Latin American financial integration: lessons from the experience of Europe

Charles Enoch
St Antony's College, Oxford
Brasilia
November 8, 2017

Latin America and Europe: Similarities and differences

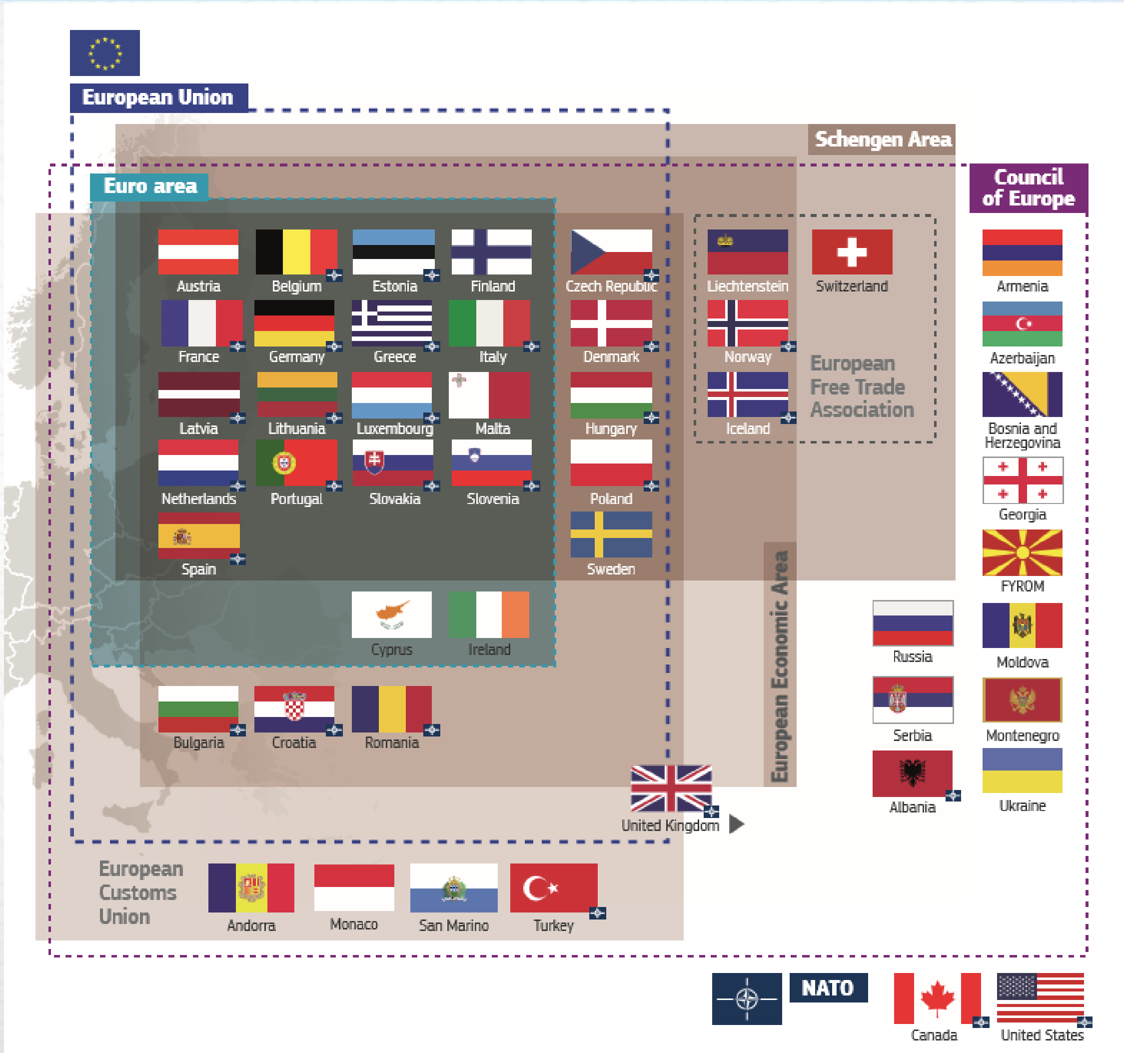
Differences:

