal integration has become a deeply politicised and delegitimising process.

With regards European financial integration since the onset of global financial and economic crisis, a preliminary conclusion is that while some organigramme's and flowcharts illustrate the supposed coherence of the reformed system of governance linking new considerations of links between sovereign debt, financial markets and economic imbalances more generally in Europe, there appears to be a lack of clarity about the overall shape of this system. Rather, the process of piecing the system together has been frustrating to markets and the public alike. Nevertheless, undeniably, the transformation since the onset of the crisis has been significant. The rough outlines emerging does suggest a more robust, albeit sometimes overlapping, system of governance. Yet, much work

remains to be done, especially in relation to what constitutes “systemic risk” and how to prevent and, in the worst case scenario, address it.

European monetary integration is a historic experiment in the pooling of monetary sovereignty pooling that, if it would be successful, will increase its role model appeal around the world. While the Euro is perceived by financial elites “as a tool to increase intraregional and international trade, secure price stability, promote fiscal discipline, provide protection against the instabilities of the dollar and integrate further the continent”, the real possibility of an EMU break-up has informed us that the Euro should be understood as “a harbinger which can show the way forward but also the limitations of the journey” (Otero 2013: 23).

Mercosul integration has, although perhaps envisaged more as a process of constructing a single free-trade market on European blueprints, on the other hand provided an often highly politicised forum for Mercosul integration. While this may to some appear a negative outcome, the picture is more complex and in some sense more positive than that. Indeed, the crisis has demonstrated that Mercosul has benefitted from the flexibility and legitimation inherent in a politicised, indeed democratic, process. Financial integration should continue to benefit from such democratic principles, transparency and public engagement.

The report now continues to its overall conclusion, in which some tentative recommendations for Mercosul financial integration will be presented.

6) Conclusion

- 6.1 Summary of Findings
- 6.2 Ten Measures and Policy Recommendations

6.1 Summary of Findings

This report has identified 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. 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 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.

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 (SWG4) 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-presidential” (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 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, SWG4 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, SWG4 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 national 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 SWG4 as policy orientation and policy language platforms diverge.

This Executive Summary 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, Buitter (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,

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- 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.

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