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

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Acknowledgements, Disclaimers and concessions

- Thanks!
- The argument and recommendations of this report are not necessarily representative of BCB or SGT4.
- And, it certainly isn't representative of the ECB or the European Commission...
- Europeanist
- Learning about the Mercosul
- You are experts on Mercosul, so I will assume more knowledge of Mercosul than European Union

Outline

- Core Argument
- Questions Arising
- Report Overview
- Analytical framework
- Historical Background
- Current Situation in European financial integration
- Current Situation in Mercosul financial integration
- Current Problems in Europe: the High Wire Act of Sustaining the Euro
- Recent Developments in financial integration: European (partial) politicisation and Political Limits in Mercosul
- Lessons learnt: 10 Policy Recommendations

Core Argument

- Overarching Question: What can Mercosul learn from the experience(s) of financial integration in Europe?
- European Union and Mercosul have long histories and pre-histories
- In both regions, financial integration have shorter histories
- Yet, financial integration has been positioned at the core of the larger projects of integration (FSAP and LSAP)
- Both aimed at the creation of regional financial markets through liberalisation
- However, crudely measured, similarities end there

Core Argument

- Europe approached financial integration enthusiastically and confidently emphasising ‘market-making’ over ‘market control’.
- Burnt by the debt crisis and a series of finance-related crises in the 1980s and 1990s, and constrained by retained national autonomy, Mercosul was more cautious.
- While each region was hit by crises around the Millennium (Brazil-98, Argentina-2001/2 and tech-stock bubble in parts of Europe), only Mercosul seems to have learnt their lessons:

1. Financial markets serve important purposes in the capitalist economy, but they are inherently unstable.
2. They require careful regulation and supervision.
3. Because of their instability, crises will happen despite careful regulation and supervision. The (countercyclical) policy tools have to be in the toolkit to deal with them so that their impact on the real economy is limited.

Core Argument

- In a proper electrical system, there are circuit-breakers and back-up systems.
- Mercosul had/has those. Europe did not/are trying to construct them.
- Financial liberalisation in Europe was ‘private-led’. In Mercosul, it was ‘public-led’. Private-led liberalisation leads to lax regulation/supervision.
- ‘Outsourcing’ regulation to private bodies (e.g. Credit rating agencies) is oxymoronic. Market self-regulation is a bad idea.
- Still, this was not just as a result of purposeful by design, but also as ‘unintended outcome’ of broader integration process.
- Europe had undertaken monetary integration (EMU). Mercosul had not. Europe saw it as a great facilitator of integration. Enviously looking at the EU, Mercosul was keen (esp. Brazil), hesitated and could not agree on its design.
- As intended, the Eurosystem served as a transmission belt for monetary policy.
- It also, through financial integration (esp. wholesale banking sector), became, albeit clearly not the expected outcome, the transmission belt for build-up of imbalances in the system between core and periphery (artificial interest rates).
- ‘Free-riding’ should have been impossible thanks to macroeconomic convergence norms and rules (GSP). These proved inadequate. Even Germany and France broke them. Moral hazard was institutionalised!

Core Argument

- Now, Europe is in a vicious cycle of recurring crises, as there are not enough circuit-breakers:
- No regional recapitalisation funds
- No fiscal integration to secure welfare systems
- No political integration
- ECB-imposed taboo around countercyclical growth policies (e.g. Europe2020)(inflation and potential credit crisis)
- Policy-makers, regulators and supervisors play catch-up with the financial markets they have been involved in integrating.
- “Bailouts, bailins and bailiffs”: It is a tragic story of Europeans paying for ‘bail-outs’ and now also ‘bail-ins’ as well as having to endure austerity policies to satisfy illegitimate bailiffs (Troika).
- A political high-wire act performed without sufficient legitimacy, but the consequences (break-up) are too severe to ponder.
- Mercosul, despite its successes in containing crisis, faces challenges in financial integration with diverging policy preferences and structural obstacles (Brazil-Argentina, Paraguay and Venezuela).

Questions Arising

- Mercosul, with a degree of gleefulness, looks on and learns lessons from the European experience.
- Yet, are of course also affected by it through reduced demand, tendential overheating and speculative flows of hot money.
- Will Europe successfully carry out the high wire act?
- What are the different scenarios imaginable in a break-up? Smaller Eurozone of core economies and economic disaster in the peripheral ones?
- How can Mercosul financial integration move further given its current stalemate?
- How much further does Mercosul want to go in liberalising and integrating, however cautiously, regional financial markets?
- What would be required for a single Mercosul financial market without a common currency to function with minimal systemic risk?
- Through 10 policy-recommendations, this report points to possible solutions to assure minimal systemic risk and that financial markets serve the public interest of Mercosul.