- Europe at outset of European integration project in the 1950s was more integrated than Latin America today
- Europe core are developed countries; Latin America emerging markets
- Europe maybe aiming further than Latin America: “ever closer union”

Similarities:

- Financial integration an important element in overall economic integration
- Financial integration has substantial economic benefits, but also risks
- Progressive: started small, but developed over time
- Some of the countries more ambitious than others

European countries and institutions



Source: European Commission

Integration multidimensional:

- Several strands to integration: countries cluster differently in different areas
- "Core" countries and "periphery", in Latin America with full members and associates in regional groupings
- 28 countries in EU, but only 19 in single currency and 17 in single currency and Schengen
- Nevertheless, close coordination where relevant between the "ins" and the "outs"
- Also, single core, deriving originally from Messina discussions and Treaty of Rome in 1956; has superseded other regional grouping such as EFTA. Contrast with Latin American simultaneous groupings of Mercosur and Pacific Alliance

Politics will intrude

- Economic considerations may be paramount for entry into a grouping, but politics(and geography) will have a role:
- Outcome as to entry will be a compromise: not necessarily economically optimal: this ok if not taken too far: do not need to be in “optimal area”
- However, serious danger in ignoring the economics
- Entry of unprepared countries into the EU
- Entry of countries prematurely into monetary union ---Greece
- But important to have a political narrative: “the European project”
- Progress in many cases born out of political or financial crisis

Entry criteria important…...

- Maximum leverage on aspiring members in Europe (or into the monetary union) is while they are trying to get in

- …….but post-entry conditions would also be important

- Hard to enforce criteria when one is in the club, and impact of exclusion/suspension from club may be excessive

- Independence of central banks enshrined in law as precondition

- And important that criteria make sense in aggregate and over cycle (e.g. Europe's 3% fiscal deficit ceiling generates deflationary bias)

Single market in financial/economic integration (1)

- Single market a key element of financial integration: provides an aspirational target even if not immediate: “four freedoms” of the EU: free movement goods, services, capital and labor.
- On financial side needs elimination of restrictions, e.g. exchange controls, national limitations on cross-border establishment.
- Needs harmonization, e.g. of accounting practices.
- Target is “single rule book” specific to the various parts of the financial sector and covering the entire union
- Rule book derives from international best practice (e.g. Basel Committee, FSB key attributes) and adapted for local conditions

Single market in financial/economic integration (2)

- Shifting balance between national and central authorities: likely to be tension.
- Need for mutual recognition of regulatory and supervisory standards and practices across national authorities; important that all maintain equivalent practices to avoid regulatory and "race to the bottom".
- Need to fill supervisory gaps, e.g. consolidated supervision.
- Avoid "national champions"—for market competition and financial stability reasons.
- Weaknesses in EU supervision led to move for banking union.
- Single supervisory mechanism (SSM) located at ECB, in order to avoid need for Treaty change: second best, "timber-framed union".
- Need consistency between what is union wide and what remains national: still aspirational in EU e.g. lender of last resort, bank resolution remain national.

Hegemon or partnership (Europe)?

- European Union designed as partnership, although not necessarily a partnership of equals
  - checks and balances: unanimity required for many decisions
  - tripartite requirement for decisions: Council, Commission, Parliament

- But Monetary Union (single currency) centered around the German model
  - aimed to inherit the credibility of the Bundesbank, so ECB (lower interest rates, easier access to borrowing)
  - German insistence, in exchange for “giving up the Deutschemark”
  - successful, insofar as it has survived, and has become major world influence
  - but “over-achieved” for some weaker members
  - question why mandatory for (new) EU member states
  - exaggerated expectations on extent of mutual support

Hegemon or partnership (Latin America)

- Brazil has a much larger share of Latin American GDP than any European country has in Europe: reflected for instance in relative size of Latin American stock exchanges
- Elimination of barriers might lead markets to foster hegemonic structure, e.g. the Brazilian real to become the common currency
- Some important attractions, including familiarity and established institutions; but might be politically dangerous, may reduce incentives for other countries to integrate, could leave integrationists vulnerable to opposition
- Also, would then lose opportunity to take best practices from others, whether in Latin America, or from elsewhere, or de novo.

