Neighborly Business: Regional Financial Integration in Latin America

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The idea of a regional financial market in Latin America is not new. Several initiatives were launched in the past with this objective. However, after the repeated crises in Latin America in the 1980s and 1990s, many countries in the region opened their financial systems to the outside world, particularly the United States and Europe, to attract capital, gain expertise, and cushion themselves against regional shocks. At the same time, they sought to protect themselves against external spillovers: foreign banks had to enter as self-standing subsidiaries; currency controls limited domestic residents' holdings of foreign currencies; and investment regulations severely restricted the external exposure of pension funds and insurance companies.

This strategy worked well for much of the last 15 years and Latin America recovered rapidly, fueled by the commodity super-cycle and growing demand from China, with prudent domestic economic management adding potency to the mix. Indeed, even the global financial crisis did little damage to this previously crisis-prone region.

But global banks, weakened by the global crisis and facing tighter rules, have been downsizing in Latin America and other emerging markets, while pension funds and insurance companies in Latin America have outgrown the domestic markets in which they have been largely confined. It is clear that Latin American countries will need to consider a change in strategy to further develop their financial markets.

A new IMF study of seven Latin American countries—Brazil, Chile, Colombia, Mexico, Panama, Peru, and Uruguay—suggests that the time is right to reconsider a regional strategy.

What has changed?

The end of the commodity super-cycle and economic rebalancing in China has seen growth slow dramatically in most of Latin America, exposing the need to identify new, alternative avenues for growth. These would require fresh capital and deep financial markets.

Latin America has also been particularly affected by the fragmentation of the international banking system in the wake of the global financial crisis. European and U.S. banks have dramatically cut their involvement in the region, either withdrawing completely or downsizing (see table). There are various factors behind this trend—including the regulatory pressure of the post-crisis reforms that have impacted the risk-return payoffs of certain business lines, and the stronger enforcement of tax, sanctions, and anti-money laundering violations. No major European or U.S. bank has entered Latin America to replace the banks that have left, leading to increasing consolidation of domestic banking systems in many countries.

Meanwhile, pension funds and insurance companies in the region have grown rapidly in recent years. In a number of cases they have outgrown their markets, with limited options to place their funds outside of domestic government bonds, as regulations constrain cross-border investments.

In short, Latin American countries need to further develop and deepen their financial markets, *not* see them shrink.

Global banks are reducing their presence in the region

(divestitures in Latin America by global banks, 2009-2015)

Global Bank / Sold operation in:	BRA	CHL	COL	MEX	PAN	PER	URY	OTH
Banco Santander (ESP)		2009	2012					2009
BNP Paribas (FRA)					2009			
Citigroup (USA)	2013				2015	2015	2013	2009
Commerzbank AG (DEU)	2009-10							
Credit Agricole (FRA)	2009-10							
HSBC Holding PLC (GBR)		2011		2011	2013			2012
Lloyds Banking Group (GBR)							2012	2010
Royal Bank of Scotland (GBR)		2010	2010					2011
Standard Bank Group (ZAF)	2015							

Source: Bloomberg, LLP.

Regional benefits

Our study argues that Latin America would profit from greater financial integration *within* the region. The study highlights various benefits of increasing regional financial integration, including:

- Diversification of market risks, both extra-regional and domestic;
- Enhancing competition in markets where the exit of global banks has increased banking concentration;
- Economies of scale, in stock exchanges for example, to reduce operational costs, and to provide a larger funding base, given the relatively small size of domestic capital markets in most Latin American countries; and
- Higher financial standards, through the assimilation of regulatory and operational best practices from regional leaders, as well as technical know-how.

Reducing risks
The study flags that regional integration would not be risk-free. As in all integration efforts, regulatory and supervisory enhancements would be critical to fully realize the benefits; particularly, close coordination between supervisors, and a heightened focus on consolidated cross-border supervision of financial institutions and conglomerates.

Current initiatives

There are important initiatives currently underway to promote regional financial integration in Latin America, which have gained considerable political traction. The Pacific Alliance countries (Chile, Colombia, Mexico, and Peru) have launched the Latin American Integrated Market, with the ultimate goal of unifying their securities markets. Furthermore, the timing is ideal for a revival of the longstanding Mercosur alliance (comprising Brazil, Argentina, Uruguay, Paraguay and Venezuela), which was also established with the ultimate objective of a common market among members, particularly given recent developments in Argentina.

The way forward

Finally, our study specifies a number of measures that could help move the regional integration process in Latin America forward. Key among these are a harmonization of accounting and regulatory practices across the countries, and coordinated and consolidated supervision, which could ultimately facilitate a "passporting" of financial institutions across the region.

The necessary ingredients for the successful pursuit of regional financial integration in Latin America are in the bag, and the iron is hot. The benefits are clear and political support is ample.

All that remains to do now is take action.

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