Report Overview

1. Introduction
2. Methodology
3. Period 1: Early Financial Integration
4. Period 2: Accelerating Financial Market Integration
5. Period 3: Crisis Response: Supervising Financial Markets
6. Conclusion and Policy Recommendations

Methodology

- Real methodological challenges arising from the study:

1. Radically different contexts of financial integration
2. While parallels are in place, different integration processes (EU neoliberalisation and Mercosul cautious liberalisation)
3. Processes are path-dependent and complex
4. Quantitative comparative analysis is therefore problematic
5. Language and unavailability of Mercosul documentation in English
6. Field interviews in Europe, document analysis and BCB Telephone conferences.

Analytical Framework

- Direction, purpose and content of policy and regulation ('technical')
- Heterodox International Political Economy approach enabling consideration of the interaction of regional processes with global and local contexts
- States are essential for the construction and sustaining of markets. But, states are neither simple transmission belts of dominant social forces nor a black box of perfect cohesiveness. It is relatively autonomous, pervaded by historical social relations.
- Policy-making and Regulation/Supervision can be located on continuum from public-led to private-led
- Processual Complentarity: Financial integration is (in)compatible with other integration processes and overall regional growth strategy
- Concepts used to understand broader growth strategies: (neo-)liberalisation, Keynesianism and Developmentalism
- Regulation is a complex term. It is (increasingly) hard to distinguish from supervision. What is its relationship to e.g. liberalisation? De-regulation? All regulatory processes are related to what was before and always involve the state, therefore re-regulation.

Analytical framework

- Negative and positive integration
- Against the historical background of focus on microprudential risk analysis, the framework emphasises macroprudential such. “Financial fragility” and “amplification risk” (Hyman Minsky) are key in a financial system.
- Internal (regional/local) and external (insertion into global political economy and international negotiations) dimensions of integration
- Path-dependent and path-breaking policy

Periodisation of financial integration

1. Pre-1998 Financial Integration

- The European Coal and Steel Community and European Economic Community
- The Latin American Free Trade Area
- The European Monetary System and the European Exchange Rate Mechanism
- The Latin American Integration Association
- The Single European Act
- The Treaty of Asuncion (Mercosul), the Montevideo Protocol and fixed exchange rate systems (Convertibility and Real Plans)
- Maastricht and the European Economic and Monetary Union
- Crises and Booms