Importance of institutions (1)

- Brussels Commission custodians of the European project
  - enables continuity, strategic design, and overall consistency
  - notionally independent of member states
  - holds power to draft Directives that have to be implemented nationally

- Critique that it may be out of touch; democratic deficit

- Essential that the best staff are recruited, so that professional integrity is maintained; staff to work for the union, not their nationality

Importance of institutions (2)

- Growth of specialist institutions as integration proceeds. Specialist pan-EU agencies tasked to take work forward: increased role for regulators after financial crisis (Larosiere reports). Strategic oversight by Brussels commission.

- Location of headquarters important. Europe started by distributing across cities in small countries—Brussels, Luxembourg (c.f. Montevideo for Mercosur). Distribution of financial regulators now across larger countries (London for banking, Paris for securities, Frankfurt for insurance).

Interface with rest of world important

- London the major financial centre in the EU—despite the UK not being in the Euro, and so far despite efforts by some Euro countries to attract the business.
- Dominant centre for offshore dollar activity, as well as for Euro financial activity.
- Prospect for loss of role if UK leaves the EU {"Brexit"), although legacy strengths likely to leave still a residual role.
- London working to be major player for renmimbi and Islamic financial business; would doubtless seek role also with regard to an integrated Latin financial market.

Importance of the "plumbing"

- Much work undertaken in the EU, for instance on the payments and settlements systems, TARGET, on definitions of eligible collateral.
- National institutional practices likely to vary at outset; not straight forward to harmonize; also incurs real financial costs. National authorities may be fiercely protective of their own structures.
- Plumbing may also be the location of overlooked systemic risks.
- Lack of take-off of MILA may be attributed to limited progress in integrating back-off functions.

Competition authority

- DGCOMP at forefront of safeguarding competition; integral part of single market.
- Key element of this is ensuring particular firms do not benefit from state aid; requires rules of behavior for state-owned institutions.
- DGCOMP key EU player in “troika” negotiations with countries under program, and in case of state-sponsored bail-outs.
- Critique that it is not sufficiently financial-sector focused: concerns at times over relative priority given to competition factors and financial stability
- As integration proceeds, such regional authority becomes increasingly central

Safety net

- Global financial crisis showed deficiencies in European safety net. Progress achieved, although still work in progress:

- Bank resolution and recovery directive (BRRD) ---although not yet properly tested;

- European stability mechanism (ESM)—although fractious creation, limited usage, and no consensus as to its future;

- Deposit insurance—proposals challenged, and introduction uncertain.

Macroprudential policies

- Macroprudential policies only developed over last 20 years.
- Limited entrenchment of national authorities, so scope for significant role at regional level; also argument that many macroprudential issues can be most appropriately handled at regional level.
- European Systemic Risk Board (ESRB) brings together regulators from banking, insurance, securities—EEA countries included as observers. Functions for cross-sectoral as well as cross-country coordination.
- Innovative approaches; “soft power”; brings opportunities and challenges, but has an important role. May be critical for averting and mitigating financial risks.

Conclusions and lessons (1)

- Europe has proceeded a long way down the road of financial integration.
- Much progress, including in recognition of past deficiencies
- One EU strength is that it is always (in principle) seeking convergence on best practices, taking these from international standards. This means also it is outward looking, maximizing leverage for external negotiations and on international bodies
- Harmonization of accounting, regulation and supervision is key.
- In the Latin American context there would be benefits in Mercosur and Pacific Alliance working together, so that one does not need to harmonize the harmonizers at a later date

Conclusions and lessons (2)

- Financial integration provides clear opportunities , but also challenges.

- Need to accompany financial opening with gap-free supervisory practices (e.g. on consolidated supervision), and cross-border understandings on resolution and safety nets. An overall balanced, consistent, and time-specific plan for steps towards a single market could draw in the benefits, while mitigating the risks.

- Political support is important, both institutionally (checks and balances, transparency, deferral to national preferences) as well as popular: the attractions of the “project” should be widely understood and endorsed.

Thank you