Periodisation of Financial integration

2. 2000-2007/8 – Accelerating Financial Market Integration

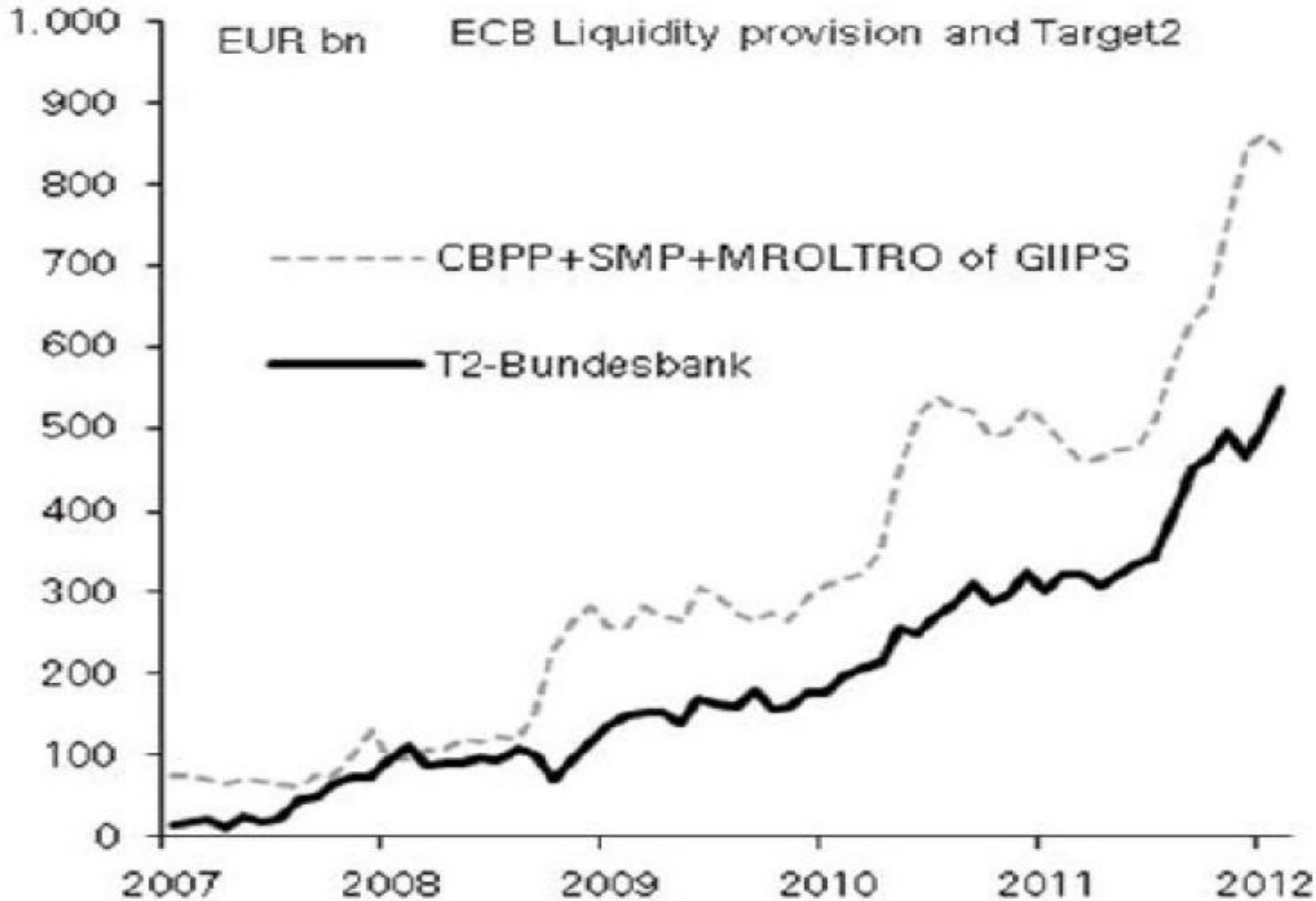
- The Lisbon Strategy
- Giovannini Barriers
- Financial Services Action Plan
- The Lamfalussy Process
- Basel II and the Capital Requirements Directive(s)
- Mercosul developments (Social Democratic Shift, cautious liberalisation acknowledgement of asymmetric benefits of Mercosul - FOCEM)

Periodisation of financial integration

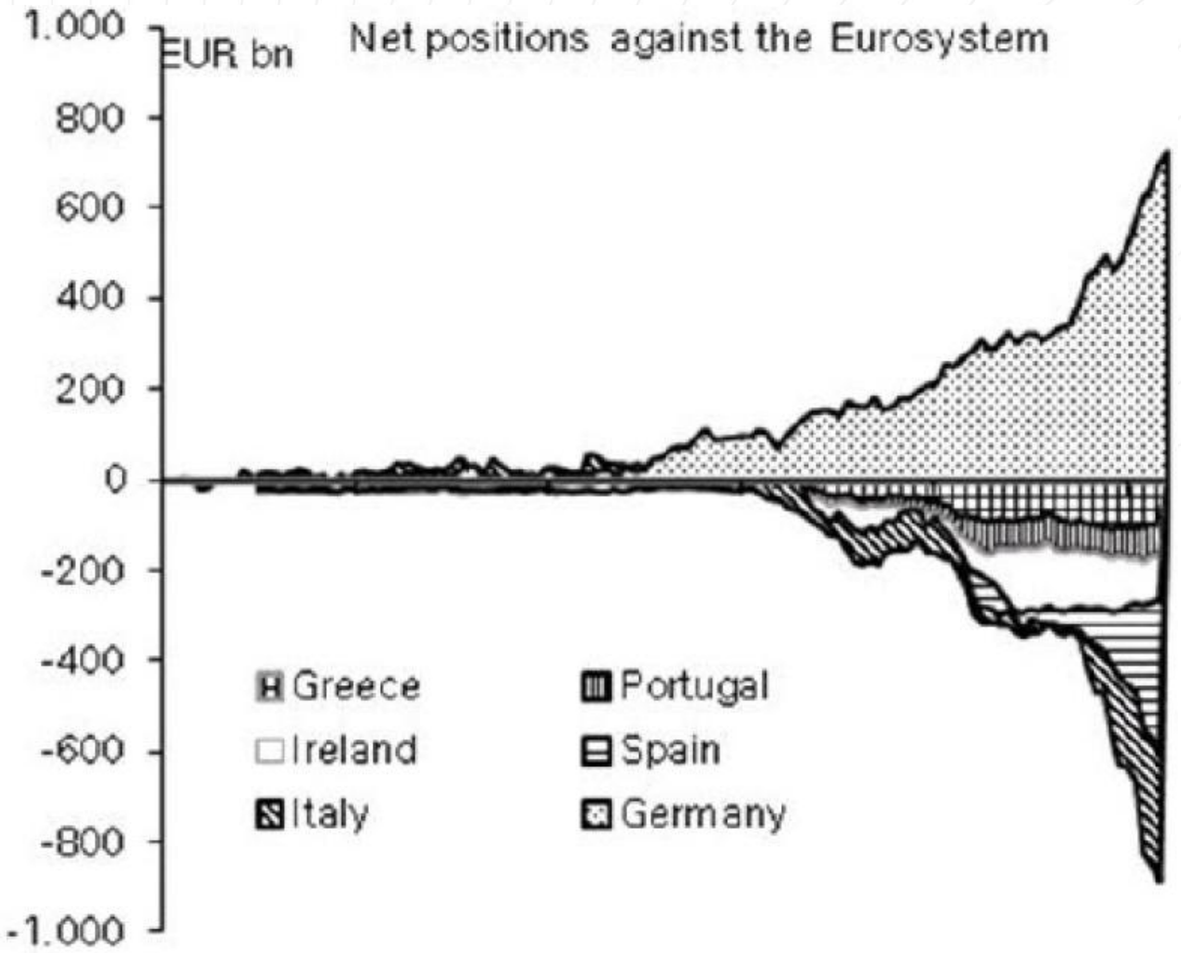
3. 2008- Crisis Response: Supervising Financial Markets

- G20, Bailout and Eurocrisis
- TARGET II (payment system)(special focus)
- TARGETIISECURITIES
- Economic Policy Governance and the European Stability Mechanism
- European Systemic Risk Board (special focus)
- European Banking Authority and the European Banking Union
- European Securities and Markets Authority
- European Insurance and Occupational Authority
- Mercosul developments (remit for ‘technical’ work achieved, bur further integration faces limits in terms of political will)

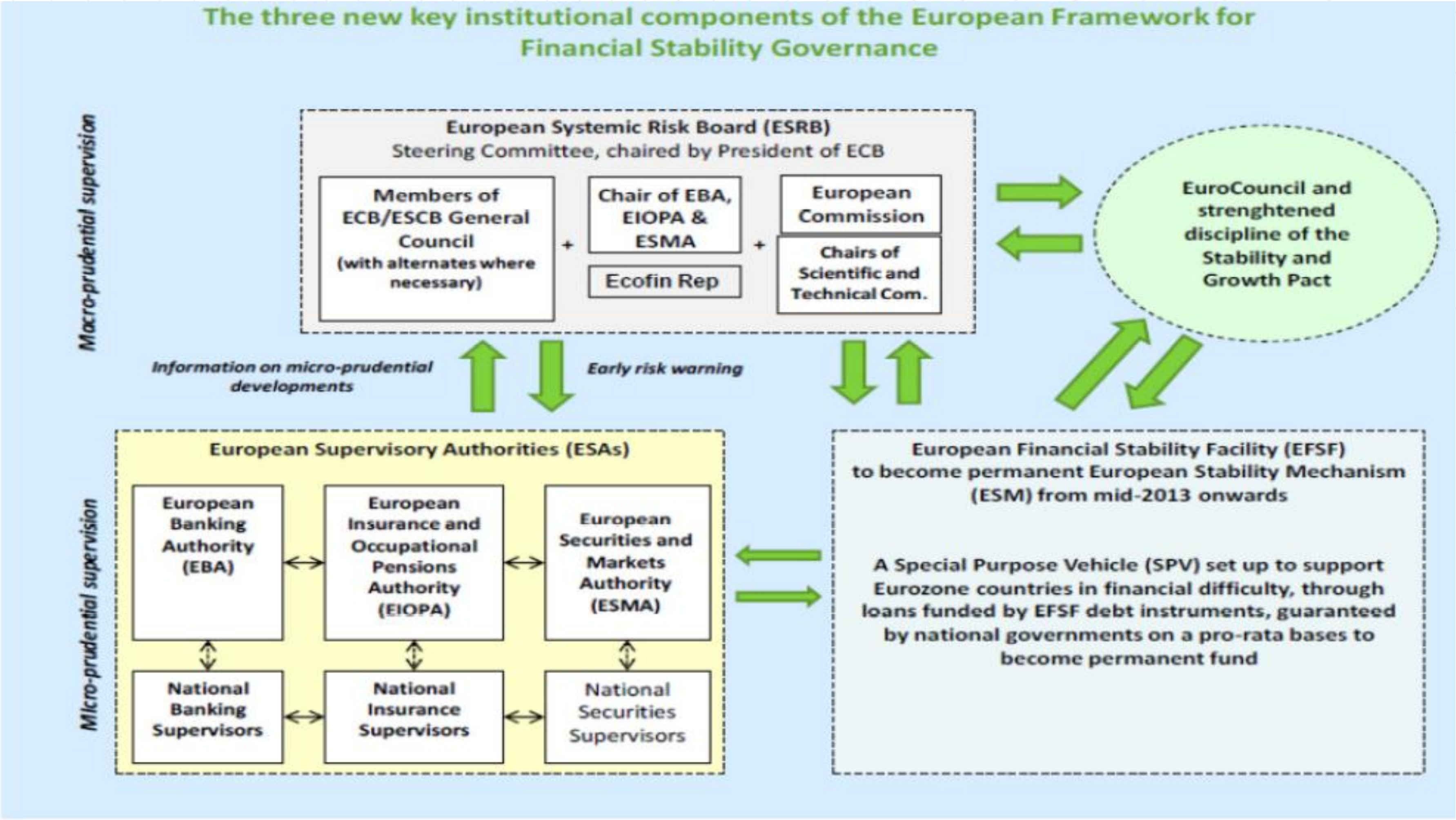
ECB Liquidity Provision and Target2



Target2 Imbalances post-crisis



The New Financial Stability Governance System



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

Towards Macroprudential Risk Analysis in Europe

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

Current Situation in European financial integration

- The wholesale interbank market is quite integrated in that the infrastructure is there,
  but national barriers remain.
- Money markets are non-existing
- Retail market integration is limited
- 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.
- 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.
- Bonds and listed derivatives markets are less integrated than equity markets.
- There has been an opening up of pan-European equity trading, but trading has not meaningfully expanded because there is a lack of harmonisation.

On the European Financial Integration Horizon

- Completion of technical implementation of FSAP
- Deepened operationalisation of new financial governance infrastructure
- Banking Union
- Target2Securities
- Implementation of Pay Structure Directive
- In related macroeconomic convergence policy area, deepened operationalisation of European Semester, Fiscal integration
- Macroprudential analysis and systemic crisis fighting (Greece, Spain, Italy, Portugal, Cyprus,...France)

Current Situation in Mercosul financial integration

- Intergovernmental circuit-breakers
- Willingness to adopt Keynesian-style countercyclical expansionary policy to deal with inevitable crises
- Lack of monetary integration, but payment system (SML) between Argentina and Brazil (Uruguay negotiations)
- Strong internal market, partly facilitated by a significant credit expansion...
- 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, limited degree of integration in the region and the historical flexibility towards suspensions of integration agreements is also a cause of tension.

1. Argentina’s recent reversion to a more protectionist stance in policy-making, but also Brazil’s.
2. Financial integration policy must remain focused on the regulation and supervision of systemic risk despite pressures to deviate from this path.
3. Paraguay suspension and Venezuelan accession are considerable challenges

Mercosul financial integration – On the short-term horizon

- Analysis of Mercosul asymmetries on Financial Services concerning National Treatment (NT) and the Market Access (MA).
- Analysis of obstacles to the progress of effective Financial integration, identification of possible alternatives and resolutions to the identified problems
- Developing a Technical Cooperation plan in order to foster the financial integration process
- Constructing a template that addresses the financial regulators' requirements to be used in all financial integration processes or financial services negotiations involving Mercosul
- Writing of a full report on 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).

Conclusion: 10 Policy Recommendations

- Policy recommendations political and usually stay clear
- Even when appearing to be ‘technical’, they always have consequences benefiting some at the expense of others. (Pareto optimality is rare.)

- For Mercosul as a whole
- For individual member states as ‘best practice’
- Typically left imprecise

1. Counter Pro-cyclicality in the Financial System by Strengthening Macroprudential Analysis ("Amplification Risk")

2. Create Lobby Groups to Represent the Public Interest in Financial Integration

(Purpose of integration: longterm (non-HFT), sustainable growth, profitability/public interest, anti-transfer of credit risk, credit access)

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

4. Create Mercosul Supervisory Colleges for Cross-border Financial Institutions

5. Create a Regional Recapitalisation Fund for Cross-border Financial Institutions

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

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

8. (Continue to) Develop Payment Systems in Local Currency (SML), but be careful with the consequences of monetary integration (OCA) for financial integration and beyond

9. Brazil Has to Be a Benevolent (FOCEM+) and Financially Responsible Hegemon (credit expansion)

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